

10 Fundamentals of Forming a Church



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Introduction



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Introduction

Churches give followers of Christ the opportunity to worship together, grow in faith, and meet the needs of the local community. Although churches are formed for spiritual purposes, there are also practical legal and financial consequences that arise when organizing a church. This resource is intended to deal specifically with a number of those common issues.

While many of the guidelines pertaining to forming a charitable organization also apply when forming a church, there are notable differences described in this resource that apply when forming a church.

The earliest lawmakers in the United States recognized just how important churches are to the community and that churches serve an eternal purpose unique and separate from that of government. As a result, the Constitution specifically guarantees churches distinct legal rights from other private associations and the freedom to worship without undue government interference.

Because churches are guaranteed unique rights and freedoms than other charitable organizations, it is important to determine at the outset whether an organization being formed indeed qualifies for church status under the law. Congress and the Internal Revenue Service (“IRS”) have not provided an exact legal definition of the term “church”; however, the IRS commonly considers 14 non-exclusive criteria when deciding whether an organization should be classified as a church:

- Distinct legal existence
- Recognized creed and form of worship
- Definite and distinct ecclesiastical government
- Formal code of doctrine and discipline
- Distinct religious history
- Membership not associated with any other church or denomination
- Organization of ordained ministers
- Established places of worship
- Literature of its own

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- Ordained ministers selected after completing prescribed courses of studies
 - Regular congregations
 - Regular religious services
 - Sunday schools for religious instruction of the young
 - Schools for preparation of its ministers

The primary difference between churches and other 501(c)(3) tax-exempt organizations is that churches are not required to file for recognition of tax-exempt status. Organizations operating as churches (based on the 14 common criteria) are automatically exempt from federal income tax and do not need to file the Form 1023, Application for Recognition of Exemption, although many choose to do so for reasons discussed later.

Another major difference is that churches are not required to file an annual report to the IRS (Form 990, Return of Organization Exempt From Income Tax). Unless an exception applies, most charitable organizations are required to file the Form 990 each year. The Form 990 is made available for public inspection.

Despite these major differences, churches must still make certain filings concerning unrelated business income, the operation of private schools, payroll tax, sales tax, and any other local reporting requirements that do not provide specific exemptions for churches.

Churches, like all other nonprofit organizations, must be organized primarily for a tax-exempt purpose to be recognized under Section 501(c)(3). Churches generally have no trouble meeting this standard because they are automatically considered tax-exempt as serving religious purposes. In addition to being organized for religious purposes, churches are also often organized for other lawful tax-exempt purposes such as education and charity.

The benefits of 501(c)(3) status are that churches do not have to pay income taxes and are authorized to issue tax-deductible receipts to donors for contributions. As discussed later, this status may be at risk, however, if the church is used to provide unlawful private benefit to those who founded or operate the church.

The following information specific to the church formation process.

Develop and convey the church's vision



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Develop and convey the church's vision

One of the most fundamental places to begin the formation process is to solidify what the vision is for the church and how to best convey the vision. This step is crucial in the success of an organization because the founder's role will be one of gathering others around the vision and rallying them to implement it whether it is through contributions, volunteering, or serving the church in various ways.

Mission drift can occur for various reasons—often from a lack of focused direction, which can then spiral into a church's demise. It is therefore important that the church's vision and mission are firmly grounded before the church is launched. This is not to say that a mission statement is to be a constraint to growth, but rather that a well-crafted vision will inspire growth and keep that growth focused.

Find the right advisors



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Find the right advisors

Where does a church start in the church formation trek?

First and foremost, seek advice. Find one or more wise counselors. It's biblical—in a multitude of counselors, there is safety (Prov. 24:6).

As noted nonprofit attorney Bruce Hopkins says, “The label nonprofit does not mean ‘no planning.’” This caution certainly applies to churches. An experienced advisor can be a great resource to the founder in formation and operational issues. A review of significant issues by a professional is often desirable to navigate the statutory, tax, and accounting rules pertaining to churches.

It may only take one individual to incorporate in your state. But, it usually takes more than a few people to get most churches up and running.

Measuring the cost of filing for recognition of tax-exempt status



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Measuring the cost of filing for recognition of tax-exempt status

The Internal Revenue Code provides an automatic federal tax exemption for churches and the application process is often expensive. Preparing a Form 1023 can easily cost several thousands of dollars—in addition to the user fee charged by the IRS. Based on the legal counsel you receive, you may decide it is not worth the time and money to file an official application for recognition of exemption.

Determine the style of governance and board size



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Determine the style of governance and board size

The style of governance chosen will determine how a church's bylaws are written.

The first question to ask is whether a church should require its board members to be independent. ECFA's Standard 2 requires board independence.

While there are some variations, the two basic governance styles for churches are membership style and self-perpetuating style:

- **Membership style.** The membership style is popular among many churches. In the most typical membership governance style, members have the authority to elect board members and change the bylaws.

While the membership style provides representation broader than a church board, there are challenges that accompany this style of governance. It can be awkward to manage

competing interest of members and the church board. It can also be difficult to persuade a large membership group to make fundamental changes in governing documents.

- **Self-perpetuating style.** In this style, the board generally has the power to elect board members and change governing documents.

Board size is also an important issue. Many church bylaws give the church flexibility in determining board size, e.g., "The board shall be comprised of between three and nine board members." If this approach is followed, a church may start with a smaller board and increase as the organization grows. (Bylaws that specify an exact number of board members, e.g., "There shall be seven board members," establish a very inflexible restriction and this should be avoided unless state law requires this approach.)

Prepare church organizing documents



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Prepare church organizing documents

Developing organizing documents is a fundamental next step after deciding in which state the church will be formed. While incorporation is usually desirable, it generally is not mandatory.

To apply for recognition of tax-exempt status, a church must submit a conformed copy (a copy that agrees with the original document and all amendments to it) of its Articles of Incorporation (and the Certificate of Incorporation, if available), Articles of Association, Trust Indenture, Constitution, or other enabling document. If the organization does not have an organizing document, it will not qualify for recognition of exempt status.

Bylaws alone are not organizing documents; however, if the church has adopted bylaws, include a current copy with the Form 1023 application. It is advisable to begin keeping these important documents in a corporate records book.

Religious discrimination in hiring is allowed for churches and religious organizations (or parachurch nonprofits) according to Title VII of the Civil Rights Act of 1964. The Supreme Court unanimously affirmed this principle in the 2012 case *Hosanna-Tabor v. EEOC*.

Obtain the employer identification number (EIN)



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Obtain the employer identification number (EIN)

Although churches are not required to incorporate or file for recognition of federal tax-exempt status with the IRS, every newly formed church must obtain its own employer identification number. The EIN, which is also sometimes referred to as a taxpayer identification number, is required to do even the most basic business as an organization, for example, opening the church's first bank accounts.

The IRS assigns an EIN after a church properly completes and files Form SS-4. A good time to file Form SS-4 is when the church's organizing documents have been completed.

There is often confusion about when a church has a tax-exempt number. The employer identification number is not a tax-exempt number. The EIN has nothing to do with tax-exempt status; it is simply the church's unique identifier in the IRS's records, similar to an individual's social security number.

Structure the organization
to avoid private inurement
and private benefit



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Structure the organization to avoid private inurement and private benefit

The basic private inurement principle is to ensure that a 501(c)(3) organization is serving public interests, not private interests. A church must not be organized or operated for the benefit of private interests (the founder of the church, his or her family, persons controlled by private interests, or any persons having a personal and private interest in the activities of the church.)

The private benefit concept is broader than private inurement and it can operate without the involvement of an insider. This concept may apply even when the beneficiary is a for-profit corporation.

Address charitable contribution issues



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Address charitable contribution issues

Because churches are automatically considered tax-exempt organizations, a newly-formed church may begin issuing charitable receipts to donors as soon as the organization starts functioning as a church (based on the 14 criteria for churches outlined earlier).

(See ECFA Standard 7, which relates to issues associated with charitable contributions.)

Address administrative issues



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Address administrative issues

The following administrative issues are very important:

- **Determine your accounting system and related controls.**

Many churches start with a very simple accounting system. (See ECFA Standard 3.) If a significant number of donations will be received, it is also important to use an electronic donor management system (see below).

It is vital to establish sound accounting and internal control systems. Procedures or internal controls are generally the most cost effective means to avoid fraud, lawsuits and self-dealing. (See ECFA Standard 4.) Furthermore, these will allow the church to transition smoothly as its personnel expands. Here are a few basic concepts:

- **Cash and other revenues.** When one individual has control over an entire accounting transaction, fraud is possible. Segregate employee duties to prevent most types of theft. At minimum, the following duties should be segregated: collecting cash; preparing bank deposits;

reconciling bank statements; and posting receipts to the general ledger/contribution system.

- **Expenditures.** At a minimum the following duties related to expenditures should be segregated: approval of expenditures; writing checks; and signing checks.

- **Donor management systems.** A donor management system will assist the church in building and using its donor database. Such systems enable the tracking of contributions and receipting. It is also important to track restricted contributions as a failure to use the funds as instructed could irritate donors and violate state law.)

- **Policies.** It will be important as the church expands to ensure there are sufficient policies to have uniform momentum between employees and the organization as a whole. While organizational policies may not be a priority at formation, they should be considered during these initial steps and adopted as applicable.

The following policies are relevant:

▸ **Ensuring biblical financial and other operations.**

“Devise methods to confirm that the financial and other operations of the ministry are conducted in a manner which reflects generally accepted biblical truths and practices.”

▸ **Board independence.** Ensure that members of the board of directors are those who will make decisions in the best interests of the organization, as opposed to decisions benefitting their personal interests. (See Board Independence.)

▸ **Conflict of interest policy.** Churches are asked in the Form 1023 if they have a written conflict of interest policy. Consider having all board members agree to a policy that they will take proper precautions should a conflict of interest arise. (See ECFA Standard 6.)

▸ **Whistleblower policy.** Put in place procedures where a whistleblower can confidentially report improper activity. A church should communicate the procedures to employees in a written policy

▸ **Document retention and destruction policy.**

A church's document retention policy should ensure that necessary records and documents are adequately protected and maintained as well as discarded at the proper time.

▸ **Compensation approval of senior church staff.**

A major challenge to church boards is carefully establishing and documenting the compensation process for senior church staff process and then balancing fair and reasonable compensation within the budgetary constraints of the organization.

▸ **Payment of benefits rules.** It is important to have a policy related to certain benefits paid to employees toward personal services (services for the personal benefit of employees).

▸ **Gift acceptance guidelines.** It is wise to set up guidelines for deciding when to accept non-cash contributions.

Determine required filings
with federal, state, and local
governments



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Determine required filings with federal, state, and local governments

Although exempted from Form 990, your church may be subject to a variety of other filing requirements. If the church has at least one employee, there are Form 941 and W-2 filings. If the church has at least one independent contractor to whom it has paid \$600 or more in a calendar year, the church must file Forms 1099-MISC and 1096. (See ECFA Standard 5.)

Each year, churches that have \$1,000 or more of unrelated business income (“UBI”) must file Form 990-T, Exempt Organization Business Income Tax Return. Also, consider adopting a sample UBI policy.

Summary



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An excellent time to adopt fundamental and biblically-based standards is at a church's inception. (See ECFA Standard 1.) Even if a church is not yet a member of ECFA, the organization can follow ECFA's Standards of Responsible Stewardship found on ECFA's website (ECFA.org).

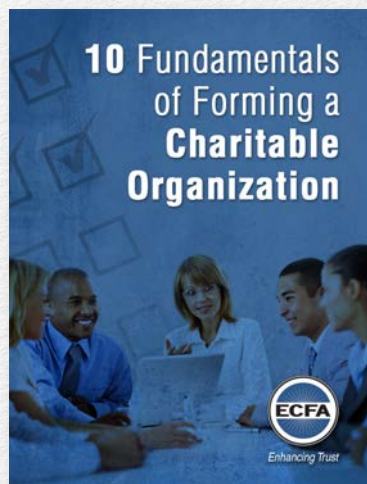
While there are a host of other issues that may be important for you to consider early in the development of your church (use of the Internet, lobbying, political activities, liability insurance, proper fundraising techniques, and much more), this list of 10 fundamentals covers some of the most basic issues.

Resources

- Zondervan Church and Nonprofit Tax & Financial Guide, Dan Busby and John Van Drunen
- "Financial Information for Nonprofit Managers," Part I: Compliance (Anderson University & ECFA)
- "Tax-Exempt Status for Your Organization," which provides information about filling out Form 1023 (IRS Publication 557)
- "Tax on Unrelated Business Income of Exempt Organizations" (IRS Publication 598)

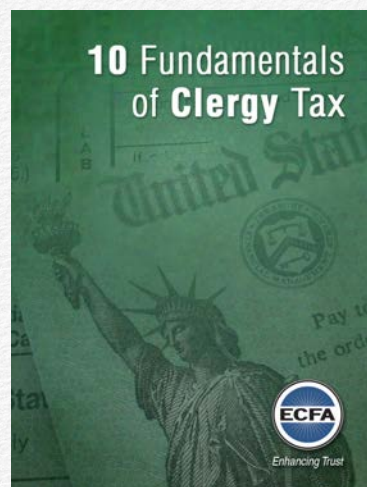


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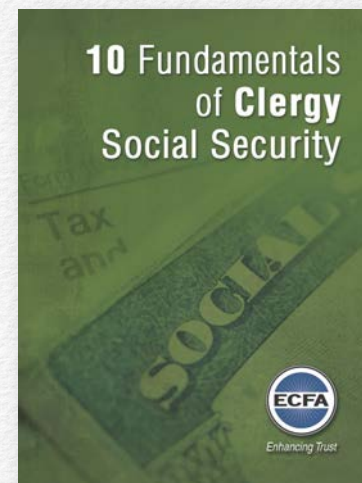
10 Fundamentals of Forming a Charitable Organization

Tens of thousands of new nonprofits are formed each year. Of those applying for tax-exempt status with the IRS, about three out of four applications are approved. When forming a new nonprofit, there are some fundamental issues to consider before starting the process. This book provides an easy-to-read guide to the ten fundamental issues related to starting a new nonprofit organization.



10 Fundamentals of Clergy Tax

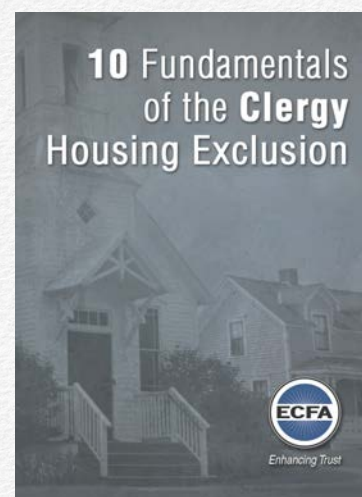
This book provides a cogent overview of the ten most basic fundamentals of clergy tax. Clergy who understand these ten fundamentals will have a better understanding of the Federal tax issues impacting them. Some of these crucial issues include the clergy housing allowance, expense reimbursements, social security tax and more.



10 Fundamentals of Clergy Social Security

Clergy social security is one of the most complicated issues for many clergy in the U.S. It all starts with two types of social security—and a minister might be subject to both types of social security in the same tax year. The tax forms do not provide a convenient way to calculate the amount subject to social security tax—and this is just the

beginning of the challenges facing clergy. If you understand the ten fundamentals discussed in this book, you will have a good grasp of the social security basics that are often puzzling to ministers.



10 Fundamentals of the Clergy Housing Exclusion

The clergy housing exclusion provides an income tax advantage to nearly every member of the clergy—in some instances ministers can save thousands of dollars per year using this tax provision. Maximizing this benefit requires coordination with the church, keeping good records of housing expenses, and applying the housing exclusion limits provided in the tax law. If you understand the ten fundamentals

discussed in this book, you will have a sound understanding of the housing exclusion basics for clergy.

Watch for future books which will be published soon.

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