

Issue 6 – Should audit protection be removed for a church leader’s penalty tax arising from excess benefits provided by a church?

Excerpt from Staff Memo to Senator Grassley Relating to Commission

Appendix C: Church & Religious Organization Issues for Consideration

4) Church Tax Inquiries and Section 4958 Excise Taxes

Present law

Section 7611 prohibits the IRS from conducting a church tax inquiry or church tax examination unless certain procedural prerequisites are met. Before the IRS can conduct a church tax inquiry, an appropriate high-level Treasury official must reasonably believe, on the basis of facts and circumstances recorded in writing, that the church in question may not be exempt or may be carrying on an unrelated trade or business,¹ and the church must be given written notice of the beginning of such inquiry.² A “church tax inquiry” is defined as any inquiry to a church (other than an examination) to serve as a basis for determining whether a church is exempt from tax under section 501(a) by reason of its status as a church, or is carrying on an unrelated trade or business or is otherwise engaged in activities which may be subject to federal taxation.³ The statute contains procedural provisions designed to hasten the determination of church tax liabilities, including a requirement that church tax inquiries and examinations generally be completed no later than two years after the date of the examination notice.⁴

Section 7611(i)(2) states that the section 7611 does not apply to any inquiry or examination relating to the tax liability of any person other than a church. Similarly, Treas. Reg. 301.7611-1, Q&A-6, states that the church inquiry and examination procedures described in section 7611 do not apply to any inquiry or examination relating to the tax liability of any person other than a church. However, Treas. Reg. 53.4958-8(b) states that the church audit procedures of section 7611 must be followed by the IRS in initiating and conducting any inquiry or examination into whether an excess benefit transaction has occurred between a church and a disqualified person even though no tax liability would be imposed on the church itself under section 4958.

¹ I.R.C. § 7611(a)(2).

² I.R.C. § 7611(a)(3).

³ I.R.C. § 7611(h)(2).

⁴ I.R.C. § 7611(c)(1).

Discussion

Section 7611 was enacted as part of the Deficit Reduction Act of 1984. According to the Joint Committee on Taxation's explanation of the 1984 Act, Congress, in putting restrictions on church tax inquiries and examinations, "recognized that an increasing number of taxpayers had ... utilized the church form primarily as a tax-avoidance device. Congress believed that the IRS must retain an unhindered ability to pursue individuals who use the church form in this manner."⁵ In describing the scope of the church tax inquiry and examination procedures, the JCT explanation says that:

Congress intended that inquiries or examinations that relate primarily to the tax status or liability of persons other than the church ... rather than the tax status or liability of the church itself, not be subject to the church tax inquiry and examination procedures. These inquiries or examinations may include ... (1) inquiries or examinations regarding the inurement of church funds to a particular individual or to another organization, which inurement may result in the denial of all or part of such individual's or organization's deduction for contributions to the church, (2) inquiries or examinations regarding the assignment of income or services or excessive contributions to a church, and (3) inquiries or examinations regarding a vow of poverty by an individual or individuals followed by a transfer of property or an assignment of income or services to the church. The IRS may inquire of a church regarding these matters without being considered to have commenced a church tax inquiry and may proceed to examine church records relating to these issues (including enforcement of a summons for access to such records) without following the requirements applicable to church tax examinations, subject to the general Code rules regarding examinations of taxpayer books and records.... In an inurement case, the IRS may request information or examine church records regarding amounts of money, property, or services transferred to the individual or individuals in question (including wages, loans, or noncontractual transfers), the use of church funds for personal expenses, or other similar matters, outside of the church tax inquiry and examination procedures.⁶

Since section 4958, imposes tax only on the disqualified person who is provided an excess benefit (and on any organization manager who knowingly participates in an excess benefit transaction), but not on the organization that provides the excess benefit, an IRS inquiry or examination into someone's tax liability under section 4958 for excess benefits provided by a church would not be an inquiry or examination into the tax status or liability of the church itself and, thus, not a "church tax inquiry" as defined in section 7611(h)(2).

⁵ Staff of the J. Comm. on Taxation, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 1140 (J. Comm. Print 1985).

⁶ *Id.* at 1146-47.

Issues for Consideration

Should 7611 protections be removed for a disqualified person's 4958 tax liability arising from excess benefits provided by a church?⁷

Appendix D: Other Tax-Exempt Organization Issues for Consideration

The issues and discussion impact all 501(c)(3) organizations, including churches and religious organizations. These issues are discussed in this memo because they are also issues for the churches we reviewed.

⁷ See IRS correspondence to Senator Grassley dated February 21, 2008, for information about IRS audit information regarding churches and 4958.