

**DRAFT – PRIVILEGED AND CONFIDENTIAL – ATTORNEY CLIENT
COMMUNICATION – ATTORNEY WORK PRODUCT**

TO: Executive Committee of the ABCUSA Board of General Ministries

FROM: David N. Knipel

DATE: March 7, 2014

RE: ABCUSA 501(c)(3) Group Exemption

Over the last year and a half, ABCUSA has been working with Morgan Lewis & Bockius (MLB) to clarify the rules applicable to organizations seeking to qualify as a Section 501(c)(3) organization under ABCUSA's group exemption. This process has been complicated by the fact that the IRS is in the middle of a long-term review of its existing standards for group exemptions.

BACKGROUND

The background and analysis applicable to ABCUSA's group exemption, in effect since 1979, are described in a draft memorandum from MLB dated January 16, 2013, available upon request.

The "Legal Discussion" portion of that memo provides a helpful background for understanding the purpose and maintenance of a group exemption as follows:

"In order to ease the administrative burden associated with processing exemption applications for certain affiliated organizations, the IRS will issue a group exemption under Section 501(c)(3) to a central organization and its subordinates. A central organization must establish its own recognition for exemption under Section 501(c)(3) and demonstrate that the subordinates to be included under group exemption are: (1) affiliated with it; (2) subject to its "general supervision or control;" (3) exempt under the same paragraph of Section 501(c), although not necessarily the same paragraph as the central organization; (4) not a private foundation; and (5) all on the same accounting period as the central organization if they are to be included in a group return.

Subordinates must submit written authorization, signed by an officer, for the central organization to include it in the group exemption; new organizations must submit this authorization before the end of the 15th month after it was formed in order to be recognized as exempt as of the date of creation, and the central organization must include the subordinate in its next annual submission. The IRS has not defined what it means for a subordinate to be subject to a central organization's "general supervision or control," but it is currently in the process of reviewing the standards for group exemption and may issue guidance on this definition over the next few years. In 2011, the Advisory Committee on Tax Exempt and Government Entities ("ACT") released a report analyzing the group exemption process and recommending updated guidance on the meaning of

“general supervision or control.” The IRS followed this report in 2012 by issuing a compliance survey asking selected group ruling holders a number of questions regarding their relationship with subordinates, including possible indicia of “general supervision and control,” and it is likely that these surveys will help form the basis of any future IRS guidance on the definition.

“A central organization that obtains group exemption for its subordinates is responsible for ensuring that its subordinates continue to qualify as exempt under Section 501(c)(3) and verifying that new subordinates qualify for group exemption. It must provide an annual update to the IRS, notifying the IRS of any changes to the purpose, character, or operations of subordinates; new subordinates to be included in the group exemption; subordinates that should no longer be included in the group exemption; and any changes to the name or address of subordinates. If the information about new subordinates does not materially resemble the information contained in the initial application for group exemption, the request for inclusion of new subordinates must contain the same information required for an initial application, such as verification of the “general supervision or control” relationship, a sample copy of a uniform governing instrument adopted by the subordinates, and a detailed description of the purposes and activities of the subordinates, including the sources of receipts and the nature of expenditures.

“Finally, inclusion under a central organization’s group exemption does not relieve a subordinate organization from the Form 990 filing requirements applicable to Section 501(c)(3) organizations under Section 6033(a). Most Section 501(c)(3) organizations are required to file a version of the Form 990, although churches, their integrated auxiliaries*, and conventions or associations of churches are exempt from this requirement. Central organizations can file a group return on behalf of some or all of their subordinates, but if a subordinate is not included in a group return then it is responsible for adhering to the Form 990 filing requirements. Organizations that fail to file a return for three years automatically lose their tax-exempt status.”

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

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

Men's and women's organizations, seminaries, mission societies and youth groups that satisfy the first two requirements above are considered integrated auxiliaries whether or not they meet the internal support requirement.]

As noted in the MLB memo:

“In its request for group exemption, ABCUSA established that it served as the principal coordinating entity of the American Baptist denomination. ABCUSA also described conversations during which the IRS recognized that ABCUSA and its affiliates met the requirements for group exemption in spite of its less hierarchical structure. For example, ABCUSA affiliates were not required to characterize their status as subordinates when providing written authorization for their inclusion in the group exemption, and ABCUSA’s dissemination of nationally-adopted ecclesiastical and spiritual policies to the local churches and affiliates met the underlying standards for group exemption. The request included additional information contained in exhibits, such as a list of electing affiliated organizations, a discussion of the congregational structure of the American Baptist denomination, a statement describing the purposes and activities of ABCUSA and its electing affiliates, a copy of a sample governing instrument of an electing affiliate, and representative financial information for an electing affiliate that indicated the affiliate’s sources of receipts and nature of expenditures. ABCUSA’s records no longer contain these exhibits, and it would need to make a request to the IRS for a copy of its complete group exemption application in order to obtain such exhibits.

[Subsequent to this memo, MLB contacted the IRS for a copy of the 1979 application and exhibits. The IRS eventually responded that although the group exemption ruling remains in effect, the IRS no longer has a copy of the application or the exhibits.]

“On June 28, 1979, the IRS issued a determination letter to ABCUSA indicating that ABCUSA and the electing affiliated organizations qualified for group exemption under Section 501(c)(3). The determination letter provides that the electing affiliates are organizations described in Section 509(a)(1) and 170(b)(1)(A)(i) (i.e., churches or conventions or associations of churches) and require ABCUSA to provide annual updates to the IRS. Since receipt of the IRS determination letter recognizing its group exemption, ABCUSA has added new affiliates, including organizations classified as churches or conventions or associations of churches and other types of organizations such as day care centers, youth camps, cemeteries, and computer centers. The process for including an organization under ABCUSA’s group exemption has consisted of ensuring that the organization is in good standing and affiliated with ABCUSA and reviewing a copy of the organization’s articles and bylaws for compliance with Section 501(c)(3).”

ISSUE

Although it seems clear that churches and associations of churches were covered by the 1979 group exemption ruling, the process for including other types of organizations is less clear, especially in light of (1) the absence of the exhibits to the 1979 application (which might have identified the types of such organizations included in the group exemption request) and (2) the ongoing IRS review of its existing standards relating to group exemptions.

In its draft January 1979 memo, MLB concluded that “it seems consistent with ABCUSA’s group exemption application to continue to include organizations that are classified as churches and conventions or associations of churches in its group exemption. It is less clear that other types of organizations, such as day care centers, camps, cemeteries, and computer centers, are consistent with the electing affiliates described in the initial application. Unless ABCUSA

subsequently learns that these organizations resemble the initial electing affiliates, ABCUSA should ensure that these organizations qualify as Section 501(c)(3) organizations, are not private foundations, and are subject to ABCUSA's "general supervision or control" prior to including them in ABCUSA's group exemption. As noted, we recommend that ABCUSA review the articles, bylaws, a description of activities, and financial information of electing affiliates to ensure that each organization is in compliance with Section 501(c)(3) standards and would not be classified as a private foundation. ABCUSA should then monitor these organizations on an ongoing basis by requiring them to provide copies of financial statements, the Form 990 (if applicable), and any changes to the governing documents to ABCUSA each year. ABCUSA should notify any electing affiliates (that are not classified as churches or conventions or associations of churches) of these new requirements, and it can offer to serve as a fiscal sponsor for organizations that do not want to comply. ABCUSA should also remind electing affiliates of the possible need to file the Form 990 each year with the IRS."

In light of the labor-intensive review that would be associated with the MLB recommendation in the case of the other types of organizations (other than churches or associations of churches), the question was raised whether ABCUSA should continue to accept applications for inclusion in its group exemption from such organizations, and what an appropriate course of action would be for those 58 such organizations already included in the ABCUSA group exemption.

ABCUSA OFFICER QUESTIONS

In September of last year, the ABCUSA officers asked a series of questions related to this matter. Following are those questions and my responses.

What about entities like some camps that were spun off by regions or associations and now have independent boards, but those boards are made up of ABC churches. Does that fit the definition of an association of churches?

Response:

Since Boards of Directors cannot be made up of churches, but must be comprised of Directors who are natural persons, I am rephrasing the question as follows: What about entities like some camps that were spun off by regions or associations and now have independent boards, but those boards are made up of [directors from] ABC churches. Does that fit the definition of churches?

The answer is no. Such an entity would not be an association of churches. In Lutheran Social Service of Minnesota, an organization whose board was appointed by three Lutheran churches and whose primary activities consisted of providing social services to the public was not a convention or association of churches.

2) *What does an association of churches mean? Our formal associations that are constituents of regions are associations of churches for other purposes.*

Response:

I believe that Associations that are constituents of Regions are associations of churches for our purposes here. There is no clear definition of an association of churches, but the concept is intended to provide parity between the central organization of a religious denomination that has a church hierarchy and the central organization of a denomination that has autonomous local churches. Generally an association of churches is an organization whose membership consists of churches, often within some geographical region. An organization does not have to be incorporated to be an association of churches.

3) *What are the consequences to the non-local church, non-integrated auxiliaries if we don't cover them?*

Response:

If the entities are not churches, associations of churches or integrated auxiliaries, there are three options. One is to submit an IRS Form 1023 (application for exemption) to apply for their own recognized 501(c)(3) exemption. A second option is to arrange for a fiscal sponsorship while the exemption application is pending. See “Fiscal Sponsorships” below. A third is to qualify as a Type I Supporting Organization. See that section below.

4) *From the material it seems as though integrated auxiliary only applies to being attached to one congregation. Can one be an integrated auxiliary of several congregations as in 1) above?*

Response:

The definition of an integrated auxiliary states that it must be affiliated with “a church or convention or association of churches.” This seems to leave open the possibility that the integrated auxiliary could meet the requirements by being supported by more than one church. There are a number of requirements to be an integrated auxiliary, however, and the other requirements would have to be met.

5) *How do the 58 groups breakdown in terms of daycares, camps, etc.?*

Response:

It's quite a mixed bag – Camps, day cares, educational institutions, retirement homes, etc. See attached list.

6) *If we grandfather a group in, how often do we have to review their status?*

Response:

Annually. Rev. Proc. 80-27 outlines the annual review process. The group exemption holder has to notify the IRS of “all changes in the purposes, character, or method of operations of subordinates included in the group exemption letter,” as well as any changes in names or addresses. The group exemption holder also has to notify the IRS of any subordinates that have been dropped because they no longer meet the requirements to be included (such as meeting the public charity test). The group exemption holder has to get some information annually from subordinates (particularly those that aren’t churches) to allow it to meet this requirement.

MLB is concerned with the whole concept of “grandfathering in” organizations. They explained that their concern with “grandfathering in” organizations is that the grandfathered organizations may not be aware of the risk they are running by remaining under the group. For that reason, MLB suggests that organizations outside the scope of the original group exemption (those that would otherwise have to apply for exemption under Section 501(c)(3)), be required to follow the procedure outlined below under “Type I Supporting Organizations.” Given the lack of IRS guidance, there is some uncertainty even with this approach, but requiring that non-church subordinates be Type I supporting organizations, therefore meeting the public support test and providing a mechanism for some degree of “supervision or control,” should help lower the risk significantly.

7) *Are we liable for tax penalties if we have covered or cover a group that winds up not being a 501(c)(3)?*

Response:

No. However, although the group exemption holder would not have any liability, the subordinate organization would retroactively lose its exempt status. This could happen even though the organization would have met the 501(c)(3) requirements had it applied on its own, if the group exemption is determined not to be broad enough to cover the organization, if there is no “supervision or control,” or if the organization fails to meet the public support test.

OPTIONS

As mentioned above, for organizations other than churches or associations of churches who may not be eligible to be included in the group exemption, or who ABCUSA may determine to no longer include because of capacity or cost issues related to ensuring compliance with present or future group exemption requirements, there are several options. One is to submit an IRS Form 1023 (application for exemption) to apply for their own recognized 501(c)(3) exemption. A second option is to arrange for a fiscal sponsorship while the exemption application is pending. A third is to qualify as a Type I Supporting Organization and accordingly, be eligible for inclusion in the group exemption.

FISCAL SPONSORSHIPS

A fiscal sponsorship refers to a relationship in which one organization that is tax-exempt serves as the official recipient of charitable donations for another organization that is not yet recognized as tax-exempt. In this relationship the organization that has tax-exempt status is the "fiscal sponsor" and the organization that (usually) does not have tax-exempt status (and may not even be incorporated) is the sponsored organization. Typically the sponsored organization seeks out a fiscal sponsor that has a similar or consistent mission. There are some charitable nonprofits that actually have as part of their mission to serve as fiscal sponsors -- they may even refer to themselves as "incubators" of other nonprofit programs.

The role of the fiscal sponsor can include performing many different administrative functions on behalf of the sponsored group, including taking on the responsibility of receiving and administering charitable contributions on behalf of the sponsored organization. Since the donations are made directly to the fiscal sponsor, which then provides funds to the sponsored program, this arrangement enables donors to -- in essence -- make tax-deductible contributions to support the activities of the sponsored organization. In many sponsorships the fiscal sponsor charges an administrative fee for its services, usually a percentage of the budget of the sponsored organization or program. This is the arrangement the BGM considered and approved for the Vick and Pathfinder Camp, although the Camp eventually went in another direction.

Either ABCUSA or another American Baptist church or association of churches could serve as a fiscal sponsor for a requesting organization.

TYPE I SUPPORTING ORGANIZATIONS

Since the group exemption area is still somewhat up in the air now, with the IRS recognizing the need to update the existing standards, an interim course of action should be found for organizations that are not churches or associations of churches. MLB has suggested that until the IRS finalizes revised standards, MLB believes that the group exemption determination letter ABCUSA received in 1979 does leave open the possibility of ABCUSA adding organizations to its group exemption that are not churches or associations of churches. MLB has recommended that if ABCUSA decides to continue to admit these organizations to the group exemption, ABCUSA should:

1. Require that the organization be controlled by one of the churches in the group exemption. This can be accomplished by requiring that all or at least 60% of the organization's board be elected by the local church which is a member of the group exemption.
2. To ensure that the organization is not a private foundation, require the organization to be set up as Type I supporting organization so that it will qualify as a public charity even if it fails to meet the public support test. In order to be set up as a Type I supporting organization, the articles of incorporation of the organization will need to contain certain specific language as follows:

Purpose. The Corporation is organized and shall be operated exclusively for exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code, as it may be amended (the "Code"), for the benefit of, or to conduct or carry out the purposes of, the [provide the name of the local church that is covered by ABCUSA's group exemption], a nonprofit organization that is exempt from federal income tax under Section 501(c)(3) of the Code which is not a private foundation under Section 509(a) ("Church"). The Corporation shall be operated, supervised, or controlled by Church.

(It is intended that the Corporation shall have the status of a supporting organization exempt from federal income taxation under Section 501(a) of the Code and described in Sections 501(c)(3) and 509(a)(3) of the Code. These articles shall be construed accordingly, and all powers and activities of the Corporation shall be limited accordingly.

Church shall be the sole member of the Corporation and shall have the right to appoint the directors of the Corporation as well as the rights and duties provided in the bylaws.

The governing documents should also provide that this language cannot be amended without the consent of ABCUSA.

3. Require the organizations to submit an application to ABCUSA that will allow ABCUSA to make sure that the organization qualifies under 501(c)(3). This application should request some of the same type of information as the federal Form 1023 requires.
4. Require that the articles of incorporation of the organization contain a dissolution clause providing that all assets of the organization go to the parent church upon dissolution. This is another way of showing the closeness between the organization and the local church.

Dissolution. Upon a dissolution or final liquidation, after payment of all valid debts of the Corporation and necessary expenses thereof, or provision for same, all the remaining assets of the Corporation shall be distributed to Church for one or more exempt purposes within the meaning of section 501(c)(3) of the Code.

5. Require these organizations to submit to ABCUSA a copy of its Form 990 each year.

CONCLUSION

According to the attached 2012 list, there were 58 organizations on the "non-church" list. It's possible that some of them may be true integrated auxiliaries, and others may be associations of churches. As to the remainder, I think we can notify them of the IRS continuing review of this area and of the conditions under which ABCUSA is prepared to proceed with such organizations

(if that is the ultimate decision). For those organizations who elect not to continue, the options I can see are (1) to seek a determination letter from the IRS of their 501(c)(3) status, (2) to have ABCUSA serve as their fiscal agent until they get such a determination, (3) to have their sponsoring church serve as the fiscal agent, or (4) to seek to qualify as a Type I Supporting Organization.