ISSUE SPOTTING FOR CHURCHES & OTHER RELIGIOUS ORGANIZATIONS

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Harrison M. Smith is the founding principal of hms.law, where he partners with churches, nonprofit organizations, and purpose-driven businesses that dare to positively change the world and impact lives. Guided by a commitment to empower exceptional people to use their talents to make an extraordinary impact, Harrison provides practical, strategic counsel that helps mission-driven organizations thrive while faithfully pursuing their calling.

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Harrison and his wife will soon celebrate ten years of marriage. Together, they are the proud parents of three wonderful (and energetic) children and cherish the memory of the son they lost. As a family, they love sports and the outdoors and are deeply invested in serving their local church and community. Harrison has served on the boards of ministries and nonprofits committed to taking steps of faith to serve others in their communities.

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I. WISDOM BEFORE ANSWERS: AN ISSUE-SPOTTING FRAMEWORK FOR RELIGIOUS ORGANIZATIONS

Churches[1] and other religious organizations occupy a unique place in American law. They are simultaneously faith communities, nonprofit corporations, employers, property owners, charitable organizations, and, frequently, tax-exempt and, in some circumstances, tax-paying entities. As a result, they operate at the intersection of constitutional protections, statutory requirements, regulatory obligations, and governance principles that often do not apply—or do not apply in the same manner—to other organizations.

Adding to the complexity, religious organizations frequently function according to theological convictions, ecclesiastical structures, and ministry objectives that do not neatly fit within traditional legal frameworks. Terms that appear familiar may carry different meanings depending on the context in which they arise. A "minister," for example, may be treated one way for federal income tax purposes, another way for employment-law purposes, and yet another way for church-governance purposes. Likewise, an organization may qualify as a religious organization without qualifying as a church, while a church may enjoy legal protections and regulatory exemptions unavailable to other religious entities.

This paper does not attempt to provide an exhaustive treatment of every legal issue affecting churches and religious organizations. Entire treatises have been written on many of the subjects discussed herein. Instead, this paper is intended to serve as an issue-spotting guide for practitioners who advise churches, ministries, and other faith-based organizations. The focus is on identifying recurring legal questions, common pitfalls, and practical considerations that frequently arise in the governance and operation of religious organizations.

Throughout this paper, a recurring theme emerges: the legal analysis often turns less on finding the right answer than on asking the right question. Whether evaluating tax exemption, political activity, employment relationships, volunteer programs, property-tax issues, governance disputes, or professional-responsibility concerns, practitioners frequently encounter threshold questions that determine the outcome of the analysis long before the substantive issue is reached. In many instances, the greatest risk is not misunderstanding the law; it is failing to recognize that a particular issue exists in the first place.

Accordingly, the discussion that follows is designed to help counsel identify those issues before they become problems. Effective representation of churches and other religious organizations often begins with a simple exercise: slowing down, asking the right questions, and carefully determining what, exactly, we are dealing with in the first place.

That inquiry frequently proves more important than the answer itself. Before analyzing taxes, governance, employment, political activity, property, or professional responsibility, counsel must first understand the nature of the organization involved and the legal framework that applies to it. From there, the path forward usually becomes much clearer.

II. TESTING THE SPIRITS: WHAT ARE WE DEALING WITH HERE?

A. What is a "*church*"?

Few questions in representing religious organizations are more consequential than whether an entity qualifies as a "church." Under federal tax law, churches receive unique treatment unavailable to many other religious organizations, including exemption from the requirement to apply for recognition of tax-exempt status and exemption from the annual Form 990 filing requirements. Churches also receive certain procedural protections in connection with Internal Revenue Service ("IRS") examinations. Consequently, whether an organization is a church is often a threshold issue with significant governance, tax, compliance, and operational implications.

Despite the significance of the term, neither the Internal Revenue Code nor the Treasury Regulations specifically define "church." In fact, the Treasury Regulations state, somewhat circularly, that an organization is a "church or a convention or association of churches" if it is a church or a convention or association of churches. *See* 26 C.F.R. § 1.170A-9(b). The IRS likewise acknowledges that the term appears throughout the Internal Revenue Code but is not expressly defined by federal tax law.

The absence of a statutory definition does not mean that an organization may simply declare itself a church and receive the legal benefits associated with church status. Rather, courts and the IRS have developed a fact-intensive, totality-of-the-circumstances analysis to determine whether an organization qualifies as a church. Although courts generally recognize that churches are a subset of organizations organized and operated for religious purposes, not every religious organization is a church. Accordingly, the inquiry focuses on the organization's structure, governance, activities, and relationship to a congregation, with no single factor being dispositive and the absence of any particular

[1] The term "church," as used in this paper, includes synagogues, mosques, temples, and other places of worship and is not limited to any particular religious faith or denomination.

characteristic not necessarily proving fatal to church status.

Historically, the IRS has considered a number of factors in determining whether an organization qualifies as a church, including the following (in no particular order or significance):

1. A distinct legal existence;
2. A recognized creed and form of worship;
3. A definite and distinct ecclesiastical government;
4. A formal code of doctrine and discipline;
5. A distinct religious history;
6. Membership not associated with another church or denomination;
7. An organization of ordained ministers serving congregants;
8. Ordained ministers selected after prescribed courses of study;
9. Literature of its own;
10. Established places of worship;
11. Regular congregations;
12. Regular religious services;
13. Religious instruction for the young; and
14. Schools for the preparation of ministers.

Several of these concepts warrant additional explanation. A recognized creed generally consists of a statement of faith or summary of religious beliefs. A form of worship refers to the religious practices through which those beliefs are expressed. An ecclesiastical government includes the persons, offices, or institutions exercising religious authority over the organization. A formal code of doctrine and discipline typically encompasses the rules, practices, and standards governing matters such as membership, religious rites, leadership qualifications, weddings, funerals, baptisms, and similar activities. An established place of worship need not be owned by the organization and may consist of rented or donated facilities so long as regular worship services are conducted there. Likewise, a regular congregation generally consists of individuals who routinely gather and participate in the organization's religious services.

Although neither the IRS nor the courts treat any single factor as controlling, certain considerations have received particular emphasis, frequently focusing on the presence of an established congregation served by an organized ministry, regular worship services, a distinct body of believers, religious instruction, and an identifiable system of doctrine and discipline. These characteristics often distinguish a church from organizations that merely advance religious *purposes*, rather than religious *worship*, for example. *See, e.g.*, *Swearingen v. City of Texarkana*, 596 S.W.2d 157 (Tex. Civ. App. 1979), *writ refused n.r.e.* (Tex. 1980) (noting in the religious organization property tax exemption context that "there is a vast difference between property used for religious purposes and property used as an actual place of religious worship. The constitution does not permit the exemption of the former, but only the latter type of property.").

A related issue arises when a religious order or religious organization claims church status. Treasury regulations provide that a religious order or religious organization may itself be considered a church if it is both an integral part of a church and engaged in carrying out church functions. *See* 26 C.F.R. § 1.414(e)-1(e). Whether an entity is an integral part of a church depends upon factors such as its organizational, financial, legal, and ecclesiastical relationship with the church and the degree of church control exercised over it. *See* I.R.S. Priv. Ltr. Rul. 9521033 (May 26, 1995). Activities such as conducting religious worship and performing sacerdotal functions are indicators that the organization is carrying out the functions of a church. *See* 26 C.F.R. § 1.511-2(a)(3)(ii).

This issue is not merely academic. An organization may be organized and operated exclusively for religious purposes and qualify for exemption under Section 501(c)(3) of the Internal Revenue Code ("Section 501(c)(3)") while nevertheless failing to qualify as a church. That distinction carries significant consequences. Whether an organization qualifies as a church may determine eligibility for the automatic exemption provisions of Section 508(c)(1)(A), exemption from annual Form 990 filing requirements, the applicability of church-specific IRS examination procedures, and the treatment of affiliated ministries as integrated auxiliaries.

Accordingly, practitioners should consider several threshold questions:

1. Does the organization maintain a regular congregation?
2. Are religious worship services conducted on a regular basis?
3. Does the organization have recognized religious leadership?
4. Is congregational worship the organization's primary function, or is it primarily engaged in educational, charitable, missionary, media, or other ministry activities?
5. Is the organization seeking treatment as a church, or would it be more appropriately classified as a religious organization or an integrated auxiliary of a church?

The answers to these questions carry significant constitutional and statutory implications. Counsel should therefore avoid assuming that a faith-based organization is a church merely because it is religious in character or describes itself as one. Instead, counsel should carefully evaluate an organization's governance structure, worship practices, religious leadership, congregational life, and operational realities before concluding that church-specific benefits and protections apply.

Ultimately, an organization may be deeply religious without being a church. Because substantial legal consequences turn on that distinction, determining whether an organization qualifies as a church should often be among the first—and most important—questions counsel asks when advising a religious client.

Issue-Spotting Takeaway. Whether an organization qualifies as a church is often the threshold question from which many other legal issues flow. Churches enjoy certain benefits, filing exemptions, and procedural protections that may not be available to other religious organizations.

Accordingly, counsel should resist the temptation to assume that every faith-based organization is a church simply because it describes itself as one. The legal analysis focuses on how the organization is actually structured and operated, not merely how it identifies itself.

Put differently, before asking what benefits a church receives, practitioners should first ask: *Are we actually dealing with a church?*

B. Then what is a "*religious organization*"?

If not every religious organization is a church, what then constitutes a "religious organization?" The term is broader than the term "church" and encompasses a wide range of entities organized and operated exclusively for religious purposes but do not maintain a regular congregation or otherwise satisfy the characteristics commonly associated with a church. Examples include mission organizations, religious schools, publishing ministries, camps, discipleship ministries, media organizations, faith-based charities, and interdenominational ministries. Such organizations may qualify for exemption under Section 501(c)(3) while not qualifying as churches. *See* I.R.S. Pub. 1828, at 1.

Although these organizations may be religious in purpose and operation, federal tax law does not automatically or necessarily treat them as churches. The IRS expressly distinguishes churches from other religious organizations because special tax rules apply only to churches and certain related entities. Consequently, determining how a religious organization is classified under federal tax law is often an important threshold issue.

The distinction can carry important practical consequences. A ministry may be wholly religious in purpose and operation, yet still not qualify as a church. In those circumstances, the organization may be required to apply for recognition of exemption under Section 501(c)(3) and may be subject to annual federal information return filing requirements unless another exception applies. Churches and certain related entities, by contrast, receive more favorable treatment under the Internal Revenue Code.

Issue-Spotting Takeaway. Not every religious organization is a church, and that distinction can carry significant legal consequences. Ministries, schools, camps, mission organizations, media ministries, and faith-based charities may all be religious organizations while falling outside the legal definition of a church.

Accordingly, practitioners should avoid assuming that an organization's religious character automatically entitles it to church-specific benefits, exemptions, or protections.

Put differently, before asking whether the rules applicable to churches apply, counsel should first ask: *Are we dealing with a church—or simply a religious organization?* The legal consequences often depend on understanding the difference.

C. Wait, you mentioned "*integrated auxiliaries*"…[2]

Correct, the term "integrated auxiliary" has already surfaced in the discussion above. That is no accident. Integrated auxiliaries occupy something of a middle ground in federal tax law: they are generally not churches themselves, yet they may receive certain favorable treatment that federal law also affords to churches. Accordingly, understanding whether an organization qualifies as an integrated auxiliary can be just as important as determining whether it qualifies as a church.

But what, exactly, is an integrated auxiliary?

Stated simply, an integrated auxiliary is a ministry or religious organization that is sufficiently connected to and affiliated with a church or a convention or association of churches that federal tax law treats it similarly to the church itself for certain purposes. While the organization may have its own legal existence, governing board, employees, and ministry activities, it remains closely tied to the church in its doctrine, governance, operations, or financial support.

The significance of integrated auxiliary status is substantial. Under Section 508 of the Internal Revenue Code, churches, their integrated auxiliaries, and conventions or associations of churches are not required to apply for recognition as a tax-exempt organization under Section 501(c)(3). Similarly, these organizations generally are not required to file an annual federal tax disclosure, such as a Form 990. These types of organizations are exempt from the filing pursuant to Treasury Regulation § 1.6033-2(g)(1)(i), although may

[2] Much of this content was derived from the *What is an Integrated Auxiliary of a Church?* article published by Freeman Law, PLLC, authored by Cory Halliburton, and available at https://freemanlaw.com/what-is-an-integrated-auxiliary-of-a-church/.

be required to file Form 990-T to report unrelated business taxable income that the organization may generate.

So, the next question, of course, is how an organization qualifies for "integrated auxiliary" status.

To qualify as an integrated auxiliary, the organization must be:

(i) described both in sections 501(c)(3) (i.e., charitable, religious, educational) and 509(a)(1), (2), or (3) (i.e., not a private foundation);
(ii) affiliated with a church or a convention or association of churches; and
(iii) internally supported.

An organization is affiliated with a church if the organization is operated, supervised, or controlled by or in connection with a church or a convention or association of churches or relevant facts and circumstances show that the organization is so affiliated. An organization is internally supported, unless it both:

(i) Offers admissions, goods, services or facilities for sale, other than on an incidental basis, to the general public (except goods, services, or facilities sold at a nominal charge or for an insubstantial portion of the cost); and
(ii) Normally receives more than 50 percent of its support from a combination of governmental sources, public solicitation of contributions, and receipts from the sale of admissions, goods, performance of services, or furnishing of facilities in activities that are not unrelated trades or businesses.

See 26 C.F.R. § 1.6033-2(h)(4).

Some organizations need not meet the internally supported test. In this regard, men's and women's organizations, seminaries, mission societies, and youth groups that satisfy paragraphs (h)(1) (i) and (ii) of Section 1.6033-2 of the Treasury Regulations can qualify as integrated auxiliaries, regardless of whether such an organization meets the internal support requirement under paragraph (h)(1)(iii).

Paragraph (h)(1)(ii) requires that the organization be "affiliated" with a church or a convention or association of churches. An organization is "affiliated" with a church for these purposes if –

(i) The organization is covered by a group exemption letter issued to a church or a convention or association of churches;
(ii) The organization is operated, supervised, or controlled by or in connection with a church or a convention or association of churches; or
(iii) Relevant facts and circumstances show that it is so affiliated.

Below are the *Facts and Circumstances* enumerated in the Treasury Regulation. The absence of one or more of the factors does not necessarily preclude classification of an organization as being affiliated with a church or a convention or association of churches.

(i) The organization's corporate charter, bylaws, or similar governing documents affirm that the organization shares common religious doctrines, principles, disciplines, or practices with a church or a convention or association of churches;
(ii) A church or a convention or association of churches has the authority to appoint or remove, or to control the appointment or removal of, at least one of the organization's officers or directors;
(iii) The corporate name of the organization indicates an institutional relationship with a church or a convention or association of churches;
(iv) The organization reports at least annually on its financial and general operations to a church or a convention or association of churches;
(v) An institutional relationship between the organization and a church or a convention or association of churches is affirmed by the church, or convention or association of churches, or a designee thereof; and
(vi) In the event of dissolution, the organization's assets are required to be distributed to a church or a convention or association of churches, or to an affiliate thereof.

Integrated auxiliary status is a valuable organizational structure. No application for tax exemption is required to qualify as a tax-exempt organization under Section 501(c)(3), and the organization is not required to file a Form 990.

Due care should be taken in organizing an entity or "auxiliary" that is intended to be an integrated with a church, as defined in the Treasury Regulations. The governing documents and affiliation or ties to a church or an association of churches should be well structured and concrete so that there is no question the favorable tax status applies, thus preventing the significant consequences that can arise from failing to file a federal tax disclosure form when required.

Another important consideration is mission drift.

Sometimes an integrated auxiliary will, over time, forget that its governing documents are vitally important to its favorable tax status or that its affiliation with a church is critical to the favorable tax status. Those who direct or control an auxiliary may desire to amend governing documents to promote greater independence from the church or association of churches with whom the auxiliary is affiliated or may want to distance from the faith or tenets that, too, may have evolved over time. Those amendments could draw the organization out of the integrated auxiliary tax cocoon, so careful attention to and recollection of the integrated auxiliary status is key to ensuring the favorable tax treatment can withstand governance or mission-related changes that the organization may desire to employ.

Issue-Spotting Takeaway. Integrated auxiliaries occupy a unique position in federal tax law. Although they generally are not churches themselves, they may qualify for certain favorable treatment that federal law affords to churches.

Accordingly, whenever a ministry claims exemption from Form 1023 filing requirements, Form 990 filing requirements, or other church-related benefits, counsel should ask questions such as:

1. Is the organization affiliated with a church or association of churches?
2. Is that affiliation adequately documented?
3. Does the organization remain sufficiently integrated with the church?
4. Have governance changes, operational changes, or mission drift jeopardized that status?

Integrated auxiliary status depends not only on how an organization was formed, but also on whether it continues to maintain the relationship and characteristics that support that classification.

Put differently, before assuming church-specific benefits apply, practitioners should ask: *Are we dealing with a church, an integrated auxiliary, or simply a religious organization?*

III. RENDERING UNTO CAESAR: FEDERAL TAX EXEMPTION CONSIDERATIONS

A. Do we have to tell Ceasar? – IRS Filings

Now that we have identified whether we are dealing with a church, a religious organization, or perhaps an integrated auxiliary, the next question is often the most practical one: *what, if anything, must be filed with the IRS*?

For most charitable organizations, the answer is relatively straightforward. To obtain federal tax-exempt status under Section 501(c)(3), an organization generally applies to the IRS for recognition of exemption by filing Form 1023 (or, where eligible, Form 1023-EZ). Thereafter, the organization is generally required to file an annual information return, most commonly Form 990, Form 990-EZ, or Form 990-N, depending on its revenue and activities.

Churches, however, play by a different set of rules.

Under Section 508(c)(1)(A) of the Internal Revenue Code, churches, their integrated auxiliaries, and conventions or associations of churches generally are not required to apply to the IRS for recognition of exemption under Section 501(c)(3). In other words, if an organization truly qualifies as a church, an integrated auxiliary of a church, or a convention or association of churches, federal law generally treats the organization as tax-exempt whether or not it files a Form 1023. Likewise, churches, their integrated auxiliaries, and conventions or associations of churches generally are exempt from the annual Form 990 filing requirements that apply to most other tax-exempt organizations.

At this point, some religious organizations ask an understandable question: "*If we can avoid the paperwork, why would we ever file*?"

The answer is that the legal ability to forgo filing and the practical wisdom of doing so are not always the same thing.

Organizations seeking church status should carefully evaluate both the advantages and disadvantages of church classification before proceeding. While church status may reduce filing obligations and afford other benefits, obtaining and maintaining that status may require a thorough review of the organization's governing documents, operations, governance structure, and religious activities. An organization should be confident that its facts and circumstances support church treatment before relying upon the special rules applicable to churches.

Many churches voluntarily file Form 1023 and obtain an IRS determination letter even though they are not required to do so. A determination letter can provide comfort to donors, lenders, grant-makers, governmental agencies, and others who wish to verify the organization's tax-exempt status. In some circumstances, the certainty provided by an IRS determination letter may outweigh the burden of preparing and submitting the application. Likewise, organizations considering whether to claim church status should carefully evaluate not only the advantages of church classification, but also whether their governance, operations, doctrinal structure, and activities genuinely support that classification. Importantly, an organization that seeks a declaration of church status from the IRS must complete and file the Form 1023 (not the Form 1023-EZ) and, in the process, complete Schedule A – Churches that accompanies the Form 1023.

The Form 990 analysis presents a different consideration. Religious organizations that do not qualify as churches or integrated auxiliaries are frequently required to file annual information returns. Those filings serve a purpose beyond tax compliance. Form 990 is a publicly available document that may be reviewed by donors, grant-makers, state regulators, charity watchdog organizations, journalists, prospective board members, and even potential employees. As a result, the Form 990 often functions as both a disclosure document and a reflection of an organization's governance, stewardship, and mission-related activities. Organizations that view the filing solely as an annual tax obligation may overlook the importance of thoughtful and accurate reporting.

Churches generally enjoy the benefit of not having to make those annual public disclosures. Religious organizations that do not qualify for a church or integrated-auxiliary exception, however, should recognize that Form 990 obligations may apply even when religion is central to the organization's mission. Accordingly, counsel should not assume that an organization's religious character alone relieves it of federal filing obligations. A ministry that fails to properly evaluate its filing status may face penalties and, in some circumstances, automatic revocation of tax-exempt status.

Issue-Spotting Takeaway. Federal filing obligations are often determined by what the organization is, not by what the organization calls itself. Accordingly, practitioners should resist the temptation to begin with the forms. The better approach is to start with the threshold classification questions discussed above.

Before asking whether Form 1023, Form 990, or other federal filings are required, counsel should first determine whether the organization is:

1. a church;
2. an integrated auxiliary;
3. a convention or association of churches; or
4. another type of religious or charitable organization.

Only after answering those questions can counsel confidently answer the next one: *Do we have to tell Caesar?*

Put differently, the filing analysis begins with classification, not paperwork.

B. Staying in Ceasar's Good Graces – The Organizational and Operational Tests.[3]

We began by asking whether a church or religious organization must apply for recognition of exemption or file annual information returns. Equally important, however, is maintaining the tax-exempt status that makes those questions relevant in the first place.

Tax exemption is not a one-time accomplishment. An organization that qualifies for exemption today can jeopardize that status tomorrow if its governing documents or activities fail to satisfy the requirements of Section 501(c)(3). Accordingly, before discussing unrelated business income, excess benefit transactions, or other tax considerations, it is helpful to understand the foundational requirements of federal tax exemption.

To qualify for exemption under Section 501(c)(3), an organization must be both organized and operated exclusively for one or more exempt purposes. *See* 26 U.S.C. § 501(c)(3); 26 C.F.R. § 1.501(c)(3)-1(a)(1). Failure to satisfy either requirement (known as the organizational test and the operational test, respectively) may result in the loss of tax-exempt status, regardless of how worthy the organization's mission may be.

The organizational and operational tests work together, but they ask different questions. The organizational test examines whether the organization's governing documents properly limit the organization to exempt purposes. Stated simply, the IRS first looks at what the organization is authorized to do. The operational test then examines how the organization actually conducts itself in practice. In other words, the IRS next looks at what the organization actually does. An organization generally must satisfy both tests throughout its existence to maintain its tax-exempt status.

The organizational test is usually the easier of the two to satisfy because it focuses primarily on the organization's formation documents. The operational test, by contrast, is often where churches and religious organizations encounter difficulty because it requires an ongoing review of the organization's activities, programs, and use of resources.

The organizational test focuses on the organization's governing documents. To qualify for exemption under Section 501(c)(3), the organization's organizational documents must limit its purposes to one or more exempt purposes and may not authorize more than an insubstantial amount of nonexempt activity.

Section 1.501(c)(3)-(1) of the Treasury Regulations contains the organizational test:

> *Organizational test*—(1) *In general.* (i) An organization is organized exclusively for one or more exempt purposes only if its articles of organization (referred to in this section as its *articles*) as defined in subparagraph (2) of this paragraph: (A) Limit the purposes of such organization to one or more exempt purposes; and (B) Do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities

[3] Much of this content was derived from the three-part series published by Freeman Law, PLLC, authored by Cory Halliburton, and titled *Tax Exemption and Unrelated Business Income Rules (UBIT)*; available at https://freemanlaw.com/tax-exemption-and-unrelated-business-income-rules-ubit-substantially-related-part-3-of-3//

> which in themselves are not in furtherance of one or more exempt purposes.

26 C.F.R. § 1.501(c)(3)-1(b)(1) (emphasis added).

> An organization is organized exclusively for one or more exempt purposes only if its articles of organization: (A) Limit the purposes of such organization to one or more exempt purposes; and (B) Do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

Id. at § 1.501(c)(3)-1(b)(1)-(b)(1)(i)(B) (emphasis added).

> In no case shall an organization be considered to be organized exclusively for one or more exempt purposes, if, by the terms of its articles, the purposes for which such organization is created are broader than the purposes specified in section 501(c)(3).

Id. at § 1.501(c)(3)-1(b)(1)(iv) (emphasis added).

The term ”articles of organization” or ”articles” includes the corporate charter or any other written instrument “by which an organization is created.” *See id.* at § 1.501(c)(3)-1(b)(2). The articles of organization do not include, for example, an organization’s bylaws.

Satisfying the organizational test, however, is only half the battle. An organization may have perfectly drafted governing documents and still fail to qualify for exemption if its actual activities do not further exempt purposes. This is where the operational test comes into play.

Unlike the organizational test, which focuses on written organizational documents, the operational test focuses on behavior. The question is whether the organization is actually operated primarily in furtherance of one or more exempt purposes. The IRS and the courts look beyond mission statements and governing documents to evaluate the organization’s day-to-day activities, allocation of resources, and overall operational reality.

An organization will be regarded as operated exclusively for one or more exempt purposes only if the organization engages primarily in activities that accomplish one or more of the exempt purposes specified in section 501(c)(3). *See* 26 C.F.R. § 1.501(c)(3)-1(c). Under the Treasury Regulations:

> [a]n organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.

See 26 C.F.R. § 1.501(c)(3)-1(e).

The organizational and operational tests are often discussed during the formation of a tax-exempt organization. In practice, however, the greater risk is not improper formation but mission drift.

Churches and religious organizations rarely lose their exempt status because of defective organizational documents. More commonly, problems arise when an organization’s activities gradually evolve beyond the exempt purposes for which it was organized. New revenue streams are pursued. Commercial activities expand. Ministries become enterprises. Leadership changes. The organization’s religious, charitable, or educational functions may remain intact, but they no longer occupy center stage.

The operational test serves as a reminder that tax exemption depends not only on what an organization says it exists to do, but also on what it actually does. An organization may have impeccably drafted governing documents and a sincerely held religious mission, yet still encounter difficulty if a substantial portion of its activities serves nonexempt purposes.

As the Supreme Court famously observed in *Better Business Bureau v. United States*, and as courts have repeatedly reaffirmed, “the presence of a single nonexempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes.’” *American Ass’n of Christian Schools Voluntary Employees Beneficiary Ass’n Welfare Plan Trust v. United States,* 850 F.2d 1510, 1513 (11th Cir.1988) (quoting *Better Business Bureau v. United States,* 326 U.S. 279, 283, 66 S.Ct. 112, 114, 90 L.Ed. 67 (1945)). The issue is not whether the organization has exempt purposes; the issue is whether a substantial nonexempt purpose has emerged alongside them.

This principle is particularly important for churches and religious organizations because the threat is often not defective formation, but gradual mission drift. Organizations rarely lose exemption because their formation documents were improperly drafted. More commonly, issues arise when the organization's activities evolve in ways that become increasingly disconnected from its exempt purposes.

Issue-Spotting Takeaway. Maintaining tax exemption requires more than a properly drafted certificate of formation. An organization must continue to operate in a manner consistent with its exempt purposes.

Accordingly, practitioners should periodically ask:

1. Have the organization's activities evolved beyond its stated exempt purposes?
2. Are new programs or revenue streams substantially related to the organization's mission?
3. Is a substantial portion of the organization's resources devoted to commercial activities?
4. Do the governing documents continue to reflect the organization's actual activities?
5. Has a substantial nonexempt purpose emerged?

These questions become particularly important when an organization launches a new business venture, acquires income-producing property, expands into unrelated programming, or increasingly relies on commercial revenue sources.

Put differently, the organizational test asks what the organization is authorized to do. The operational test asks what the organization is actually doing. Both matter.

C. Ceasar Still Gets His Share – Unrelated Business Income Considerations.[4]

Churches and other religious organizations often assume that tax exemption means immunity from federal income taxation. Not so fast.

Assuming an organization satisfies the organizational and operational tests discussed above and maintains its exempt under Section 501(c)(3), a separate question arises: *must it nevertheless pay tax on certain revenue-producing activities?*

The answer is yes.

While organizations exempt under Section 501(c)(3) generally do not pay federal income tax on income derived from activities substantially related to their exempt purposes, Congress has long been concerned that exempt organizations could gain an unfair competitive advantage by operating commercial businesses free from taxation. As a result, the Internal Revenue Code imposes the Unrelated Business Income Tax ("UBIT") on certain income generated by otherwise tax-exempt organizations.

The basic concept is straightforward: an organization may remain tax-exempt while owing tax on particular streams of income. In other words, *tax-exempt does not necessarily mean tax-free*.

Determining whether income is subject to UBIT frequently turns on three questions:

1. Is the activity *a trade or business*?
2. Is the activity *regularly carried on*?
3. Is the activity *substantially related* to the organization's exempt purpose?

If the answer to the first two questions is "yes" and the answer to the third is "no," the income may be subject to federal income taxation notwithstanding the organization's tax-exempt status.

For churches and religious organizations, issue spotting often begins with activities that look increasingly commercial in nature. Coffee shops, bookstores, event venues, parking operations, cell tower leases, advertising arrangements, fitness centers, media ventures, and other revenue-producing activities may raise UBIT questions depending on the underlying facts and circumstances. The mere fact that the profits are used to support ministry activities does not, by itself, make the activity related to the organization's exempt purpose. Put differently, the IRS generally asks whether the activity contributes importantly to accomplishing the organization's exempt purposes, not merely whether the organization uses the resulting income for exempt purposes.

The issue-spotting takeaway is simple: tax-exempt does not necessarily mean tax-free. Whenever a church or religious organization engages in a revenue-generating activity that resembles a commercial enterprise, counsel should ask whether Caesar may still be entitled to a share.

Of course, identifying potential UBIT is often easier than determining whether UBIT actually applies. Like many provisions of the Internal Revenue Code, however, the general rule is followed by a host of exceptions, exclusions, modifications, and exceptions to those exceptions. Rental income, royalties, dividends, certain sponsorship payments, volunteer-operated activities, sales of donated goods, and various other activities may receive favorable treatment under the UBIT rules. Accordingly, careful analysis of the specific activity is essential before assuming that revenue

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generated by a church or religious organization is either taxable or exempt.

As U.S. Tax Court Senior Judge Mark V. Holmes observed, tax law often consists of "a series of general rules qualified by exceptions, and exceptions to those exceptions, and exceptions to those exceptions to those exceptions." *See Continuing Life Communities Thousand Oaks LLC v. Comm'r*, T.C. Memo. 2022-31 (April 6, 2022). With that in mind, several foundational principles of unrelated business income taxation are worth highlighting.

1. What is Unrelated Business Taxable Income?

Under Section 511 of the Code, a tax-exempt organization generally must pay income tax on income classified as unrelated business income. In general, if an organization exempt under Section 501(a) derives income from an unrelated trade or business, that income is called unrelated business income and is taxable, unless a modification, exclusion or exception applies. *See* 26 U.S.C. §§ 511(a)(1), 512-514; *see also* IRS Unrelated Business Income Tax (providing guidance on the subject). Gross income and deductions attributable to the activity are generally computed the same way in which corporate income taxes are calculated. *See* 26 U.S.C. §§ 511(a) (corporate rates applicable to unrelated business income), 162 (trade or business expenses), 167 (depreciation). Section 513 defines an unrelated trade or business as a trade or business that is not substantially related to the organization's exempt purposes. Section 512 then provides numerous exclusions, modifications, and exceptions that may remove otherwise taxable income from UBIT.

Determining whether income is subject to UBIT requires more than identifying a revenue-producing activity. The real issue-spotting exercise involves determining whether the activity constitutes an unrelated trade or business, whether it is regularly carried on, whether it is substantially related to the organization's exempt purposes, and whether any statutory exclusion, modification, or exception removes the income from taxation. The discussion below examines each of these components of the UBIT analysis and the practical considerations they present for churches and other religious organizations.

Generally, an activity is an unrelated business if the activity meets three requirements: (1) it is a trade or business, (2) it is regularly carried on, and (3) it is not substantially related to furthering the exempt purposes of the organization.

i. "Unrelated Trade or Business" and "Unrelated Trade or Business Taxable Income"

The first step in the UBIT analysis is determining whether the activity constitutes an "unrelated trade or business." Although the concept sounds straightforward, it is a defined term under the Internal Revenue Code and serves as the foundation for the entire UBIT framework.

Section 513 of the Code defines an **unrelated trade or business** as "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501[.]" *See* 26 U.S.C. § 513(a).

The term "**unrelated business taxable income**" means the gross income derived by any organization from any "unrelated trade or business" (as defined in section 513) regularly carried on by the organization, less applicable deductions connected with the carrying on of such trade or business, **computed with the modifications in subsection 512(b)**. *See* 26 U.S.C. § 512(a)(1).

Stated simply, the focus is not on whether the activity generates revenue. The focus is whether the organization is engaging in a business activity that lacks a sufficient connection to its exempt purposes.

ii. "Regularly Carried On"

Not every revenue-producing activity conducted by a church or religious organization triggers UBIT concerns. The activity must also be "regularly carried on."

Whether a trade or business for these purposes is "*regularly carried on"* is determined by evaluation of the frequency and continuity with which the activities productive of the income are conducted and the manner in which those activities are pursued. Specific business activities of an exempt organization will ordinarily be deemed to be "*regularly carried on*" if, for example, "they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations." 26 C.F.R. § 1.513-1(c)(1).

What is "regular" from a timing or performance perspective depends on the industry involved, any non-exempt market performance of similar activities, and the type of activity. The Treasury Regulations provide these rules and examples:

> Where income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business. For example, the operation of a sandwich stand by a hospital auxiliary for only 2 weeks at a state fair would not be the regular conduct of trade or business.

> However, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. Thus, the operation of a commercial parking lot on Saturday of each week would be the regular conduct of trade or business. Where income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business. For example, the operation of a track for horse racing for several weeks of a year would be considered the regular conduct of trade or business because it is usual to carry on such trade or business only during a particular season.

Id. at § 1.513-1(c)(2)(i).

The practical takeaway is that UBIT rarely turns on whether an activity is profitable. Instead, the question is often whether the organization is engaging in the activity with a level of frequency and continuity that resembles a commercial enterprise.

iii. "Substantially Related"

The third element of the UBIT analysis is often the most important—and frequently the most difficult—to apply in practice. Even where an activity constitutes a trade or business and is regularly carried on, the resulting income may not be subject to UBIT if the activity is substantially related to the organization's exempt purposes.

The critical distinction is that the IRS does not focus solely on whether the income generated by the activity is used to support the organization's exempt purposes. Rather, the IRS examines whether the activity itself contributes importantly to accomplishing those purposes.

> An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a <u>**substantial part**</u> of its activities, **if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes <u>and</u> if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513**. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.

See 26 C.F.R. § 1.501(c)(3)-1(e) (emphasis added).

A trade or business is "**substantially related**" (and therefore *not* an "unrelated" trade or business for unrelated business income tax rules) only if the production or distribution of the goods or the performance of the services from which the gross income is derived contributes importantly to the accomplishment of the purposes for which exemption was granted. "A 'substantially related' trade or business 'has causal relationship to the achievement of exempt purposes' and 'must contribute importantly to the accomplishment of those purposes.'" *Ocean Pines Ass'n v. Comm'r*, 672 F.3d 284, 287-289 (4th Cir. 2012) (quoting 26 C.F.R. § 1.513-1(d)(2)).

The Treasury Regulations express the same principle: the activity must have a substantial causal relationship to the organization's exempt purposes, and the contribution must be more than the mere production of income. Whether that standard is satisfied depends upon the facts and circumstances of each case. Section 1.513-1(d)(2) of the Treasury Regulations provides as follows:

> *Type of relationship required.* **Trade or business is *related* to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is *substantially related,* for purposes of section 513, only if the causal relationship is a substantial one.** Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived **must contribute importantly to the accomplishment of those purposes**. Where the production or distribution of the goods or the performance of the services **does not contribute** importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

26 C.F.R. § 1.513-1(d)(2) (emphasis in bold added).

In determining whether an activity is "substantially related" to an exempt purpose, the courts look to the operation of the activity, and not to the benefit of the organization's members. *See Veterans of Foreign Wars, Dep't of Michigan v. Comm'r of Internal Revenue*, 89 T.C. 7, 38 (1987) (finding that income received from a certain Christmas card fundraising activity of the VFW was not substantially related to its exempt purpose).

For example, the IRS has ruled that sales of pharmaceutical supplies by a tax-exempt hospital to members of the general public, or to private patients of physicians practicing in a building owned by the hospital, do not qualify for the "convenience" exception. Rev. Rul. 68–375, 1968–2 C.B. 245; Rev. Rul. 68–374, 1968–2 C.B. 242.

The IRS determined that "[t]he buyer-seller relationship between these off-street patrons and the pharmacy" was insufficient to classify them as "patients" of the hospital. The IRS concluded that these revenues were subject to unrelated business income taxation because there was "no substantial causal relationship between the achievement of the hospital's exempt purposes and the sale of pharmaceutical supplies" to such individuals. *See* Rev. Rul. 68–374; *see also New Jersey Council of Teaching Hosps. v. Comm'r of Internal Revenue*, 149 T.C. 466, 480-81 (2017) (providing detailed analysis on "substantially related" and the "convenience of members" exception).

a. Examples of "Substantially Related"

In Revenue Ruling 74-399, 1974-2 C.B. 172, the IRS found that a **tax-exempt museum's operation** of an eating facility that helped to attract visitors to a museum and enhanced the efficient operation of the entire museum by enabling the staff and employees to remain on its premises throughout the workday may contribute importantly to the accomplishment of the museum's exempt purposes and would not constitute unrelated trade or business. The Revenue Ruling states, in relevant part, as follows:

> Because there are places of refreshment in the museum visitors are able to devote a greater portion of their time and attention to the museum's collection, exhibits and other educational facilities than would be the case if they had to interrupt or terminate their tours of the museum to seek outside eating facilities at mealtime. The eating facilities also enhance the efficient operation of the entire museum by enabling the museum staff and employees to remain on its premises throughout the workday. Thus, **the museum's operation** of the eating facilities is a service that contributes importantly to the accomplishment of its exempt purposes.

Rev. Rul. 74-399 (emphasis added).

In Rev. Rul. 69-268, 1969-1 C.B. 160, a **tax-exempt hospital operated** a cafeteria and coffee shop open to hospital staff and persons visiting hospital patients. The general public was not encouraged to use the food facilities. One of the exempt purposes of the hospital is to provide health care for members of the community. The IRS found that the operation of the hospital's eating facilities was held **not unrelated trade or business** within the meaning of section 513 of the Code. The IRS found that visits by outsiders are regarded as a form of therapy that assisted in patient recovery. The IRS noted that the hospital's permitting outside visitors to use its eating facilities enabled the visitors to spend more time with the patients and thus contributed significantly to the hospital's exempt purpose.

In Rev. Rul. 81-138, 1981-1 C.B. 358, the IRS evaluated a commercial lease arrangement involving a chamber of commerce, being an exempt organization under section 501(c)(6) of the Code. The chamber's exempt purposes included encouraging business development in a community. The chamber obtained a mortgage to help finance a shell building's construction leased to an industrial tenant at less than full rental value. The IRS found that the leasing of the property was **not an unrelated trade or business** as defined in section 513 of the Code because the lease was substantially related to the chamber organization's exempt purpose. The Revenue Ruling concluded as follows:

> The building that the organization owns may constitute "debt-financed property" within the meaning of section 514(b)(1) of the Code since such property is held to produce income and is subject to acquisition indebtedness. Thus, it is necessary to determine whether substantially all of the use of the building is substantially related to the exercise or performance by the organization of the purpose or function constituting the basis for its exemption, and therefore excluded from the definition of debt- financed property under the provisions of section 514(b)(1)(A)(i). . . .
>
> [T]he leasing of the building by the organization, under the circumstances described, when the project is initially financed by contributions from the business community and is leased at less than fair market value for similar facilities, is an activity designed to attract industry to the

> community and is not an activity of a kind ordinarily carried on for profit. The activity therefore contributes importantly to the purposes constituting the basis for the organization's exempt status under section 501(c)(6) of the Code, and thus is substantially related to those purposes within the meaning of section 514(b)(1)(A)(i).

In Rev. Rul. 77-47, 1977-1 C.B. 157, the IRS evaluated a historical preservation association that was exempt under section 501(c)(3) of the Code. The association acquired, restored, and preserved historical significant buildings and opened the restored buildings to the public for a nominal admission fee. The association acquired other historically significant buildings by the assumption of outstanding mortgages. It leased them at fair rental value for uses that bore no relationship to the building's historical significance and did not allow for viewing by the general public. The IRS concluded that, **because the leasing did not contribute significantly to the association's exempt purpose and had no causal relationship to the achievement of that purpose, the exception under section 514(b)(1)(A) did not apply, and the leased buildings were held to constitute debt-financed property**.

In *Living Faith, Inc. v. Commissioner*, 950 F.2d 365 (7th Cir. 1991), the issue was whether Living Faith was operated exclusively for exempt purposes under section 501(c)(3) of the Code when Living Faith's sole activities involved the operation of two religious-based food stores and restaurants called Country Life.

Living Faith was a Seventh-Day Adventist Church organized in part to perform "outpost evangelism programs." Living Faith operated Country Life based on the Seventh-Day Adventist religious dietary standards. *Id.* at 367. The Country Life facilities were required to employ Seventh-Day Adventist management and maintain a working relationship with the local Seventh-Day Adventist Church. Living Faith's food prices were competitive with other vegetarian restaurants and health food stores. *Id.* at 368.

Living Faith asserted that it operated its health food stores with the exclusive, tax-exempt purpose of furthering the Seventh-Day Adventist Church's religious work as a health ministry. *Id.* at 370. Living Faith used Country Store as a means to evangelize the Seventh-Day Adventist faith. Each day, Living Faith conducted a devotional and religious ceremony at the facility. Living Faith provided the public with an opportunity to sample vegetarian cooking by offering free meals. Living Faith offered to the public a fee-based cooking school that promoted vegetarian cooking. Living Faith also offered weekly Bible study classes, free of charge, and occasionally provided meals to the needy in exchange for chores. *Id.* at 368.

The IRS Commissioner and the Tax Court found that Living Faith was not qualified as exempt under section 501(c)(3) of the Code due to the substantial nonexempt activity of operating commercial food stores.

The Court of Appeals for the Seventh Circuit affirmed. The court noted:

> [W]e focus on "the purposes toward which an organization's activities are directed, and not the nature of the activities." The purposes need not be solely religious; courts recognize that a nonexempt purpose, even "somewhat beyond a de minimis level," may be permitted without loss of exception. The nonexempt purpose, however, cannot be substantial. "The presence of a single nonexempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes."
>
> A single activity may be carried on for more than one purpose. The fact that an organization's primary activity may constitute a trade or business does not, of itself, disqualify it from classification under § 501(c)(3), provided the trade or business furthers or accomplishes an exempt purpose. If one of the activity's purposes, however, is substantial and nonexempt (*e.g.,* commercial), the organization will be denied exempt status under § 501(c)(3), even if its activity also furthers an exempt (*e.g.,* religious) purpose.

Living Faith, 950 F.2d at 370 (internal citations omitted).

The Court of Appeals found that Living Faith's activities were limited to the operation of the two food stores. The operation of the eating facilities was presumptively commercial. The facility was open to the public. It competed directly with other restaurants. It used profit-making pricing formulas and engaged in advertising. The facility had hours of operation competitive with commercial enterprises. The underlying organization had no plans to solicit donations. In sum, the food store operations were substantial commercial operations and thus, the denial of exemption under section 501(c)(3) was affirmed. *See id.* at 371, 373-377.

Indeed, "'the presence of a single nonexempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes.'" *American Ass'n of Christian Schools Voluntary Employees Beneficiary Ass'n Welfare Plan Trust v. United States,* 850 F.2d 1510, 1513 (11th Cir.1988) (quoting *Better Business Bureau* *v. United States,* 326 U.S. 279, 283, 66 S.Ct. 112, 114, 90 L.Ed. 67 (1945)).

2. <u>Exceptions to "Unrelated Trade or Business"</u>

Certain activities are expressly excepted from the meaning of "unrelated trade or business." For the exceptions to apply, the organization and the activity producing the income must be evaluated.

For example, "unrelated trade or business" does not include (1) qualified fair or exposition public entertainment activities of certain organizations which regularly conduct, as one of its substantial exempt purposes, an agricultural and educational fair or exposition; (2) qualified convention and trade show activities that attract persons in an industry generally as well as members of the public for the purpose of displaying industry products or to simulate interest in the particular industry. Qualified hospital services, qualified bingo games, and, of course, certain pole-rental activities are also excluded from the meaning of "unrelated trade or business" for organizations described in these carve outs set forth in section 513. *See id.* at § 513(d)-(h).

Qualified sponsorship payments are also excepted from the meaning of "unrelated trade or business." A "qualified sponsorship payment" is any payment made by any person engaged in a trade or business with respect to which there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgement of the name or logo of such person's trade or business in connection with the activities of the organization that receives such payment. Limitations apply, such as conditioning the payment on factors relating to the degree of public exposure to a particular event. *See id.* at § 513(i)-(i)(3).

3. <u>Modifications to "Unrelated Business Taxable Income"</u>

"Except as otherwise provided in this subsection, the term "unrelated business *taxable* income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed . . . which are directly connected with the carrying on of such trade or business, **both computed with the modifications provided in subsection (b)**." 26 U.S.C. § 512(a)(1) (emphasis added). Generally, gross income from an unrelated trade or business, and the applicable deductions related to that income, are computed the same way in which corporate income taxes are calculated. *See* 26 U.S.C. §§ 511(a) (corporate rates applicable), 162 (trade or business expenses), 167 (depreciation).

There are about 20 modifications contained in subsection 512(b). They include the following:

- **Dividends and Interest.** Subsection section 512(b)(1) excludes dividends, interest income, and payments with respect to securities loans, amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income.
- **Royalties.** Subsection 512(b)(2) excludes all royalties, and all deductions directly connected with such income.
- **Rents Attributable to Real Property.** Subsection 512(b)(3)(A)(i) excludes from unrelated business taxable income rents attributable to real property, provided that an exception to the exclusion does not apply, including the debt-financed property exception.
- **Rents from Personal Property.** Subsection 512(b)(3)(A)(ii) excludes from unrelated business taxable income all rents from personal property leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease (and provided that an exception to the exclusion does not apply).
- **Research.** Income from research performed for any federal or state governmental agency, or from research performed by a college, university, or hospital for any person is excluded. *id.* at § 512(b)(7)-(9).
- **$1,000 Deduction.** With limited exception, the Code permits a specific deduction of $1,000 of any unrelated business taxable income. And, in the case of a diocese or convention of churches, there is also allowed, with respect to each individual church, a specific deduction equal to the lower of $1,000 or the gross income derived from any unrelated trade or business regularly carried on by such individual church.
- **Controlled Entities and Receipts from Foreign Corporations.** Subsection 512(b)(13) provides special rules and modifications to unrelated business taxable income for amounts received from controlled entities.

4. <u>Exceptions to the Modifications Applicable to Real Property and Personal Property</u>

In the case of personal property leased with real property (which is commonly referred to as a "mixed lease") the rental income is excludable from unrelated business taxable income if the rents that are attributable to the personal property are not more than 10% of the total rents received under the lease. *See* 26 C.F.R. § 1.512(b)-1(C)(2)(ii)(b).

Moreover, the exclusions from unrelated business taxable income for rental income in subsection 512(b)(3)(A) (i.e., rents from real property and personal property) shall not apply: (i) if more than 50 percent of the total rent received or accrued under the lease is attributable to personal property, or (ii) if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). *See* 26 U.S.C. § 512(b)(3)(B)(i).

5. Debt-Financed Property Exceptions to the Modifications

As noted above, subsection 512(b)(3)(A)(i) excludes from unrelated business taxable income rents attributable to real property. However, exceptions apply. Section 514 of the Code provides special (and complex) rules for inclusion of income derived from real property that is debt-financed. The term "debt-financed property" means any property which is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year. *See id.* at § 514(b)(1).

When income is derived through the use of borrowed funds, section 514 is triggered, and the income—while perhaps once excluded or modified for taxation purposes by section 511, 512, or 513—may be brought back into the taxable category. *See id.* at § 514(a)-(b).

If, for example, a church receives leases debt-financed property to a third party for a purpose that is not substantially related to the exempt purposes of the church, the rent from that activity is likely includable in unrelated business taxable income.

Similarly, if an exempt organization purchases securities with borrowed funds, the dividends or interest earned on those securities is likely subject to the unrelated business taxable income rules. (Exceptions apply, such as in the case of tax-exempt bond issuances or tax-exempt loans, but that is a whole other can of tax worms for another future blog.)

6. Exceptions to Unrelated Business Income Tax Rules

In addition to the modifications, section 513 of the Code expressly excepts any trade or business—

1. in which substantially all the work in carrying on such trade or business is performed for the organization without compensation [**e., a volunteer-run business]**; or
2. which is carried on **by the organization** primarily for the **convenience of its members**, students, patients, officers, or employees; or
3. which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions [**e., sale of donated goods]**.

See id. at § 513(a)-(a)(3).

7. The Commerciality Doctrine

The discussion above largely assumes that the organization remains tax-exempt and that the question is whether a particular activity generates unrelated business taxable income. The commerciality doctrine presents a different concern. Rather than asking whether a particular stream of income is taxable, the doctrine asks whether the organization itself has become too commercial in nature to qualify for tax-exempt status.

Developed through judicial decisions, the "commerciality doctrine" reflects a concern that tax-exempt organizations should not obtain an unfair market advantage by operating businesses that are substantially indistinguishable from their for-profit counterparts while enjoying the benefits of tax-exempt status. The doctrine generally focuses on whether the activities of the purported tax-exempt organization are being operated in a manner that resembles a commercial enterprise rather than an exempt ministry.

Some types of tax-exempt organizations get a "pass" from the commerciality doctrine. For example, exempt research organizations, exempt educational institutions, and hospitals generally are not subject to the commerciality doctrine with respect to their foundational and traditional exempt activities, even though those entities compete with for-profit enterprises that provide similar goods or services.

The difficult cases arise when a church or religious organization develops revenue-producing activities that increasingly resemble ordinary commercial enterprises. At some point, the issue ceases to be merely whether income is subject to UBIT and becomes whether the organization has developed a substantial commercial purpose that threatens its exempt status. If an organization is deemed to have violated the commerciality doctrine by the operation of a non-exempt purpose or activity, the organization's tax exemption may be revoked and the income from that non-exempt activity (as well as other organizational income) may be subject to federal income taxation.

Neither the Tax Courts nor Congress have established a bright-line test for deciding when a tax-exempt organization's "commercial activity" meets the threshold for a violation of the commerciality doctrine. Factors that the courts consider include whether the organization is competing with for-profit commercial enterprises, pricing policies of the organization such as market-comparable or at-cost provision of goods or services, whether the organization markets its goods or services like a for-profit enterprise.

Many of these considerations should sound familiar. Indeed, the concerns underlying the commerciality doctrine are illustrated by the *Living Faith* decision discussed above. Although *Living Faith* asserted that its health-food stores and restaurants furthered its religious mission, the courts focused on the commercial characteristics of the operation, including competition with for-profit businesses, market-based pricing, advertising, and other indicia of ordinary commercial activity.

For practitioners, the commerciality doctrine is best viewed as an issue-spotting tool. When a church or religious organization launches a new business venture, counsel should ask not only whether the activity generates unrelated business taxable income, but also whether the activity is beginning to look, operate, and compete like a commercial enterprise.

Put differently, the UBIT rules ask whether Caesar gets a share of the income. The commerciality doctrine asks a more fundamental question: has the ministry begun to look more like a business than a ministry?

Or, to borrow a familiar expression, *if the organization looks like a for-profit duck, waddles like a for-profit duck, and quacks like a for-profit duck*, courts and regulators may treat the organization like a for-profit duck.

8. Overall Issue-Spotting Takeaway

Issue-Spotting Takeaway. Churches and religious organizations often assume that tax-exempt means tax-free. It does not.

Whenever a church or religious organization launches a new revenue-generating activity, counsel should ask questions such as:

1. Is this a trade or business?
2. Is it regularly carried on?
3. Is it substantially related to the organization's exempt purposes?
4. Does an exclusion, modification, or exception apply?
5. Is the activity beginning to resemble a commercial enterprise?

Put differently, before counting the revenue, practitioners should first ask: *Is Caesar entitled to a share of this income?*

And if the activity increasingly resembles an ordinary business, a second question may be even more important: *Have we created unrelated business income, or are we creating a substantial commercial purpose?*

Those two questions often determine whether the concern is merely taxation of income—or the organization's tax-exempt status itself.

D. Yes, You Can Pay the Apostle Paul—Just Not Whatever You Want: Excess Benefit Transactions.[5]

Churches and other religious organizations frequently rely on pastors, ministry founders, executive directors, officers, and other leaders to carry out their missions. Inevitably, questions arise concerning compensation, housing arrangements, expense reimbursements, use of organizational property, loans, and other financial relationships between the organization and those who exercise influence over it.

Federal tax law does not prohibit reasonable compensation for legitimate services provided to a tax-exempt organization. It does, however, prohibit insiders from receiving economic benefits that exceed the value provided to the organization in return. When that occurs, what may have begun as a well-intentioned arrangement can become an excess benefit transaction under Section 4958 of the Internal Revenue Code and the corresponding Treasury Regulations. This section provides a brief overview of those rules and some practical issue-spotting considerations for churches and other religious organizations.

In general, an excess benefit transaction occurs when the value of an economic benefit provided directly or indirectly by a tax-exempt organization to a disqualified person exceeds the value of the consideration received by the organization in exchange.

Put differently, if a church or religious organization gives more than it gets, and the person receiving the benefit is an insider, the IRS may view the transaction as an excess benefit transaction. A disqualified person generally includes individuals who are in a position to exercise substantial influence over the organization's affairs, such as founders, pastors, officers, directors, certain key employees, and other control persons.

For practitioners, excess benefit transactions are a classic issue-spotting concern. The question is rarely whether the organization intended to do something improper. Rather, the question is whether the organization provided compensation, property, privileges, or other economic benefits to an insider on terms that would not have been available in an arm's-length transaction. The Internal Revenue Service asks a straightforward question: Did the organization receive fair value in return?

If the answer is no, substantial excise taxes may be imposed on the recipient of the benefit and, in some circumstances, on the organization's managers who approved the transaction. Accordingly, church and ministry leaders should approach insider transactions with caution, careful documentation, and a clear understanding of the excess benefit rules.

1. Taxes Triggered

The first issue-spotting question is obvious: *what happens if the IRS determines that an excess benefit transaction occurred?* The answer is that the excise

[5] Much of this content was derived from the *We Did What? Now What? Nonprofit Organizations and Excess Benefit Transactions* article published by Freeman Law, PLLC, authored by Cory Halliburton, and available at https://freemanlaw.com/we-did-what-now-what-nonprofit-organizations-and-excess-benefit-transactions/

taxes can be severe and can affect not only the insider who received the benefit, but also those responsible for approving the transaction.

The Internal Revenue Code imposes a tax equal to 25% of the excess benefit on each excess benefit transaction. That 25% tax "shall be paid by" the disqualified person. In addition, the Code imposes a tax equal to 200% of the excess benefit in any case in which the 25% tax is imposed, and the transaction is not corrected within the applicable taxable period. Thus, the amount of excess in an excess benefit transaction can trigger excise taxes assessed against the disqualified person who benefits from the transaction up to 225% of the excess involved.

2. Taxes Assessed Against the Organization's Manager(s)

Excess benefit transactions are not solely the recipient's problem. Church boards and ministry leaders sometimes assume that liability ends with the person who received the benefit. Federal tax law takes a broader view.

The organization's managers (i.e., those serving on the governing board or otherwise approving the transaction, as applicable) who knowingly participate in the approval of, or who acquiesce by silence to such a transaction can be assessed with an excise tax of up to 10% (up to $20,000) of the excess. The term "knowing" includes actual knowledge of and/or negligently failing to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a transaction.

3. Reasonable Cause

Fortunately, the Code recognizes that not every board member who participates in an excess benefit transaction acted recklessly or intentionally. The law therefore provides a limited protection for managers who exercise appropriate diligence and business judgment.

The managers may avoid the excise taxes under section 4958 of the Code if their participation is due to "reasonable cause," meaning the manager exercised responsibility on behalf of the organization with ordinary business care and prudence.

4. Joint and Several Liability

In any case where more than one "manager" is liable for a tax imposed under section 4958, "all such persons shall be jointly and severally liable for the taxes" so imposed with respect to that excess benefit transaction.

5. Correction

The next issue-spotting consideration is equally practical: *what can be done if the transaction has already occurred?* The excess benefit rules focus not only on identifying problematic transactions but also on correcting them.

An excess benefit transaction is (and should be) corrected by undoing the excess benefit to the extent possible. This is done by executing any measures necessary to place the applicable tax-exempt organization involved in the excess benefit transaction in a financial position not worse than that in which it would be if the disqualified person were dealing under the "highest fiduciary standards." Correction may include return of cash or property or modifying any contractual arrangement that created the excess benefit. And, the cash amount of correction should include interest in order to make the tax-exempt organization whole.

6. IRS Form for Reporting

Discovering an excess benefit transaction does not end the analysis. In certain circumstances, reporting obligations may also arise. The transaction and taxes arising from same may be required by law to be reported to the IRS. The reporting process is through IRS Form 4720.

7. Overall Issue Spotting Takeaway

Issue-Spotting Takeaway. Excess benefit transactions rarely begin with bad intentions. More often, they arise from informal governance practices, inadequate documentation, insufficient board oversight, or a failure to evaluate transactions from the perspective of an independent third party.

Accordingly, whenever a church or religious organization proposes compensation arrangements, housing benefits, below-market leases, loans, property transfers, expense reimbursements, or other transactions involving insiders, counsel should ask a simple question: *Would the organization agree to the same arrangement with an unrelated third party?*

If the answer is no—or if the answer is unclear—the transaction warrants closer scrutiny. The goal is not to prevent organizations from compensating leaders or conducting business with insiders. The goal is to ensure that the organization receives fair value in return and that those responsible for stewarding the organization's resources do so in a manner consistent with both their fiduciary obligations and federal tax law.

Equally important, if a potential excess benefit transaction is discovered, the applicable tax-exempt organization should act promptly to investigate, correct, and report the issue as circumstances require. Delay often increases both the tax consequences and the practical difficulties associated with unwinding the transaction.

Left unaddressed, excess benefit transactions can harm more than the organization's tax position. They can erode trust among leaders, create governance disputes, damage credibility with donors, and distract the organization from its mission. For that reason, the best course is usually the simplest one: identify the issue early, address it directly, and ensure that the ministry's stewardship practices are as sound as the mission it seeks to advance.

Put differently, the issue is not whether the Apostle Paul gets paid. The issue is whether the Apostle Paul gets paid whatever he wants. Federal tax law permits reasonable compensation. It does not permit excess benefits disguised as compensation, generosity, or ministry support.

IV. JERUSALEM HAD TAX COLLECTORS, TOO: STATE AND LOCAL TAX EXEMPTION CONSIDERATIONS

A. Is Austin Still Looking for It's Cut? – Franchise Tax Exemption.

After navigating the federal tax rules, many churches and religious organizations assume that Texas franchise tax will require a similarly complex analysis. Fortunately, this is often one of the shorter tax conversations.

Texas imposes a franchise tax on taxable entities doing business in the state. Organizations that qualify for exemption under Section 501(c)(3) of the Internal Revenue Code will frequently qualify for exemption from Texas franchise tax as well. However, practitioners should not assume that federal tax exemption automatically results in Texas tax exemption. Texas is one of the few states that generally requires a separate application to obtain exemption from certain state taxes.

One practical issue-spotting consideration is determining whether the organization has completed the necessary state filings. The Texas Comptroller utilizes several exemption applications depending upon the nature of the organization. Religious organizations commonly apply using Form AP-209, while many other organizations relying upon their federal exempt status use Form AP-204. The appropriate application depends upon the basis for the exemption being claimed.

Another frequently overlooked issue is timing. Until state exemption is granted, an organization may remain subject to certain state filing requirements. Failure to comply with those requirements can result in penalties, loss of good standing, or even forfeiture of the organization's charter. Once exemption is approved, those obligations may change significantly.

Practitioners should also remember that franchise tax exemption is not necessarily a one-time analysis. Changes in mission, operations, organizational structure, or exempt status may warrant a fresh review of whether the organization continues to qualify for favorable treatment under Texas law.

Issue-Spotting Takeaway. Federal tax exemption and Texas tax exemption are related, but they are not the same thing. Whenever a church or religious organization is formed, reorganized, merged, or experiences significant operational changes, counsel should ask a simple question: *Is Austin still looking for its cut?*

B. Do We Have to Pay Sales Tax on This? – Sales Tax Exemption.

If franchise tax issues are often a short conversation, sales tax questions seldom are.

Texas law provides sales and use tax exemptions for qualifying religious, charitable, educational, and other nonprofit organizations. At the same time, those exemptions are not unlimited, and churches frequently discover that sales tax issues are more nuanced than expected.

One of the most common misconceptions is that a tax-exempt organization is automatically exempt from paying sales tax on every transaction. That is not the case. Whether an exemption applies often depends upon the nature of the organization, the purpose of the transaction, and the manner in which the property or service will be used.

Equally important, exemption from paying sales tax does not necessarily mean exemption from collecting sales tax. Churches and religious organizations frequently focus on whether they must pay tax when making purchases, but many overlook the separate question of whether they must collect and remit tax when engaging in certain sales activities. Texas law often treats those inquiries differently.

Admissions provide a useful example.[6] Texas generally imposes sales tax on admissions to amusement services, which may include concerts, performances, entertainment events, and similar activities. Churches and nonprofit organizations sometimes assume that admissions charges are automatically exempt from taxation. The analysis, however, can be more complicated and may depend upon the nature of the event, the organization conducting it, and the applicable statutory exemption.

For churches and religious organizations, issue spotting often begins when someone says: "Let's sell tickets." Conferences, concerts, camps, retreats,

[6] For a more detailed discussion of Texas sales tax issues relating to admissions charges, amusement services, and applicable nonprofit exemptions, see the article *Texas Nonprofits and Sales Tax on Admissions* published by Freeman Law, PLLC, authored by Cory Halliburton, and available at https://freemanlaw.com/texas-nonprofits-and-sales-tax-on-admissions/

fundraising dinners, holiday productions, and similar events may all raise sales-tax questions that warrant further analysis before tickets go on sale.

For practitioners, sales tax questions are highly fact dependent. Church bookstores, coffee shops, conferences, fundraising events, merchandise sales, catering activities, facility rentals, and other ministry activities may all create sales tax questions depending upon the specific facts and circumstances involved.

Accordingly, counsel should approach sales tax issues by asking two separate questions:

1. Must the organization _pay_ Texas sales tax on this purchase?
2. Must the organization _collect_ Texas sales tax on this transaction?

Although those questions are often confused, the answers are not always the same.

Issue-Spotting Takeaway. Whenever a church or religious organization buys, sells, rents, sponsors, publishes, caters, hosts, or markets something, counsel should pause and ask a simple question: *Do we have to pay sales tax on this?* The answer is often less obvious than the client expects.

C. Can We Keep the Tax Assessor off the Property? – Property Tax Exemption.[7]

The Gospels contain no shortage of references to tax collectors, and for good reason: taxes were a fact of life in the ancient world just as they are today. Churches and other religious organizations may spend considerable time focusing on federal tax exemption, but many of the most significant tax issues they encounter arise much closer to home—in the local appraisal district.

For many ministries, real property is among their most valuable assets. Sanctuaries, classrooms, fellowship halls, offices, parking lots, camps, and clergy residences can all generate substantial property tax exposure if an exemption is unavailable. Yet a common misconception is that federal recognition as a Section 501(c)(3) organization automatically results in exemption from Texas property taxes. It does not.

A nonprofit organization that owns property in Texas _may_ be entitled to exemption from Texas property tax. However, not all nonprofit organizations—even those that enjoy exemption from federal income tax under Section 501(c)(3) of the Internal Revenue Code—are entitled to an exemption from state property taxes.

The Texas Tax Code sets forth various statutory regimes for exemption that may be available for a Texas nonprofit organization, depending on the purposes for which the organization is formed or organized and the manner in which it is operated. However, the organization must apply for and receive an exemption through forms promulgated by the Texas Comptroller or local tax appraisal district.

There are numerous categories and subcategories of organizational and operational types that may qualify for an exemption, and these statutes are contained, primarily, in Chapter 11 of the Texas Tax Code. Some of those statutes set forth a complex, yet precise framework for determining whether or not a tax exemption may be available. *See, e.g.,* TEX. TAX CODE §§ 11.18 (charitable organizations), 11.19 (youth spiritual, mental, and physical development associations), 11.20 (religious organizations), 11.21 (schools).

1. _The Texas Constitution_

All property that the State of Texas has jurisdiction to tax is taxable unless exempt by law. *See* TEX. CONST. art. VIII, § 2(a). The state has jurisdiction to tax (1) real property if located in Texas and (2) tangible personal property if the property is: (a) located in Texas for longer than a temporary period; (a) temporarily located outside Texas and the owner resides in Texas; or (3) used continually, whether regularly or irregularly, in Texas. *See* TEX. TAX CODE § 11.01(a)-(d).

"Property" means any matter or thing capable of private ownership. *Id.* at § 1.04(1). The term "real property" includes land and improvements. *Id.* at § 1.04(2)-(2)(B). "Tangible personal property" means "personal property that can be seen, weighed, measured, felt, or otherwise perceived by the senses, but does not include a document or other perceptible object that constitutes evidence of a valuable interest, claim, or right and has negligible or no intrinsic value." *Id.* at § 1.04(5).

The legislature may, by general laws, exempt from taxation actual places of religious worship, clergy residences, property used by charitable institutions, and other. *See* TEX. CONST. art. VIII, § 2(a). All statutes for the exemption of property from taxation are strictly construed against the exemption and in favor of the state and taxation. *See Davies v. Meyer*, 541 S.W.2d 827, 828 (Tex. 1976).

2. _Section 11.20, Texas Tax Code – Religious Organizations Property Tax Exemption_

Pursuant to the Texas Constitution, article VIII, section 2(a), the Texas Legislature enacted Texas Tax Code section 11.20(a), exempting real and tangible personal property if it is **(1)** owned by a religious

[7] Much of this content was derived from the *Texas Religious Property Tax Exemption* article published by Freeman Law, PLLC, authored by Cory Halliburton, and available at https://freemanlaw.com/texas-religious-organizations-property-tax-exemption/.

organization, **(2)** used primarily as, or at, a place of regular religious worship, and **(3)** is reasonably necessary for engaging in religious worship. *See Earle v. Program Centers of Grace Union Presbytery, Inc.*, 670 S.W.2d 777, 781 (Tex. App.—Fort Worth 1984, no writ) ("To qualify for exemption under sec. 11.20, the property in question must be owned by a religious organization.").

Specifically, section 11.20 provides as follows:

> An **organization that qualifies as a religious organization** as provided in Subsection 11.20(c) is entitled to an exemption from taxation of:
>
> 1. **the real property that is <u>owned by the religious organization</u>, is <u>used primarily as a place of regular religious worship</u>, and is <u>reasonably necessary for engaging in religious worship</u>**;
> 2. the tangible personal property that is owned by the religious organization and is reasonably necessary for engaging in worship at the place of worship specified in Subdivision (1).

TEX. TAX CODE § 11.20(a)-(a)(2) (emphasis added).

Pursuant to subsection 11.20(a)(1), the real property must be: **A.** owned by the religious organization, **B.** used primarily as a place of regular religious worship, and **C.** reasonably necessary for engaging in religious worship.

Issue-Spotting Takeaway. The property-tax analysis for religious organizations often begins with three deceptively simple questions such as:

1. Who owns the property?
2. How is the property actually used?
3. Is that use primarily religious worship?
4. Is revenue generated by occasional secular use put back into the property as a place of religious worship?

If any one of those questions cannot be answered favorably, the exemption may be in jeopardy. Federal tax exemption alone is not enough.

3. <u>"Religious Organization"</u>

To qualify as a "**religious organization**," the entity must meet these requirements:

1. be organized and operated primarily for the purpose of engaging in religious worship or promoting the spiritual development or well-being of individuals;
2. be operated in a way that does not result in accrual of distributable profits, realization of private gain resulting from payment of compensation in excess of a reasonable allowance for salary for services rendered, or any form of private gain;
3. use its assets in performing the organization's religious functions or the religious functions of another religious organization; and
4. by charter, bylaw, or other regulation adopted by the organization to govern its affairs direct that on discontinuance of the organization by dissolution or otherwise the assets are to be transferred to the government or an organization that is qualified as a charitable organization under section 501(c)(3) of the Code.

TEX. TAX CODE § 11.20(c)-(c)(4). Most local appraisal district's application for a religious organizations property tax exemption incorporates each of the requirements of section 11.20(c) of the Texas Tax Code. *See, e.g*, Dallas Central Appraisal District Exemption Application for Religious Organization, Step 2 and Schedule AR: *Real Property Used as Actual Place of Religious Worship, Clergy Residence or Endowment Fund Property*, (incorporating all requirements of section 11.20(c) of the Texas Tax Code).

Most importantly, perhaps, to qualify for a religious organizations property tax exemption afforded by section 11.20 of the Texas Tax Code, the real property must be used **<u>primarily</u>** as a place of regular religious worship. *See* TEX. TAX CODE § 11.20(a)(1).

4. <u>"Religious Worship"</u>

"Religious worship" is defined as "individual or group ceremony or meditation, education, and fellowship, the purpose of which is to manifest or develop reverence, homage, and commitment in behalf of a religious belief." *Id.* at § 11.20(e). This definition was adopted by the Texas Legislature in 1982 following the *Davies* decision. *See Kerrville Independent Sch. Dist. v. Southwest Tex. Encampment Assoc.*, 673 S.W.2d 256, 259-60 (Tex. App.—San Antonio 1984, no writ).

The term "**primarily**" has been interpreted to mean—first; principal; chief; leading. *See Earle*, 670 S.W.2d at 781.

Texas courts—including the Texas Supreme Court—recognize and emphasize that there is a difference between **religious purposes** and **religious worship**, but a program which is collateral to a religious program will not necessarily defeat an exemption which would otherwise be allowed. *See Davies*, 541 S.W.2d at 828, 830 (noting that "The worship of God is not prohibited in any place, but we are of the opinion that the spirit of the Constitution would include any place at which the worship might be indulged in so continuously and in such a manner as to give it the character of 'a place of worship.'"); *Southwest Tex. Encampment Assoc.*, 673 S.W.2d at 260.

In *Swearingen v. City of Texarkana*, 596 S.W.2d 157 (Tex. Civ. App. 1979), *writ refused n.r.e.* (Tex. 1980), the court of appeals, citing *Davies*, noted:

> Although we recognize that the preparation and dissemination of religious materials for the purposes of inspiration, education and evangelization can be considered as worship in the larger meaning of the word, **most courts which have dealt with the problem of tax exemptions for places of worship have construed and applied the term in the sense of a place where persons come together for congregational worship and for the administration or observance of church sacraments and ordinances. Implicit in such a view is the truth that there is a vast difference between property used for religious purposes and property used as an actual place of religious worship. The constitution does not permit the exemption of the former, but only the latter type of property.**

Swearingen, 596 S.W.2d at 159-60 (citation omitted; emphasis added).

Following *Davies* and *Swearingen*, the Texas Legislature enacted section 11.20(d) of the Texas Tax Code which allows for a religious organization property tax exemption even when there is "**occasional**" secular use of the property, provided that the primary use of the property is for religious worship **and** the revenue derived from secular uses is devoted exclusively to the improvement of the property as an actual place of religious worship. *See* TEX. TAX CODE § 11.20(d); *First Baptist Church of San Antonio v. Bexar County Appraisal Rev. Bd.*, 833 S.W.2d 108, 111 (Tex. 1992) (finding that a property leased by a church to a for-profit company for commercial parking lot purposes was still entitled to an exemption from property tax under section 11.20 because the parking lot property was primarily used for religious worship); *City of Austin v. Univ. Christian Church*, 768 S.W.2d 718, 720 (Tex. 1988) (addressing religious organizations exemption under section 11.20 of the Texas Tax Code for property owned by a church but leased to a for-profit business for commercial parking lot purposes).

For purposes of a religious organization property tax exemption, "a place of religious worship includes not only the sanctuary, but also those grounds and structures surrounding the sanctuary which are necessary for the use and enjoyment of the church." *City of Austin v. Univ. Christian Church*, 768 S.W.2d 718, 719 (Tex. 1988). But, the extent of the possible exemption is not boundless. In *Davies*—a decision that pre-dates the enactment of Section 11.20(e) (statutory definition of "religious worship")—the Episcopal Diocese of North Texas sought a religious organizations exemption for a 155-acre church camp. The trial court held that an open-air chapel and an acre surrounding it as well as the minister's residence with its surrounding acre of land were the only parts of the camp that were exempt. The Diocese failed to prove entitlement to an exemption to the remaining 153 acres. The court of civil appeals refused to hold that the evidence established as a matter of law that the entire tract was "an actual place of religious worship." The Texas Supreme Court affirmed. *See Davies*, 541 S.W.2d at 828-830.

The case of *City of Austin v. University Christian Church*, 768 S.W.2d 718, 719 (Tex. 1988) regarded a religious organization property tax exemption sought for parking spaces owned by the church. The court of appeals' opinion in *University Christian Church v. City of Austin* was reversed due to improper jury instruction and remanded by the Texas Supreme Court in *City of Austin v. University Christian Church*, 768 S.W.2d 718, 719 (Tex. 1988). But, the court of appeals' discussion on the evidence presented to support the issue of "primarily used as a place of religious worship" is illustrative of the effort that a religious organization should undertake to prove entitlement to a property tax exemption:

> A strong case can be made on behalf of the church. Dr. Ervin Crain, minister of the church, testified that the parking lots are used by those attending Sunday morning worship services, Sunday School, and other regular Sunday events such as evening worship and afternoon religious studies and socials. He further testified that the property is used extensively throughout the week by the church staff, and by those attending devotionals, college group meetings, choir practices, concerts, weddings, funerals, Texas Bible Chair classes held in conjunction with the University of Texas, as well as by congregation members seeking to meet with staff members or to use the chapel for private meditation and prayer. Floyd Savage and Hugh Eckols, long-time members of both the church and its governing board, substantially repeated this testimony. All three witnesses testified that all who participate in these activities depend on using the lots.
>
> The lots unquestionably serve purposes of primary importance to the religious institution. They are the essential means of providing access to the church building. They contain a total of approximately fifty spaces to

> serve three hundred members, comparable to the reasonable needs of the congregation, albeit inadequate. The evidence showed with almost no dispute that were it not for the two lots in question, this church could not continue, and that the availability of parking in this location is a vital component of the church's ministry for at least two reasons. First, the lots permit church members to utilize their sanctuary building and engage in church activities. Second, the lots play a role in attracting new members to the church. Four of appellant's five witnesses stated that the availability of parking has an impact on this congregation's growth comparable to other ministerial programs. Without the lots, the church probably could not pursue its ministry. Without the lots, the church might well have no ministry.

Univ. Christian Church v. City of Austin, 789 S.W.2d 361, 363–64 (Tex. App.—1990), *rev'd and remanded by*, *City of Austin v. Univ. Christian Church*, 768 S.W.2d 718, 721 (Tex. 1988) (finding that, at the trial court level, the jury instruction regarding whether the property in question was used primarily for religious worship was erroneous and thus required a remand).

Issue-Spotting Takeaway. Texas courts have repeatedly recognized a distinction between property used for religious purposes and property used as an actual place of religious worship. The distinction matters. When analyzing church property, counsel should ask questions such as:

1. Is worship the primary use of this property?
2. If the property has mixed uses, which use is dominant?
3. Can the organization document the religious use if challenged by the appraisal district?

As the parking lot cases demonstrate, even property that is not itself a sanctuary may qualify for exemption if it is reasonably necessary to support religious worship. Conversely, property that advances religious objectives may fail to qualify if it is not sufficiently connected to actual religious worship.

5. <u>Clergy Residence</u>

The Texas Constitution also provides, in part:

> [T]he legislature may, by general laws, exempt from taxation public property . . . actual places of religious worship, **also any property owned by a church or by a strictly religious society for the <u>exclusive use</u> as a dwelling place for the ministry of such church or religious society, <u>and which yields no revenue whatever to such church or religious society</u>; provided that such exemption shall not extend to more property than is reasonably necessary for a dwelling place and in no event more than one acre of land** . . . [.]

See TEX. CONST. art. VIII, § 2(a) (emphasis added).

Section 11.20(a)(3) of the Texas Tax Code provides that a religious organization is entitled to an exemption of "the **real property that is owned by the religious organization** and is reasonably necessary for use as a residence (but not more than one acre of land for each residence) if **the property**: (A) is used exclusively as a residence for those individuals whose principal occupation is to **<u>serve in the</u>** **<u>clergy *of the religious organization*</u>**; and (B) **produces no revenue for the religious organization**[.]" TEX. TAX CODE § 11.20(a)(3) (emphasis added).

Additionally, a religious organization is entitled to an exemption of the tangible personal property that is owned by the religious organization and is reasonably necessary for the use of the clergy residence. *Id.* at § 11.20(a)(4).

6. <u>Issue-Spotting Takeaway.</u>

Texas property tax exemption analysis often begins with the wrong question. The question is usually not whether the organization is religious, charitable, or exempt under Section 501(c)(3). The question is whether the organization can satisfy the specific requirements imposed by Texas law.

For churches and religious organizations, several practical questions should immediately come to mind:

1. Does the organization qualify as a "religious organization" under the Texas Tax Code?
2. Is the property owned by the organization claiming the exemption?
3. Is the property's primary use religious worship?
4. Is the property reasonably necessary to accomplish that purpose?
5. Has the property's use changed since the exemption was granted?
6. If a clergy residence is involved, are the constitutional and statutory requirements still being satisfied?

The church or religious organization that owns property in Texas should not take its potential exemption—or the continued availability of that exemption—lightly. Due care should be taken to ensure that the organization remains qualified as a "religious organization" under the Texas Tax Code and that its property continues to be used primarily as a place of actual religious worship as that concept has evolved through decades of Texas jurisprudence.

Accordingly, whenever a church acquires property, leases property, develops additional facilities, establishes a ministry campus, operates a camp or retreat center, or permits third-party use of its property, counsel should ask a simple question: *If the local appraisal district reviewed this exemption tomorrow, could we prove that the statutory requirements are satisfied?*

Many churches and religious organizations assume that federal tax exemption necessarily translates into exemption from Texas property taxes. It does not. Property-tax exemptions are strictly construed against the exemption and in favor of taxation, and local appraisal districts often take that principle seriously.

Federal tax exemption may keep Caesar at bay in Washington. It does not necessarily keep the county tax assessor off the property.

V. RENDER UNTO CEASER—BUT DON'T ENDORSE HIM: POLITICAL ACTIVITY CONSIDERATIONS

A. When the Pulpit Meets Politics – Political Activity

Churches and religious organizations frequently speak on matters that have political implications. Questions involving abortion, religious liberty, marriage, education, immigration, poverty, criminal justice, and other public issues often occupy both the public square and the pulpit. Consequently, practitioners are frequently asked whether a church risks its tax-exempt status by addressing political or legislative matters.

The answer is generally no.

Section 501(c)(3) does not prohibit churches from speaking on issues of public concern. Nor does it prohibit churches from educating congregants regarding legislation, encouraging civic participation, or advocating positions consistent with their religious beliefs. Indeed, many of the most significant social and political movements in American history involved active participation by religious organizations.

The principal limitation involves lobbying. Section 501(c)(3) provides that "no substantial part" of the activities of a charitable organization may consist of carrying on propaganda or otherwise attempting to influence legislation. *See* 26 U.S.C. § 501(c)(3) ("[N]o substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h))…"). Thus, churches may engage in some lobbying activity, provided it does not become a substantial part of the organization's overall activities.

Importantly, lobbying and political campaign intervention are not the same thing. Lobbying generally involves attempts to influence legislation, while political campaign intervention involves support for or opposition to a candidate for public office. A church may advocate for or against a bill without necessarily supporting or opposing a candidate.

Likewise, churches may conduct voter education programs, provide nonpartisan public education concerning issues, encourage civic engagement, and sponsor educational events addressing matters of public concern. *See* Rev. Rul. 2007-41, 2007-25 I.R.B. 1421. The critical consideration is whether those activities remain focused on issues rather than candidates.

Issue-Spotting Takeaway. When evaluating a church's involvement in public affairs, counsel should first determine whether the activity relates to:

1. Issues or legislation, or
2. Candidates for public office.

The distinction matters. Churches generally possess significant freedom to address public issues and advocate positions consistent with their religious beliefs. The greater legal risk arises when issue advocacy begins to resemble support for—or opposition to—a particular candidate.

Accordingly, whenever a church proposes a legislative advocacy campaign, public-policy initiative, voter-education effort, or similar activity, counsel should ask a simple question: *Are we talking about the issues, or are we talking about the candidates?*

B. Ceasar Says Keep Your Endorsements – The "Johnson Amendment"

Once the discussion shifts from issues to candidates, the Johnson Amendment enters the conversation.

Section 501(c)(3) of the Internal Revenue Code provides that an organization qualifying for tax-exempt status may not "participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office." *See* 26 U.S.C. § 501(c)(3). This prohibition—commonly known as the "Johnson Amendment"—remains federal law and has not been repealed.

For churches and religious organizations, the distinction is important. A church may generally speak on moral, social, and public-policy issues that intersect with its religious beliefs. The difficulty arises when commentary on issues becomes support for or opposition to a particular candidate for public office.

The IRS has long taken the position that a Section 501(c)(3) organization may not endorse candidates, oppose candidates, make contributions to political campaigns, publish statements favoring or disfavoring candidates, or otherwise participate in a political campaign. Unlike the lobbying restrictions applicable to public charities, this prohibition is generally understood to be absolute. The prohibition applies regardless of whether the activity occurs through sermons, publications, websites, social media accounts, newsletters, or other organizational communication channels.

At the same time, not every interaction with a political candidate is prohibited. Candidate appearances, educational forums, voter registration efforts, voter education programs, and get-out-the-vote activities may be permissible if conducted in a genuinely nonpartisan manner. See e.g., *See e.g.*, Rev. Rul. 2007-41, 2007-25 I.R.B. 1421 ("Providing a forum for candidates is not, in and of itself, prohibited political activity."). The manner in which the forum is provided could, however, result in prohibited political activity under the Johnson Amendment. The analysis is highly fact-specific.

The IRS considers all the facts and circumstances. For example, if a candidate is invited to appear at an official religious function in the candidate's capacity as a candidate for public office, the IRS considers factors such as:

1. "Whether the organization provides an equal opportunity to participate to political candidates seeking the same office;
2. Whether the organization indicates any support for or opposition to the candidate (including candidate introductions and communications concerning the candidate's attendance); and
3. Whether any political fundraising occurs."

Rev. Rul. 2007-41, 2007-25 I.R.B. 1421.

That Revenue Ruling was issued long before more recent renewed attention (and challenges) to the Johnson Amendment and its contours. In 2017, President Trump issued Executive Order 13798, which signaled his desire to repeal the Johnson Amendment. Although not entirely helpful due to its inclusion of "to the extent permitted by law" verbiage, the Order includes the following:

> "All . . . agencies . . . shall, to the greatest extent practicable and to the extent permitted by law, respect and protect the freedom of persons and organizations to engage in religious and political speech. In particular, the Secretary of the Treasury shall ensure, to the extent permitted by law, that the Department of the Treasury does not take any adverse action against any individual, house of worship, or other religious organization on the basis that such individual or organization speaks or has spoken about moral or political issues from a religious perspective, where speech of similar character has, consistent with law, not ordinarily been treated as participation or intervention in a political campaign on behalf of (or in opposition to) a candidate for public office by the Department of the Treasury. . . ."

Exec. Order No. 13,798, 3 C.F.R. 336 (2018). With President Trump back in office, the IRS will, presumably, take this approach to enforcement as well, but there is no guarantee on that.

Moreover, recent litigation challenging the Johnson Amendment generated significant attention regarding the ability of churches to discuss political candidates with their congregations. In 2025, the IRS took the position in proposed settlement documents that certain communications occurring between a house of worship and its congregation through customary channels of religious communication did not constitute prohibited political campaign intervention. However, subsequent developments in that litigation have left the broader legal effect of those positions uncertain, and the Johnson Amendment remains in force. Accordingly, churches and religious organizations should continue to evaluate political speech under existing statutory authority, Revenue Ruling 2007-41, and other applicable guidance.

Issue-Spotting Takeaway. The Johnson Amendment does not prohibit churches from discussing moral issues, public policy, legislation, elections, or matters of civic concern. It does prohibit Section 501(c)(3) organizations from participating or intervening in political campaigns for or against candidates for public office.

Accordingly, whenever a church or religious organization proposes to:

1. endorse a candidate;
2. oppose a candidate;
3. host a candidate forum;
4. distribute a voter guide;
5. publish election-related communications;
6. permit campaign activity on church property; or
7. use church resources in connection with an election,

Counsel should pause and ask a simple question: *Would a reasonable observer view this activity as supporting or opposing a particular candidate?*

If the answer is yes—or even maybe—the organization should proceed with caution.

Put differently, churches may speak to Caesar. The Johnson Amendment says they should not tell the congregation which Caesar to vote for.

VI. THE LABORER IS WORTHY OF HIS WAGES: EMPLOYMENT AND VOLUNTEER CONSIDERATIONS

A. Who Is a "Minister of the Gospel"? – Housing Allowances and Tax Considerations[8]

For many churches, the housing allowance is among the most significant tax benefits available to clergy. The issue-spotting challenge, however, is not usually determining whether a housing allowance exists. The challenge is determining who qualifies as a "*minister of the gospel*" for federal tax purposes.

The answer is not always as obvious as it may appear. Titles alone do not control, and federal tax law does not provide a comprehensive statutory definition of the term. As a result, churches frequently encounter questions involving associate pastors, chaplains, ministry leaders, denominational employees, religious educators, and workers serving ministries that are not themselves churches.

Before designating a housing allowance, counsel should therefore ask a threshold question: *Is this person a "minister of the gospel" for purposes of Section 107?*

Section 107 of the Internal Revenue Code sets forth a parsonage allowance for federal gross income tax purposes:

> "In the case of a minister of the gospel, gross income does not include—
>
> (1) the rental value of a home furnished to the minister as part of compensation; or
> (2) the rental allowance paid to the minister as part of the minister's compensation, to the extent used by the minister to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities."

I.R.C. § 107(1) and (2); *see* Treas. Reg. § 1.107-1(a).

This gross income exclusion applies to "a minister of the gospel" and includes either the rental value of a home furnished to the minister or a comparable rental allowance.

The rental value of a parsonage or the rental allowance is excludable only for income tax purposes. The minister must include the amount of the rental value of a parsonage or the rental allowance for social security coverage purposes. The exclusion also does not apply to the computation of self-employment tax. However, in addition to the exclusion discussed above, a minister may still claim deductions for mortgage interest or real property taxes on a separate, personally-owned home.

Neither Section 107, nor the applicable Treasury Regulations, define the term "minister" for these federal income tax purposes. The United States Tax Court has repeatedly stressed this fact:

> "There is no legislative definition in the statute of the phrase 'minister of the gospel' and the legislative history of *the statute contains no clear statement as to the meaning ascribed to the term 'minister of the gospel.' The Commissioner's regulations under section 107 do not attempt to define the term 'minister of the gospel'*."

See Lawrence v. Comm'r, 50 T.C. 494, 497 (1968) (emphasis added); *see also Congregation Ahavath Torah v. Englewood City*, 21 N.J.Tax 318 (2004), *Haimowitz v. Comm'r*, 73 T.C. Memo 1997-40 ("The regulations define only what a minister does, but not what a minister is.").

Whether an individual is "duly ordained, commissioned, or licensed" is a question on which government agencies must heavily defer to churches and church authority. "It is reasonably clear that the purpose of this reference in the regulations is to exclude self-appointed ministers…[b]ut there is in the regulations no test, or even a suggestion of it, that the ordination, commissioning, or licensing must come from some higher ecclesiastical authority." *See, e.g.*, *Salkov v. Comm'r*, 46 T.C. 190, 196 (1966).

"[M]inisterial authority can be conferred by the church or congregation itself. . . . If the statute and the regulations were so severely restrictive as to exclude ministers elected, designated, or appointed by a religious congregation, there would be a serious question in our minds as to propriety of such an exclusion under the Constitution of the United States." *Id.*

The Internal Revenue Code and Treasury Regulations provide a series of activities that are considered "duties of a minister." Treasury Regulation § 1.107-1 provides that specific services the performance of which will be considered duties of a minister for purposes of section 107 include:

1. The performance of sacerdotal functions;
2. The conduct of religious worship;
3. The administration and maintenance of religious organizations and integral agencies; and

[8] Much of this content was derived from the *Housing Allowance: What is a Minister of the Gospel?* article published by Freeman Law, PLLC, authored by Cory Halliburton, and available at https://freemanlaw.com/housing-allowance-what-is-a-minister-of-the-gospel/

4. The performance of teaching and administrative duties at theological seminaries.

In the context of reviewing Treasury Regulation § 1.107-1, "the ministerial duties which qualify a minister for the allowance exclusion is [*sic*] very broad, thereby including most practicing ministers." *See Warnke v. U.S.*, 641 F.Supp. 1083, 1088 (E.D. KY 1986). Treasury Regulation § 1.107-1 also states that "the rules provided in § 1.1402(c)-5 will be applicable to [determining whether services are considered the duties of a minister of the gospel]." 26 C.F.R. § 1.107-1(a). The regulations provide a set of rules in this regard:

1. Whether service performed by a minister constitutes the conduct of religious worship or the ministration of sacerdotal functions depends on the tenets and practices of the particular religious body constituting his church or church denomination.
2. Whether services performed by a minister in the control, conduct, and maintenance of a religious organization relate to directing, managing, or promoting its activities.
3. If a minister is performing service in the conduct of religious worship or the ministration of sacerdotal functions, such service is in the exercise of his ministry whether or not it is performed for a religious organization.

See 26 C.F.R. § 1.402(c)-5(b)(2).

These regulations were discussed at length by the Tax Court in *Wingo v. Commissioner*, 89 T.C. 64 (1987). The Tax Court summarized sections 1.107-1 and 1.402(c)-5 to create (basically) five factors:

1. Ministration of sacerdotal functions;
2. Conduct of religious worship;
3. Performing services in the control, conduct and maintenance of organizations within the congregation;
4. Whether the person is "duly ordained, commissioned, or licensed" (with only one of these being required); and
5. Whether the congregation itself considers the person to be a religious leader or minister (*i.e.*, whether the person is regarded as a spiritual official and leader in the faith).

Whether a worker for an organization that is not a "church" (or similar religious organization, such as a temple, synagogue, mosque, etc.) can be classified as a "minister" for federal income tax purposes is a more delicate and scrutinized analysis. As the Tax Court has noted, "[i]t is seldom the case that a minister who is working for a non-church organization is provided with a parsonage or residence." *Boyer v. Comm'r*, 69 T.C. 521, 524 (1977). The *Boyer* court further noted, "if a minister, pursuant to an assignment by his church, performs services for an organization which is neither a religious organization nor operated as an integral agency of a religious organization, all service performed by him, even though such service may not involve the conduct of religious worship or the administration of sacerdotal functions, is in the exercise of his ministry." *Id.* at 531.

The "assignment" to perform religious services must be significant. In the eyes of at least one Tax Court, "[m]ore is required than mere ordained status and the perfunctory ratification by religious authority of secular employment obtained by the minister for non-church-related reasons." *See id.* at 532.

If ever challenged by the IRS, or if the matter is presented to the Tax Court, a taxpayer seeking "minister of the gospel" status must be able to introduce credible evidence to show that the taxpayer is licensed, ordained, or commissioned (a required showing); performs sacerdotal functions; participates in the conduct or control of religious boards, societies, or other agencies related to the religious affiliation; or performs teachings or administrative duties at religiously affiliated institutions. The religious assignment generally must be directly related to accomplishing the purposes of the assigning religious organization.

Treasury Regulation section 1.1402(c)-5 provides the following examples that help identify those outside traditional minister roles who may qualify as ministers for federal income tax purposes. In these examples, either the specific duties of the minister or the assignment of duties by the religious organization generally determine whether the person qualifies as a minister for these purposes:

- Example 1: "M, a duly ordained minister, is engaged to perform service as chaplain at N University. M devotes his entire time to performing his duties as chaplain which include the conduct of religious worship, offering spiritual counsel to the university students, and teaching a class in religion. M is performing service in the exercise of his ministry."
- Example 2: "M, a duly ordained minister, is engaged by the N Religious Board to serve as director of one of its departments. He performs no other service. The N Religious Board is an integral agency of O, a religious organization operating under the authority of a religious body constituting a church denomination. M is performing service in the exercise of his ministry."
- Example 3: "M, a duly ordained minister, is assigned by X, the religious body constituting his

church, to perform advisory service to Y Company in connection with the publication of a book dealing with the history of M's church denomination. Y is neither a religious organization nor operated as an integral agency of a religious organization. M performs no other service for X or Y. M is performing service in the exercise of his ministry."

- Example 4: "M, a duly ordained minister, is engaged by N University to teach history and mathematics. He performs no other service for N although from time to time he performs marriages and conducts funerals for relatives and friends. N University is neither a religious organization nor operated as an integral agency of a religious organization. M is not performing the service for N pursuant to an assignment or designation by his ecclesiastical superiors. The service performed by M for N University is not in the exercise of his ministry. However, service performed by M in performing marriages and conducting funerals is in the exercise of his ministry."

26 C.F.R. § 1.1402(c)-5.

Issue-Spotting Takeaway. The housing allowance rules often begin with the wrong question. The question is not whether an individual works for a church or ministry. The question is whether the individual qualifies as a minister of the gospel for federal tax purposes.

When evaluating ministerial status, counsel should consider questions such as the following:

1. Has the individual been duly ordained, commissioned, or licensed?
2. Does the individual perform sacerdotal functions?
3. Does the individual conduct religious worship?
4. Does the individual exercise leadership or administrative authority within a religious organization?
5. Does the church or religious body regard the individual as a minister?
6. If the individual works outside a traditional church setting, is the work being performed pursuant to a bona fide religious assignment?

As the case law demonstrates, ministerial status depends less on job titles and more on religious functions. A person may work for a religious organization and not qualify as a minister for Section 107 purposes, while another person serving outside a traditional church setting may nevertheless qualify because of the nature of the religious duties being performed.

Accordingly, before excluding a housing allowance from income, churches should ask a simple question: *Could we explain and support this individual's ministerial status if the IRS asked us to do so tomorrow?*

The answer to that question is often more important than the housing allowance itself.

B. The Minister, the Employee, and the Courtroom – Employment Law Considerations

One of the most common mistakes churches and religious organizations make is assuming that the word *minister* has the same meaning in every legal context. It does not.

As discussed above, federal tax law uses the phrase "minister of the gospel" for purposes of housing allowances and other tax benefits. Employment law presents a different question. The issue is not whether an individual qualifies for a housing allowance. The issue is whether the individual is a minister for purposes of the First Amendment's ministerial exception.

That distinction matters because an individual who is not a minister for federal tax purposes may nevertheless be a minister for employment-law purposes. Conversely, an employee who qualifies for a housing allowance may not necessarily be treated as a minister in every employment-law context.

For churches and religious organizations, the ministerial exception is among the most important constitutional protections available. Rooted in the Religion Clauses of the First Amendment, the doctrine recognizes the right of religious organizations to select and supervise their ministers free from government interference.

1. Ministers and the Ministerial Exception

In the employment arena, the term "minister" is often broader than the phrase "minister of the gospel" used for federal income tax purposes. Musicians, teachers, ministry leaders, and other employees who perform important religious functions may qualify as ministers for purposes of the First Amendment and employment law even though they would not qualify for ministerial tax benefits. The significance of that distinction cannot be overstated. If an employee qualifies as a minister for purposes of the ministerial exception, the dispute often ends before it begins. In many circumstances, secular courts lack authority to second-guess a church's decisions concerning the selection, supervision, discipline, or removal of its ministers.

The First Amendment provides that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof." U.S. CONST. amend. I. The United States Supreme Court recognizes the right of religious organizations to control their internal affairs. *See Watson v. Jones,* 80 U.S. 679, 727 (1872). This right includes the freedom "to decide for themselves, free from state interference, matters of church government as well as those of faith and doctrine," *Kedroff v. St. Nicholas Cathedral,* 344 U.S. 94, 116 (1952), and the right of religious organizations to select their own leaders, *Serbian E. Orthodox Diocese v. Milivojevich,* 426 U.S. 696, 724-25 (1976).

These constitutional rocks protect the right of churches to decide matters of faith and doctrine without government intrusion. State interference in that sphere violates the free exercise of religion. Any attempt by government to dictate or influence such matters constitute one of the central attributes of an establishment of religion. The First Amendment outlaws such intrusion. *See Our Lady of Guadalupe Sch. V. Morrissey-Berru*, 140 S.Ct. 2049, 2060 (2020).

In *Hosanna-Tabor Evangelical Lutheran Church and School v. EEOC*, 565 U.S. 171 (2012), the United States Supreme Court discussed, at length, the issue of who constitutes a "minister" for employment law purposes. In *Hosanna*, the issue before the Court was whether a teacher at a religious school constituted a "minister" for purposes of determining whether she could bring an employment discrimination case. The Court acknowledged the existence of the so-called "ministerial exception", which is grounded in the Religion Clauses First Amendment and generally provides that ministers do not have the right to bring wrongful termination cases based on the church's right to determine who can act as a minister.

Following the *Hosanna-Tabor* decision, and pursuant to the above-noted constitutional foundations, the courts of appeals, including the Fifth Circuit Court of Appeals, uniformly recognize the existence of a "ministerial exception," grounded in the First Amendment that precludes application of secular employment laws to claims concerning the employment relationship between a religious institution and its ministers. *See Hosanna-Tabor*, 565 U.S. at 186 and n.2 (applying the exception to Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e *et seq.* and state anti-discrimination laws); *Shaliehsabou v. Hebrew Home of Greater Washington, Inc.*, 363 F.3d 299, 309 (4th Cir. 2004) (applying the ministerial exception to claims under the Fair Labor Standards Act, 29 U.S.C. § 201-219, and holding that a mashgiach – an inspector appointed by a board of rabbis to guard against violation of Jewish dietary laws – was a minister "for purposes of the ministerial exception to the FLSA because his primary duties included supervision and participation in religious ritual and worship, and his position is important to the spiritual mission of Judaism."); *Cannata v. Cath. Diocese of Austin*, 700 F.3d 169, 176 (5th Cir. 2012) (applying the exception to an un-ordained music director of a church and dismissing claims brought pursuant to the federal Age Discrimination in Employment Act and the Americans with Disabilities Act).

An employe's secular duties may not be overemphasized in the context of the ministerial exception, and the determination of minister status for the exception "is not one that can be resolved by a stopwatch." *See Hosanna-Tabor*, 565 U.S. at 194 ("The issue before us, however, is not one that can be resolved by a stopwatch. The amount of time an employee spends on particular activities is relevant in assessing that employee's status, but that factor cannot be considered in isolation, without regard to the nature of the religious functions performed and the other considerations discussed above."); *Cannata*, 700 F.3d at 178-79 (finding that the employee's lack of formal training in church doctrine was immaterial; "this is because the ministerial exception does not apply only to those who are ordained."). The Fifth Circuit Court of Appeals, in *Cannata*, summed up the crux of the exception well when it concluded its opinion:

> As Appellees [church employer] correctly observe, the church has the right to determine who will participate in its religious ceremonies. Even assuming Cannata was "merely" an accompanist, Appellees have established the importance of music to the celebration of Mass and Cannata's role in the service. Because Cannata performed an important function during the service, there is no genuine dispute that he played a role in furthering the mission of the church and conveying its message to its congregants. Accordingly, we conclude that Appellees have established that the ministerial exception applies and therefore bars Cannata's suit [under the Age Discrimination in Employment Act and the Americans with Disabilities Act] from proceeding further.

Cannata, 700 F.3d at 180.

Like other federal and state employment laws, the Fair Labor Standards Act does not apply to ministers serving in that capacity. *See Schleicher v. Salvation Army*, 518 F.3d 472, 478 (7th Cir. 2008) (applying ministerial exception to dismiss FLSA claims); *Shaliehsabou*, 363 F.3d at 309 (same); *Alcazar v. Corp. of the Catholic Archbishop of Seattle*, 627 F.3d 1288 (9th Cir. 2010) (en banc) (applying ministerial exception to state of Washington's minimum wage laws). This is consistent with the Department of Labor Wage and Hour Division's guidance, which provides: "Persons such as nuns, monks, priests, lay brothers, ministers, deacons, and other members of religious orders who serve pursuant to their religious obligations in the schools, hospitals, and other institutions operated by their church or religious order shall not be considered to be 'employees.'" WHD Field Operations Handbook § 10b03(b); *see* WHD Ltr. Opin. FLSA 2018-29 (2018).

In sum, the ministerial exception helps preserve a church's independent authority in employment matters which is far different than a church and "minister of the gospel's" prerogatives for federal income tax purposes.

Not every church employee, however, qualifies as a minister for purposes of the First Amendment. When an employee falls outside the ministerial exception, the analysis shifts from constitutional protections to the statutory exemptions and accommodations afforded religious organizations under federal employment laws.

2. Non-Ministers and Employment Law

The term "religion," as used in Title VII, "includes all aspects of religious observance and practice, as well as belief, unless an employer demonstrates that he is unable to reasonably accommodate to an employee's or prospective employee's religious observance or practice without undue hardship on the conduct of the employer's business." *See* 42 U.S.C. § 2000e(j).

The First Amendment of the United States Constitution provides, in part, that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof . . ." U.S. CONST. amend. 1. And, Title VII recognizes the religious rights afforded by the First Amendment, and so as not to infringe on that fundamental right, Title VII contains exceptions applicable to religious organizations:

> [Title VII's anti-discrimination provisions] . . . shall not apply . . . to a religious corporation, association, educational institution, or society with respect to the employment of individuals of a particular religion to perform work connected with the carrying on by such corporation, association, educational institution, or society of its activities.

42 U.S.C. § 2000e-1(a) (emphasis added).

Similarly, Title VII provides religious educational institutions an exemption from faith-based employment decisions:

> [I]t ***shall not*** be an unlawful employment practice for a school, college, university, or other educational institution or institution of learning ***to hire and employ employees of a particular religion if*** such school, college, university, or other educational institution or institution of learning is, in whole or in substantial part, owned, supported, controlled, or managed by a particular religion or by a particular religious corporation, association, or society, or if the curriculum of such school, college, university, ***or*** other educational institution or institution of learning is directed toward the propagation of a particular religion.

42 U.S.C. § 2000e-2(e)(2) (emphasis added).

A religious corporation, association, educational institution, or society is permitted to give preference in employment to individuals of a particular religion to perform work connected with the carrying on by that corporation, association, educational institution, or society of its activities. A religious entity may require that all applicants and employees conform to the religious tenets of such organization. However, a religious entity may not discriminate against a qualified individual who satisfies the permitted religious criteria, on the basis of his or her disability. *See* 29 C.F.R. § 1630.16.

Issue-Spotting Takeaway. Employment disputes involving churches frequently begin with the wrong question. The question is often not whether the church acted correctly as a matter of employment policy. The threshold question is whether the employee is a minister for purposes of the First Amendment.

When evaluating a position within a church or religious organization, counsel should ask:

1. Does the employee perform important religious functions?
2. Does the employee lead, teach, communicate, or advance the faith?
3. Does the employee participate in worship services or religious ceremonies?
4. Does the church hold the employee out as a spiritual leader?
5. Would the employee's role be important to the organization's religious mission?

As the Supreme Court has repeatedly emphasized, ministerial status is not determined by job titles alone. The focus is on the religious functions performed by the employee and the role the employee plays in carrying out the organization's mission.

For employees who do not qualify as ministers, many generally applicable employment laws remain applicable, subject to the protections afforded religious organizations under statutes such as Title VII. Accordingly, practitioners should avoid assuming that every church employee is a minister—or that no church employee is.

Put differently, before asking whether the church can win the lawsuit, counsel should first ask a more fundamental question: *Does the court have jurisdiction to hear it at all?*

C. The Sheep, the Shepherds, and the Volunteers – Volunteer Considerations

Volunteers are the lifeblood of many churches and religious organizations. From greeters and nursery workers to musicians, youth leaders, event coordinators, and ministry volunteers, churches frequently rely upon individuals willing to serve without compensation. That reliance, however, can create a recurring issue-spotting concern: *when does a volunteer stop being a volunteer and start becoming an employee?*

The answer matters because a well-intentioned effort to thank or reward volunteers can inadvertently trigger wage-and-hour, payroll tax, workers' compensation, unemployment, and other employment-law issues.

Pursuant to DOL regulations, a volunteer is basically an individual who performs service for civic, charitable, or humanitarian reasons, without promise, expectation, or receipt of compensation for services rendered. *See* 29 C.F.R. § 553.101 (definition for public agency volunteers). Other similar state and federal law definitions exist, mainly from court opinions. As a general rule, volunteers should not displace employees, and their service should be less than full-time.

Avoid transforming a volunteer into an employee. Gift cards are viewed as cash and, if given to a volunteer for services rendered, the organization may well transform a volunteer arrangement into an employment arrangement such that the value of the gift card must be recorded on IRS Form W-2 and other applicable employment withholding issues are triggered.

By transforming a volunteer to an employee, the organization may then trigger violations of the minimum wage requirements of the Fair Labor Standards Act and other employment laws. The only situation that might receive a head-nod for a gift card is where the organization may provide a gift card to a volunteer as a gift at a "volunteer appreciation" or similar celebratory event. Even then, however, the same federal income tax issues can be triggered. Gift cards should not be given at or near the time the services are rendered or in exchange for services.

Avoid performance schedules for incentive consideration. An organization is wise to not create an incentive system for providing volunteers anything of monetary value in exchange for a certain amount of services rendered. Such programs are (or will likely be) viewed as "disguised compensation."

If an incentive program is desired, consider ways that the organization can honor the service without giving things of more than *de minimus* monetary value (and not cash or gift cards). For example, public recognition, in the form of a feature or other article, announcement, or social media post about the person(s) and their volunteerism and faithful service for the ministry, volunteer-of-the-week, etc., specially-named awards, a volunteer recognition celebration/outing, networking event for volunteers, holiday gift basket or flowers.

Issue-Spotting Takeaway. Volunteer issues often begin with good intentions. Churches naturally want to recognize, encourage, and reward faithful service. The legal risk arises when appreciation begins to resemble compensation.

Accordingly, whenever a church or religious organization proposes to provide cash, gift cards, stipends, discounts, bonuses, performance incentives, or other items of measurable economic value to volunteers, counsel should pause and ask questions such as:

1. Is this recognition, or is this compensation?
2. Would a reasonable person expect payment in exchange for the services being rendered?
3. Are volunteers being rewarded based on hours worked, tasks completed, or performance benchmarks?
4. Has the organization created an arrangement that resembles an employment relationship?

As a general rule, volunteers should serve because they desire to support the ministry—not because they expect compensation in return. Recognition programs are generally safest when they emphasize appreciation, fellowship, and de minimis gifts rather than cash or cash equivalents.

Put differently, churches rarely get into trouble because they thanked a volunteer too much. They get into trouble when the volunteer begins to look less like one of the sheep following the shepherd and more like an employee awaiting a paycheck.

VII. LET ALL THINGS BE DONE DECENTLY AND IN ORDER: GOVERNANCE CONSIDERATIONS FOR RELIGIOUS CORPORATIONS

Many lawyers are surprised to discover that the Texas Business Organizations Code contains numerous provisions that apply specifically to religious corporations and churches. While Chapter 22 generally governs nonprofit corporations, the Legislature has recognized that churches often operate pursuant to governance structures, leadership models, and religious traditions that differ significantly from those of ordinary nonprofit organizations.

As a result, Chapter 22 contains church- and religious-organization specific provisions addressing membership, meetings, directors, officers, records inspection, governance authority, and related matters. These statutes can have significant consequences for church governance disputes, leadership transitions, congregational votes, and internal organizational authority. A summary schedule of selected Chapter 22 provisions applicable specifically to churches and religious organizations is included in the Appendix as a quick-reference issue-spotting tool.

Accordingly, practitioners advising churches should resist the temptation to assume that general nonprofit rules automatically apply. Frequently, Chapter 22 provides a different answer for religious corporations.

A. Who's Really in Charge Here? – Management Authority and Religious Governance

One of the most common assumptions made by church leaders is that authority within a church is obvious. Frequently, it is not.

Unlike many nonprofit corporations, churches and religious organizations operate under a wide variety of governance structures. Some are congregational. Others are elder-led. Still others are subject to denominational oversight, conferences, conventions, or associations. The governing documents may vest authority in members, directors, trustees, elders, bishops, councils, or other ecclesiastical authorities.

Recognizing this reality, Chapter 22 affords religious corporations considerable flexibility in structuring internal governance. For example, the management of a religious corporation may be vested in its members rather than a board of directors, and the authority of a board may be limited by the certificate of formation or bylaws. *See* TEX. BUS. ORGS. CODE § 22.202. Certain religious corporations may also have boards elected or controlled by conventions, conferences, or associations of churches. *See id.* § 22.207.

Chapter 22 further permits governance flexibility through committees. If authorized by the governing documents, a committee of a religious corporation may consist entirely of individuals who are not directors. *See id.* at § 22.218(b-1). In many nonprofit corporations, such an arrangement would be unusual. For religious organizations, however, this flexibility permits participation by elders, clergy, denominational representatives, and other religious leaders who may not formally serve as directors.

The Legislature has also recognized that religious governance often depends upon reliance on spiritual authority. Accordingly, directors and officers of religious corporations are expressly authorized to rely, in good faith, upon information and reports provided by religious authorities and clergy. *See id.* at §§ 22.222, 22.234.

These provisions reflect a broader principle found throughout Chapter 22: churches frequently operate differently than ordinary nonprofit corporations, and the law often accommodates those differences.

Issue-Spotting Takeaway. Governance disputes rarely begin with a disagreement about statutes. They usually begin with a disagreement about authority.

Accordingly, whenever a church considers a significant action—whether electing leaders, purchasing property, amending bylaws, removing members, affiliating with a denomination, adopting a policy, or responding to a dispute—counsel should ask question such as:

1. Who has authority to propose the action?
2. Who has authority to approve the action?
3. Who has authority to challenge the action?
4. Is the authority derived from the bylaws, the members, the board, the elders, the denomination, or some other organizational structure?

Put differently, before asking whether a decision was wise, practitioners should first determine whether the right people made it.

B. Members, Members Everywhere

One of the most common governance mistakes churches make is assuming that ecclesiastical membership and corporate membership are the same thing. They are not.

For many churches, "membership" is fundamentally a spiritual or ecclesiastical concept. Membership may involve doctrinal commitments, participation in the life of the church, pastoral oversight, or other religious considerations. Chapter 22, however, addresses a different question: who possesses governance rights within the corporation?

The distinction matters because corporate members may possess statutory rights relating to voting, governance, and organizational control that carry legal consequences. Depending upon the church's certificate of formation and bylaws, members may elect directors, approve major organizational actions, amend governing documents, approve mergers, or exercise other governance powers. *See* TEX. BUS. ORGS. CODE §§ 22.101, 22.202.

The issue becomes even more complicated in modern church structures. Multi-campus churches, online congregations, satellite campuses, and other nontraditional membership models often create uncertainty regarding who is entitled to participate in corporate governance. A church may have attendees spread across multiple campuses, individuals who primarily participate online, inactive members who remain on membership rolls, or members who occasionally attend different locations.

These questions may seem academic until a contested vote occurs. Leadership transitions, bylaw amendments, property transactions, denominational affiliations, and other major organizational decisions often require clarity regarding who qualifies as a voting member. In many governance disputes, the outcome turns not on the merits of the issue being voted upon, but on who was entitled to vote in the first place.

Membership disputes frequently arise because churches understandably focus on spiritual membership while paying less attention to the governance implications of membership status. Yet Chapter 22 often requires practitioners to examine the latter.

Issue-Spotting Takeaway. When the governing documents use the word "member," counsel should immediately ask: *Member of what?*

1. Does the church have statutory voting members?
2. Are ecclesiastical members and corporate members the same group?
3. Who is currently entitled to vote?
4. How is membership established, maintained, or terminated?
5. How are online, inactive, satellite-campus, or remote members treated?
6. Can the church identify its voting members if a contested issue arises tomorrow?

A congregation may have thousands of worshippers, hundreds of church members, and only a handful of individuals possessing statutory governance rights. Before advising on any governance question, practitioners should determine precisely who possesses legal authority to act on behalf of the corporation.

Put differently, before asking how the vote will turn out, counsel should first ask: *Who actually gets a vote?*

If the answer is unclear, the governing documents may deserve immediate attention.

C. The President, the Secretary, and the Pastor Walk into a Church Meeting – Officer Rules for Churches

Most nonprofit corporations operate through a relatively familiar officer structure consisting of positions such as president, secretary, and treasurer. Churches, however, often organize themselves differently. Some churches are governed by elders. Others operate under a congregational model. Still others rely upon pastors, trustees, deacons, bishops, councils, or other leadership structures rooted in their religious or denominational traditions.

Recognizing these realities, Chapter 22 provides churches with flexibility unavailable to many other nonprofit corporations. A church is not required to maintain officers in the manner generally required by Chapter 22. Instead, the duties and responsibilities ordinarily assigned to officers may be vested in the board of directors or another designated body as provided in the church's certificate of formation or bylaws. *See* TEX. BUS. ORGS. CODE § 22.233.

This flexibility allows churches to structure leadership in a manner consistent with their polity and religious practices. At the same time, it creates a practical governance challenge. Churches frequently evolve over time, and leadership structures that exist in practice do not always match the leadership structures described in the governing documents.

The issue becomes particularly important during leadership disputes, property transactions, banking relationships, contract execution, and litigation. In those situations, third parties often want to know a seemingly simple fact: who has authority to act on behalf of the church?

Issue-Spotting Takeaway. A surprising number of governance problems begin with a simple mismatch between what the bylaws say and how the church actually operates. Accordingly, churches should periodically compare their actual governance practices against their governing documents. Counsel should ask questions such as:

1. Does the church have officers?
2. If not, where have those duties been assigned?
3. Do the bylaws accurately describe the church's governance structure?
4. Who is authorized to sign contracts, borrow money, purchase property, or otherwise bind the church?
5. Would an outside third party be able to determine who possesses authority to act?

Put differently, before asking whether a church leader made the right decision, practitioners should first ask: *Did that person have authority to make the decision at all?*

D. Did Anyone Tell the Congregation—and Does the Vote Count? – Meetings, Notice, and Quorum

Many church disputes do not begin with theology, doctrine, or even disagreement over the merits of an issue. Instead, they begin with a more mundane question: Was the meeting properly called?

Chapter 22 contains several provisions that recognize the unique manner in which churches communicate and conduct business. Unlike many nonprofit corporations that rely primarily on written notices and formal meeting procedures, churches often communicate through announcements made during worship services or other congregational gatherings.

For example, if the management of a church corporation is vested in its members, the organizer who calls the initial organizational meeting may satisfy the notice requirement by making an oral announcement of the time and place of the meeting during a regularly scheduled worship service before the meeting. *See* TEX. BUS. ORGS. CODE § 22.104. Likewise, notice of a meeting of the members of a church is sufficient if given by oral announcement during a regularly scheduled worship service, unless the certificate of formation or bylaws provide otherwise. *See id*. § 22.156(b).

The statute's flexibility should not be mistaken for informality. Meeting notices, voting procedures, and quorum requirements frequently become the subject of litigation when leadership elections, bylaw amendments, property transactions, pastor transitions, mergers, affiliations, or other controversial matters are involved.

A meeting that is improperly noticed may result in challenges to actions taken at that meeting. Similarly, a vote conducted without the required quorum may be vulnerable to attack regardless of how overwhelming the result may have appeared.

Chapter 22 also provides default quorum rules. Unless the certificate of formation or bylaws provide otherwise, members holding one-tenth of the votes entitled to be cast constitute a quorum. *See id.* at § 22.159(a). The act of the members is generally determined by a majority of the votes entitled to be cast by members present or represented by proxy at a meeting where a quorum exists, unless a greater vote is required by law or the governing documents. *See id.* at § 22.159(b). Certain older congregational churches incorporated before May 12, 1959, are subject to a special quorum rule recognizing that members present at a properly noticed meeting constitute a quorum unless otherwise provided in the governing documents. *See id.* at § 22.159(c).

Practitioners should therefore avoid focusing solely on the outcome of a congregational vote. The validity of the process is often just as important as the substance of the decision.

Issue-Spotting Takeaway. Whenever a church plans to conduct a membership vote, elect leaders, amend bylaws, purchase or sell property, affiliate with another organization, or otherwise take significant corporate action, counsel should ask questions such as:

1. Was notice provided in the manner required by the bylaws and Chapter 22?
2. Can the church prove that notice was provided?
3. Who was entitled to vote?
4. Was a quorum present?
5. Was the required vote threshold satisfied?
6. Were proxies permitted and, if so, properly obtained?

Put differently, before asking whether the congregation made the right decision, practitioners should first ask: *Did the congregation validly make the decision at all?*

Practically, good meeting minutes, attendance records, announcements, and documentation often become critical evidence when governance disputes arise.

E. Show Me the Books – Records Inspection Rights

One of the most common requests church leaders receive during a disagreement is deceptively simple: "I want to see the records."

Whether the dispute involves finances, leadership decisions, membership actions, property transactions, compensation, or general concerns about church governance, requests for records often become a flashpoint. Practitioners familiar with ordinary nonprofit corporations may instinctively assume that statutory inspection rights apply. For churches, however, the analysis is different.

Chapter 22 generally provides inspection rights and related procedures for members of nonprofit corporations. Churches occupy a unique position. Section 22.355 expressly provides that the statutory inspection provisions contained in Sections 22.352, 22.353, and 22.354 do not apply to a religious institution that is a church, an ecclesiastical or denominational organization, or another established physical place of worship where religious services are the primary activity and are regularly conducted. *See* TEX. BUS. ORGS. CODE § 22.355.

However, Section 22.355 does not mention that churches are exempt or excepted from the requirements of Section 22.351, which provides: "A member of a corporation, on written demand stating the purpose of the demand, is entitled to examine and copy at the member's expense, in person or by agent, accountant, or attorney, at any reasonable time and for a proper purpose, the books and records of the corporation relevant to that purpose." On the other hand, the statutory right of inspection may be thwarted or denied in the event a church member's request for records touches upon or becomes improperly entangled with ecclesiastical concerns or governance of the church.

As a result, practitioners should resist the temptation to automatically apply ordinary nonprofit inspection rules to churches and other qualifying religious institutions. The absence of a statutory inspection right does not necessarily mean that no records must ever be produced, as indicated in Section 22.351. Instead, the analysis often shifts to other sources of authority, including the church's certificate of formation; the church's bylaws; policies and procedures adopted by the church; contractual obligations; denominational governance documents; and in some cases, court orders or litigation procedures.

The issue becomes particularly important during leadership transitions, membership disputes, financial controversies, pastor searches, and litigation. Frequently, the records request is not really about the records. It is about authority, trust, and governance.

Church leaders should likewise remember that not all records are created equal. Membership rolls, contribution records, pastoral counseling records, disciplinary materials, personnel files, and financial information may present different legal, practical, and ecclesiastical considerations.

Issue-Spotting Takeaway. When a request for records is received, counsel should resist answering the request immediately and instead begin by asking several threshold questions:

1. Is the requester a corporate member, church member, director, officer, employee, volunteer, or third party?
2. What specific records are being requested?
3. What authority is being asserted as the basis for the request?
4. Do the governing documents address inspection rights?
5. Does the request implicate privacy, clergy-penitent, employment, donor, or other sensitive information?
6. Is the church even subject to the statutory inspection provisions of Chapter 22?

Put differently, before asking what records should be produced, practitioners should first ask: *Why does this person believe he or she has a right to see them?*

That question often determines the outcome of the entire dispute. Not every church member possesses a statutory right to inspect corporate records, and not every request should be treated alike.

VIII. ABOVE REPROACH: ETHICAL CONSIDERATIONS FOR COUNSEL TO RELIGIOUS ORGANIZATIONS

Attached as Appendix 2 is a collection of **Select Texas Disciplinary Rules of Professional Conduct** to consider in all instances of legal representation. Through the discussion of the above content, the presenters intend to and will pepper in anecdotal and professional experience examples of how to apply a keen eye toward an ethical practice in the representation of churches and other religious organizations.

Appendix 1

Texas Business Organizations Code, Chapter 22 Religious Society / Church-Specific Statutes	
Tex. Bus. Org. Code §	**Statutes, Excerpts, or Summary**
§ 22.101	"A religious society . . . or a church may incorporate as a corporation governed by this chapter with the consent of a majority of its members. Those members shall authorize the organizers to execute the certificate of formation."
§ 22.104	If the management of a corporation is vested in a church corporation's members, the members shall hold the initial organization meeting on the call of an organizer. An organizer who calls the meeting shall, if the corporation is a church, make an oral announcement of the time and place of the meeting at a regularly scheduled worship service before the meeting.
§ 22.156(b)	"Notice of a meeting of the members of a corporation that is a church is sufficient if given by oral announcement at a regularly scheduled worship service before the meeting or as otherwise provided by the certificate of formation or bylaws of the corporation."
§ 22.159	"(a) Unless otherwise provided by the certificate of formation or bylaws of a corporation, members of the corporation holding one-tenth of the votes entitled to be cast, in person or by proxy, constitute a quorum. (b) The vote of the majority of the votes entitled to be cast by the members present or represented by proxy at a meeting at which a quorum is present is the act of the members meeting, unless the vote of a greater number is required by law or the certificate of formation or bylaws. (c) Unless otherwise provided by the certificate of formation or bylaws, a church incorporated before May 12, 1959, is considered to have provided in the certificate of formation or bylaws that members present at a meeting for which notice has been given constitute a quorum."
§ 22.202	"(a) The certificate of formation of a corporation may vest the management of the affairs of the corporation in the members of the corporation. If the corporation has a board of directors, the corporation may limit the authority of the board to the extent provided by the certificate of formation or bylaws. (b) A corporation is considered to have vested the management of the corporation's affairs in the board of directors of the corporation in the absence of a provision to the contrary in the certificate of formation, unless the corporation is a church organized and operating under a congregational system that:

	(1) was incorporated before January 1, 1994; and (2) has the management of its affairs vested in the corporation's members."
§ 22.207	"(a) The board of directors of a religious, charitable, educational, or eleemosynary corporation may be affiliated with, elected, and controlled by an incorporated or unincorporated convention, conference, or association organized under the laws of this or another state, the membership of which is composed of representatives, delegates, or messengers from a church or other religious association. (b) The board of directors of a corporation may be wholly or partly elected by one or more associations or corporations organized under the laws of this or another state if: (1) the certificate of formation or bylaws of the corporation provide for that election; and (2) the corporation has no members with voting rights."
§ 22.218(b-1)	"If a corporation is a religious institution and if provided by the corporation's certificate of formation or bylaws, a committee designated under this section may be composed entirely of persons who are not directors of the corporation."
§ 22.222	"A director of a religious corporation, in the discharge of a duty imposed or power conferred on the director, including a duty imposed or power conferred as a committee member, may rely in good faith on information or on an opinion, report, or statement, including a financial statement or other financial data, concerning the corporation or another person that was prepared or presented by: (1) a religious authority; or (2) a minister, priest, rabbi, or other person whose position or duties in the religious organization the director believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented."
§ 22.233	"A corporation that is a church is not required to have officers as provided by this subchapter. The duties and responsibilities of the officers may be vested in the corporation's board of directors or other designated body in any manner provided for by the certificate of formation or bylaws of the corporation."
§ 22.234	"An officer of a religious corporation, in the discharge of a duty imposed or power conferred on the officer, may rely in good faith and with ordinary care on information or on an opinion, report, or statement, including a financial statement or other financial data, concerning the corporation or another person that was prepared or presented by: (1) a religious authority; or (2) a minister, priest, rabbi, or other person whose position or duties in the religious organization the officer believes justify reliance and confidence and whom the officer believes to be reliable and competent in the matters presented."

§ 22.355	"Sections 22.352, 22.353, and 22.354 [recording statutory records inspection procedures and requirements] do not apply to: . . . (4) a religious institution that is a church, an ecclesiastical or denominational organization, or another established physical place for worship at which religious services are the primary activity and are regularly conducted [.]"
Subchapter I – Church Benefits Boards §§ 22.401-.409	Addressing subjects of benefits and pensions, contributions, powers to act as trustee, documents and agreements, indemnification, and assignment of benefits of church benefits boards that provide for funding a plan or program to provide retirement benefits, welfare benefits, or both for the ministers or employees of a church or a conference, convention, or association of churches and that is controlled by or affiliated with a church or a conference, convention, or association of churches.

Appendix 2

Select Texas Disciplinary Rules of Professional Conduct	
Rule	**Content or Summary**
Preamble, Sections 1-5 **(quoted)**	1. A lawyer is a representative of clients, an officer of the legal system and a public citizen having special responsibility for the quality of justice. Lawyers, as guardians of the law, play a vital role in the preservation of society. The fulfillment of this role requires an understanding by lawyers of their relationship with and function in our legal system. A consequent obligation of lawyers is to maintain the highest standards of ethical conduct. 2. As a representative of clients, a lawyer performs various functions. As advisor, a lawyer provides a client with an informed understanding of the client's legal rights and obligations and explains their practical implications. As advocate, a lawyer zealously asserts the clients position under the rules of the adversary system. As negotiator, a lawyer seeks a result advantageous to the client but consistent with requirements of honest dealing with others. As intermediary between clients, a lawyer seeks to reconcile their divergent interests as an advisor and, to a limited extent, as a spokesperson for each client. A lawyer acts as evaluator by examining a client's affairs and reporting about them to the client or to others. 3. In all professional functions, a lawyer should zealously pursue client's interests within the bounds of the law. In doing so, a lawyer should be competent, prompt and diligent. A lawyer should maintain communication with a client concerning the representation. A lawyer should keep in confidence information relating to representation of a client except so far as disclosure is required or permitted by the Texas Disciplinary Rules of Professional Conduct or other law. 4. A lawyer's conduct should conform to the requirements of the law, both in professional service to clients and in the lawyer's business and personal affairs. A lawyer should use the law's procedures only for legitimate purposes and not to harass or intimidate others. A lawyer should demonstrate respect for the legal system and for those who serve it, including judges, other lawyers and public officials. While it is a lawyer's duty, when necessary, to challenge the rectitude of official action, it is also a lawyer's duty to uphold legal process. 5. As a public citizen, a lawyer should seek improvement of the law, the administration of justice and the quality of service rendered by the legal profession. As a member of a learned profession, a lawyer should cultivate knowledge of the law beyond its use for clients, employ that knowledge in reform of the law and work to strengthen legal education. A lawyer should be mindful of deficiencies in the administration of justice and of the fact that the poor, and sometimes persons who are not poor, cannot afford adequate legal assistance, and should therefore devote professional time and civic influence in their behalf. A lawyer should aid the legal

	profession in pursuing these objectives and should help the bar regulate itself in the public interest.
Rule 1.01 **Competent and Diligent Representation**	(a) A lawyer shall not accept or continue employment in a legal matter which the lawyer knows or should know is beyond the lawyer's competence, unless: (1) another lawyer who is competent to handle the matter is, with the prior informed consent of the client, associated in the matter; or (2) the advice or assistance of the lawyer is reasonably required in an emergency and the lawyer limits the advice and assistance to that which is reasonably necessary in the circumstances.
Rule 1.06 **Conflict of Interest: General Rule**	(a) A lawyer is prohibited from representing opposing parties in the same litigation. (b) Except where proper disclosure is made to and consent is received from a client pursuant to Rule 1.06(c), a lawyer shall not represent a person if the representation of that person: (1) involves a substantially related matter in which that person's interests are materially and directly adverse to the interests of another client of the lawyer or the lawyer's law firm; or (2) reasonably appears to be adversely limited by the lawyer's or law firm's responsibilities to another client or to a third person or by the lawyer's or law firm's own interests.
Rule 1.12 **Organization as a Client**	(a) A lawyer employed or retained by an organization represents the entity. While the lawyer . . . may report to . . . an entity's . . . authorized constituents, in the situations described in paragraph (b) the lawyer shall proceed as reasonably necessary in the best interest of the organization without involving unreasonable risks of disrupting the organization and of revealing information relating to the representation to persons outside the organization. (b) A lawyer representing an organization must take reasonable remedial actions whenever the lawyer learns or knows that: (1) an officer, employee, or other person associated with the organization has committed or intends to commit a violation of a legal obligation to the organization or a violation of law which reasonably might be imputed to the organization; (2) the violation is likely to result in substantial injury to the organization; and (3) the violation is related to a matter within the scope of the lawyers representation of the organization.
Rule 2.01 **Advisor**	"In advising or otherwise representing a client, a lawyer shall exercise independent professional judgment and render candid advice."
Rule 6.05	(a) The conflicts of interest limitations on representation in Rules 1.06, 1.07, and 1.09 do not prohibit a lawyer from providing, or offering to provide, limited pro bono

	legal services unless the lawyer knows, at the time the services are provided, that the lawyer would be prohibited by those limitations from providing the services. (b) Lawyers in a firm with a lawyer providing, or offering to provide, limited pro bono legal services shall not be prohibited by the imputation provisions of Rules 1.06, 1.07, and 1.09 from representing a client if that lawyer does not: (1) disclose confidential information of the pro bono client to the lawyers in the firm; or (2) maintain such information in a manner that would render it accessible to the lawyers in the firm. (c) The eligibility information that an applicant is required to provide when applying for free legal services or limited pro bono legal services from a program described in subparagraph (d)(1) by itself will not create a conflict of interest if: (1) the eligibility information is not material to the legal matter; or (2) the applicant's provision of the eligibility information was conditioned on the applicant's informed consent that providing this information would not by itself prohibit a representation of another client adverse to the applicant. (d) As used in this Rule, "limited pro bono legal services" means legal services that are: (1) provided through a pro bono or assisted pro se program sponsored by a court, bar association, accredited law school, or nonprofit legal services program; 89 (2) short-term services such as legal advice or other brief assistance with pro se documents or transactions, provided either in person or by phone, hotline, internet, or video conferencing; and (3) provided without any expectation of extended representation of the limited assistance client or of receiving any legal fees in that matter. (e) As used in this Rule, a lawyer is not "in a firm" with other lawyers solely because the lawyer provides limited pro bono legal services with the other lawyers.