WHAT HAPPENED TO THE TAX EXEMPTION? THE CASE OF THE RICE TABERNACLE CHURCH

TEACHING NOTE

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CASE DESCRIPTION

The primary subject matter of this case is the importance of understanding the tax consequences of business decisions in nonprofit organizations. The case is appropriate for a senior or graduate level government and nonprofit accounting course. It could be used in the nonprofit portion of the advanced accounting class. The case is designed to be taught in one class hour and is expected to require approximately one hour of outside preparation by students. The events described in this case are based on real world experiences, but all names have been disguised.

CASE SYNOPSIS

The case concerns the challenges faced by religious organizations when they add activities that might negatively impact their tax exempt status. Rice Tabernacle Church (the Church) is a 2,000-member "mega-church" located in Brandon Hill, Kentucky. The church has experienced a 75 % growth in the past years and is literally 'bursting at the seams. In order to handle this growth, church leadership decided to expand the current sanctuary by adding a 120,000- square structure which included a fitness center, a bookstore, and a café. The church's property tax exemption only applied to the original structure; therefore it applied to the taxing authority for expansion of the exemption to include the additional structure. The exemption was denied since the income from the new businesses was considered unrelated to its mission. The church appealed the ruling and needs to develop a strategy in case its appeal is denied.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

The objective of the case is to help students understand the importance of understanding the tax consequences of business decisions in nonprofit organizations. This case is flexible and could be used in a number of courses at the senior or graduate level. For instance, it is ideal for a discrete government and nonprofit accounting class or the nonprofit portion of the advanced accounting class. Students may need to supplement classroom discussions by researching applicable nonprofit organization and taxation issues in the Internal Revenue Code or other third party sources. The references provided at the end of the teaching note could serve as a starting point.

The case is best completed in groups either as an in-class or out of class graded assignment. The group size, grading scale and assigned points is at the specific instructor's discretion. If completed in class, the case should be read prior to class by the students and the discussion questions answered in class. It should take approximately one hour to complete the discussion and no advanced preparation time is required by the instructor.

Learning Outcomes

Students should be able to:

1. Identify the organizational and tax reporting issues in nonprofit organizations especially religious organizations.
2. Understand the impact of non-mission based activities on religious organizations.

Case Implementation and Effectiveness

The case was tested using graduate government and nonprofit accounting students (n=20) at a regional university during the summer 2014. The case was assigned as a non-graded project and students read the case outside of class prior to the in-class debriefing. The lack of a grade did not create a barrier since the students have a good relationship with the course instructor and willing participated in the exercise. The students reported that it took approximately 15 minutes to read the case, and that was it interesting and easy to follow. The students were very curious about the tax resolution since this was not discussed in the case. The students also noted that the case effectively illustrated the pitfalls facing a religious organization when they expand in activities outside of their mission.

DISCUSSION QUESTIONS

The following are proposed solutions to the discussion questions in the case. The answers are not intended to be all inclusive.

1. Was the church properly established for federal tax purposes?

Yes. Churches and religious organizations, quality for tax exemption under IRC Section 501(c)(3), and are generally eligible to receive tax-deductible contributions. Unlike other charitable organizations, churches are automatically considered exempt and are not required to apply for and obtain recognition of tax-exempt status from the IRS.

Rice Tabernacle could elect to seek recognition of exempt status from the IRS. The church would apply for exemption using Form 1023 or 1023 EZ which was recently released by the IRS to streamline the tax exemption application process. Filing for tax exemption would assure the board of directors, members and contributors, and the local property tax board, that Rice Tabernacle is tax-exempted and qualifies for related tax benefits.

Rice Tabernacle's status as a valid tax exempt organization was not discussed in the case and it was already recognized as such by the local property tax board through its initial tax relief. The reader could infer that the church was properly established for federal tax purposes.

2. Should the State Board of Equalization be consulted prior to the expansion?

The answer might vary by student. However, if the State Board of Equalization commonly provides such consulting services, they should have been consulted. However, if it is not common practice such consultation cannot be expected.

3. Is the church correct in suggesting that the fitness center and daycare is part of its mission? Could it be subject to Unrelated Business Taxable Income (UBTI)?

Rice Tabernacle could be correct in suggesting that the fitness center and café are part of its mission if it meets certain criteria. Perhaps if the fitness center and café are privileges only offered to members of the church then it might not be subject to UBTI. However, since membership to the fitness center is offered to the community, albeit at a reduced rate then UBTI applies. Rice is performing a valuable service to the community but the additional space, especially the fitness center is not integral to its mission and UBTI does apply.

4. Should the church have applied for property tax exemption before the project commenced?

Expanding on #2 above, if it is normal business practice for the board to review and approve property tax exemption prior to project completion then the church should have applied. Ideally, it would submit its project plan along with the proposed use for board approval. The board could confirm once the project was completed if the building was being used as intended. After all, it is common practice for tax assessor to visit properties periodically to ensure that they are being evaluated or assessed at the right valuation

5. What should the church do now that the tax exemption was denied?

The following are suggested approaches that Rice Tabernacle could use to address the current financial situation.

a) In the short term, the church could discuss the property tax situation with the congregation and ask for a special offering to raise the necessary funds. The church could also change the focus of the new facility especially the fitness center by limiting membership to church members and reapply for tax exemption.
b) In the long term, the church could increase the fitness center rates to be comparable to the market place and use those funds to pay for the annual real estate taxes.
   Since the case is based in Kentucky, some students might note that Kentucky statutes exempt all tangible personal property owned by religious organizations from taxation. *St.* Andrews Orhodox Church, Inc. v. Thompson, KY Court of Appeals (2007) is a similar case as it pertains to property tax. St. Andrews Church owned and rented 2 houses, using outside areas owned as part of the property for recreation. St. Andrews Church appealed the decision of a lower court forcing the church to pay property taxes. The court based this decision on their use (or non-use as it were) of the property. The State Court of Appeals overturned the earlier decision ruling that Section 170 of Kentucky's State Constitution does not account for use, and as such how the property is used cannot be used in determination of tax.

DISCLAIMER

This case and teaching note was prepared by Beverley Alleyne and Raymond Elson and is intended to be used for class discussion rather than either effective or ineffective handling of the situation. The case is loosely based on a real situation therefore the names of the organizations, the individuals, and locations have been disguised.

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REFERENCES

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EPILOQUE

To avoid future tax penalties, Rice Tabernacle transferred management of the fitness center to the local YMCA and closed the bookstore. The property tax bill is still unpaid as Rice Tabernacle continues to negotiate with the State Board of Equalization.