Should Churches Incorporate and Seek IRS Recognition of 501(c)(3) Status?

A client recently brought to my attention a website article that said that churches should not be “501(c)(3) corporations.” It contained dire warnings about Big Brother muzzling the church if it becomes a 501(c)(3) organization. The article contained numerous factual errors and a considerable amount of confusion about the issues involved. I see these same misunderstandings surface from time to time, usually when a member of a congregation is trying to understand some of the legal work we are doing for a church and searches the Internet and finds these unreliable websites. In this article, I will address the most common misunderstandings in order to put the unfounded fears to rest. The comments addressed to “churches” in this article are applicable to other similar religious organizations including synagogues, temples, and the like.

When you hear the phrase “501(c)(3) corporations,” you need to keep in mind that such a term is actually a blend of two legal concepts. There is technically no such thing as a 501(c)(3)-type corporation. When something is called a “501(c)(3) corporation” this means that the organization is both a corporation and that it has a tax exemption under Internal Revenue Code section 501(c)(3). A corporation is a creation of state law. Each state has one or more corporation statutes and these allow for the creation and operation of corporations as legal entities with various powers. The not-for-profit corporation is a common corporate structure for churches to use. However, 501(c)(3) status is a matter of federal tax law, not state law. The two issues are independent. For example, an unincorporated organization can be a 501(c)(3) organization under federal tax law. A corporation, even a not-for-profit corporation, does not necessarily have 501(c)(3) tax exempt status. So we need to address the two issues separately rather than allow them to be tangled together.

Section 501(c) of the Internal Revenue Code lists many different categories of exempt organizations. These include civic leagues, social welfare organizations, and local associations of employees, labor, agricultural, and horticultural organizations, business leagues, chambers of commerce, real estate boards, social and recreational clubs, teachers’ retirement fund associations, cemetery companies, black lung benefit trusts, and many more.

Income received by tax-exempt organizations in respect of their exempt purposes is generally exempt from income tax. But only contributions to 501(c)(3) organizations are deductible to the donors. The 501(c)(3) category includes religious, educational, charitable, and scientific organizations. Churches fit naturally into the “religious” category.
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Should a church incorporate?

Some people believe that a church should not incorporate. They fear that incorporation gives the government a means to censor the church’s message or otherwise intrude into the affairs of the church. There may be valid reasons to fear government intrusion, but incorporating does not give the government an increased hand in the church’s affairs or make it easier to censor the church’s message. Whether the church incorporates or not, it will be subject to certain laws such as laws related to holding funds for charity or employment laws. Other than simple annual filings necessary to keep a corporation in existence, incorporation does not bring any significant increase in regulation to a church. Instead, incorporation provides significant benefits.

If a church does not incorporate, it is most likely something we call an “unincorporated association.” Beginning operations as an unincorporated association is relatively easy. People simply come together for a purpose. Little or no structure is required. The association may have a “constitution” to establish certain operational rules. But opening a bank account for the association, signing a lease, borrowing money, or buying property can be difficult and risky. There is no “entity level” protection in an unincorporated association, so if there are any liabilities (from missed payments or lawsuits, for example) the members, collectively and individually, can be held personally liable. It is often unclear who owns church property, which could make it easier for ill-intentioned persons to abscond with the property.

There is no question that it is better to incorporate, if possible. The corporation will shield the individual members from liability that rightly should attach to the entity and will make it easier and safer to open a bank account and engage in transactions such as entering into a lease, commercial loan, or real estate purchase.

In Illinois, churches have a choice of two corporation laws under which to incorporate (the Religious Corporation Act and the Not-for-Profit Corporation Act). But in either case, these are corporations. It is beyond the scope of this article to discuss the pros and cons of the two different corporate statutes available in Illinois under which to incorporate.

Churches are 501(c)(3) tax exempt organizations by default

Some people believe that churches should not be 501(c)(3) organizations. They fear that churches will have to waive their first amendment freedom of speech rights in order to qualify as a 501(c)(3). This fear is unfounded. First, many people do not realize that any organization that is properly classified as a church is automatically deemed to be tax exempt under section 501(c)(3) of the Internal Revenue Code, whether they have applied for IRS recognition of their 501(c)(3) status or not. Churches may apply for IRS recognition of their exempt status (and receive what is called a “determination letter”), but they are not required to do so.
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There are some advantages to seeking a letter from the IRS determining that the church is exempt under 501(c)(3). An IRS determination letter can aid the church in proving it qualifies for certain exemptions from local real estate transfer taxes, property taxes, or sales and use taxes. A determination letter can also be very useful to a member of the congregation who is being audited and must prove that his contributions to the church were in fact deductible.

The perception that being 501(c)(3) means forfeiting a first amendment right to free speech is probably a misunderstanding of the restrictions on all 501(c)(3) organizations, not just churches, prohibiting them from engaging in any political campaigns. In addition to the prohibition from engaging in political campaigns, 501(c)(3) organizations must not engage in any substantial amount of lobbying. Certain organizations can engage in political campaigning or lobbying, but if they do so, they cannot claim the benefits of 501(c)(3) status. This is certainly not a restriction on free speech in any direct way, but merely a requirement to claim a tax benefit. The limitation applies to all churches, whether they have asked the IRS to issue a ruling that they are exempt under section 501(c)(3) or not. Churches can exercise free speech on moral and religious issues without crossing the line into engaging in political campaigns. Those churches that have a desire to publish voter’s guides should seek experienced legal counsel to help them avoid crossing that line.

I can certainly understand the fear of increasing government regulation, especially under the current environment. But the reality is that churches (and other similar religious organizations) are still afforded a place of relative privilege under the law. Among all types of tax exempt organizations, 501(c)(3) organizations are the most privileged in that donations to them are deductible to the donors. Churches are one of only a very few types of 501(c)(3) organizations that have the benefit of being deemed to be 501(c)(3) by default, without having to file the lengthy and complicated application other types of organizations must file. How long these privileges last may depend on the kinds of people we elect to political office.

Our law firm concentrates on helping churches and other religious organizations claim all the legal privileges they are entitled to. If your organization is in need of legal counsel, please contact us.

By David L. Bea

The foregoing article was provided for general information and must not be relied on as legal advice for any specific situation. The attorneys of David L. Bea & Associates are highly experienced in legal issues affecting churches. If you have any questions, please don’t hesitate to contact us.