CHURCH TAX UPDATE

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TAX-EXEMPTION AND RELATED DEVELOPMENTS

**Internet Ministry Does Not Qualify as ‘Church’:** PLR 201420020 (February 20, 2014). IRS concluded that a nondenominational organization, the purpose of which was to introduce or reintroduce individuals to Christianity through an electronic ministry, qualified as a section 501(c)(3) organization because it engaged exclusively in religious activities. The organization did not, however, qualify as a church within the meaning of section 170(b)(1)(a)(i), the public charity classification sought by the organization.

IRS evaluated the organization on the basis of the traditional 14 criteria for determining “church” status: 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; complete organization of ordained ministers ministering to their congregations; ordained ministers selected after completing prescribed courses of study; literature of its own; established places of worship; regular congregations; regular religious services; Sunday schools for religious instruction of the young; and schools for the preparation of its ministers.

Although the organization’s Protestant Christian beliefs satisfied the written creed and distinct religious history criteria, IRS found that most of the other criteria, particularly the “associational” element of believers assembled regularly for communal worship, were lacking. Here, IRS cited *Foundation of Human Understanding v. U.S.*, 614 F.3d 1383 (Fed. Cir. 2010), in which the court stated that “disseminating religious information,
whether through print or broadcast media, does not fulfill the associational role required to qualify as a ‘church’ under section [170(b)(1)(A)(i)].’ An organization cannot qualify as a church unless its principal purpose is that of a church, as distinguished from general religious purposes. Although IRS does not require satisfaction of all 14 criteria, several criteria comprising an “associational test” are especially significant to the determination of church status, including the existence of an established congregation and the conduct of regular religious services.

The organization lacked an established congregation because its “services” took place in a virtual manner over the Internet. Further, the organization failed to establish that its services were regularly carried on. Finally, the organization did not require members to terminate association with other churches or denominations.

**U.S. Charity’s Creation of Foreign Subsidiary Does Not Affect §501(c)(3) Status or Deductibility of Charitable Contributions : PLR 201438032 (June 24, 2014).** A domestic charity recognized as exempt and as described in section 501(c)(3) of the tax code had been organized for the purpose of providing food, clothing, housing, education and other services for foreign-born orphan children. In furtherance of these purposes, the domestic charity created a subsidiary nonprofit in a foreign country to facilitate operations in that country.

The tax code permits an income tax deduction for charitable contributions made within a taxable year to or for the use of an organization: (i) that was created or organized in the United States or in any possession thereof; (ii) that is organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes; (iii) no part of the net earnings of which inures to the benefit of any shareholder or individual; and (iv) which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in any political campaign on behalf of (or in opposition to) any candidate for public office.

Donors are precluded from taking a charitable income tax deduction for contributions to foreign organizations. However, domestic organizations are permitted to operate outside the U.S., and may organize and operate foreign subsidiaries and make grants to those organizations. Moreover, a gift from an individual donor to such a section 501(c)(3) domestic organization will be treated as a charitable contribution under section 170(c) if the gift is not earmarked for the foreign organization and the contribution is subject to the domestic organization’s control.

Members of the domestic charity comprised the foreign subsidiary’s “general assembly,” which elected the subsidiary’s five-member board of directors, three whom were required to be members of the domestic charity. In addition, the general assembly appointed an independent auditor to audit the subsidiary’s finances and accounting and to report directly to the domestic charity.

The domestic charity solicited funds both for its general use and for specific projects. It also adopted a policy of not adhering to earmarks or other restrictions placed on
donations by donors. The domestic charity proposed to fund its foreign subsidiary from
time to time, subject to requirements that the subsidiary maintain the funds in a separate
account, maintain financial records of fund uses, and permit the domestic charity’s board
to control use of the funds. In addition, the foreign subsidiary was required to comply
with provisions in its governing documents that prohibited political campaign
intervention, legislation advocacy and private inurement.

Based on the facts provided by the domestic charity, IRS ruled that the proposed funding
of the subsidiary would not affect the domestic charity’s section 501(c)(3) status, and that
donations made to the domestic charity would continue to qualify for deductibility under
section 170 notwithstanding their potential use to fund operations of the foreign
subsidiary.

Streamlined Form 1023-EZ for Small Charities: Rev. Proc. 2014-40. IRS has
implemented a new section 501(c)(3) application form for use by eligible small charities.
The form, Form 1023-EZ, Streamlined Application for Recognition of Exemption Under
Section 501(c)(3) of the Internal Revenue Code, consists of only two and a half pages,
and must be filed online at Pay.gov, along with an application fee of $400. It is
anticipated that the wait time for an approval will be significantly less than for the full
Form 1023. A “statistically valid random sample” of Forms 1023-EZ will be selected for
pre-determination reviews.

Successful applicants will be recognized by IRS as exempt under section 501(c)(3) and
will receive an IRS determination letter. They will also be listed on Exempt
Organizations Select Check on IRS.gov as eligible to receive tax-deductible charitable
contributions (Publication 78 data), and donors to the organizations may rely on such
listings for assurance of deductibility. Also, unless otherwise exempt, the organization
will be required to file an annual information return (Form 990/EZ/N).

An organization must satisfy certain eligibility requirements in order to file Form 1023-
EZ, including the following:

- The organization projects that it will not have gross receipts in excess of $50,000
  in the current tax year or any of its subsequent two tax years;
- The organization’s gross receipts did not exceed $50,000 in any of the three prior
tax years;
- The fair market value of the organization’s assets does not exceed $250,000;
- The organization was formed in the United States or its territories or possessions
  and has a U.S. mailing address;
- The organization is a corporation, trust or unincorporated association; and
- The organization is a publicly supported charity described in section
  509(a)(1)/170(b)(1)(A)(vi) or section 509(a)(2), or is a private foundation.

These and additional restrictions are outlined in the Form 1023-EZ Eligibility Worksheet
found in the Form 1023-EZ instructions.
Among organizations not eligible to apply for exemption using Form 1023-EZ are:
churches described in 170(b)(1)(A)(i); schools described in 170(b)(1)(A)(ii); hospitals
described in 170(b)(1)(A)(iii); supporting organizations described in 509(a)(3); and
limited liability companies (both single-member and multiple-member).

An otherwise eligible integrated auxiliary of a church may use this form. However, to
change the IRS’s internal records to reflect the integrated auxiliary’s exemption from
filing Form 990-EZ/N, it would subsequently need to file Form 8940 and demonstrate its
qualification as an integrated auxiliary.

In addition to the new form, IRS also published instructions, a revenue procedure (Rev.
), and final and
temporary (T.D. 9674) and proposed regulations to implement the new Form 1023-EZ
filing procedures.

Relief for Certain §501(c)(3) Bond Issuers Subject to Automatic Revocation for
Failure to File Annual Returns: Announcement 2015-02 (December 30, 2014).
In general, a tax-exempt organization subject to the annual information return (Form
990/EZ/N) filing requirement will automatically lose its tax-exempt status upon failure to
file for three consecutive years, effective on the due date of the third such non-filed
return. To obtain reinstatement of its tax-exempt status, an auto-revoked organization
must reapply to IRS by filing Form 1023/EZ, regardless of whether the organization was
originally required to make such an application. Generally, successful reinstatement is
effective as of the post-mark date of the application, although IRS has discretion to
approve reinstatement retroactive to the date of revocation if the organization can
demonstrate evidence of reasonable cause for its failure to file.

Late last year, IRS issued guidance concerning organizations that had issued “qualified
501(c)(3) bonds” within the meaning of section 145, the status of which would be
jeopardized by auto-revocation of the issuers’ section 501(c)(3) tax-exempt status on
account of failure to file annual information returns. Specifically, IRS has provided a
new Voluntary Closing Agreement Program (subject to payment of the required fee) for
revoked bond-issuer organizations that failed to qualify for retroactive reinstatement of
tax-exempt status. Under this program, the organizations will be able to maintain the
qualified status of their bonds during the taxable gap period and avoid costly default on
bond obligations.

COURT CHALLENGES TO TAX CODE PREFERENCES FOR RELIGIOUS
ORGANIZATIONS

Housing Allowance Exclusion for Ministers Survives – For Now: Freedom from
Section 107 of the tax code provides an exclusion from income available to any “minister
of the gospel” for either (1) employer-provided housing, such as a rectory, or (2) a
designated (cash) allowance used by the minister to rent or purchase a home.
Plaintiffs Laurie Gaylor and Don Barker were avowed atheists, who as co-presidents of the Freedom from Religion Foundation, had a portion of their salaries designated as housing allowances. Because they did not consider themselves to be “ministers of the gospel”, federal income taxes had been withheld from their housing allowances. Based on the disparate tax treatment of housing allowances received by ministers and non-ministers, plaintiffs brought suit to challenge the constitutionality of section 107. (Plaintiffs, who did not receive in-kind housing, had conceded before the lower court that they had no standing to challenge the constitutionality of section 107(1). Hence, this case focused on section 107(2) relating to housing allowances.)

To have standing, a plaintiff must establish that he or she has suffered (i) a concrete and particularized “injury in fact,” (ii) that is fairly traceable to the challenged action of the defendant, and that is (iii) likely to be redressed by a favorable judicial decision. On November 13, 2014, nearly a year after a federal district court in Wisconsin held that the section 107(2) housing allowance exclusion for ministers was an unconstitutional violation of the Establishment Clause, the Court of Appeals for the Seventh Circuit vacated that judgment on the grounds that the plaintiffs lacked standing to challenge the exclusion, without “reach[ing] the issue of the constitutionality of the parsonage exemption.” In the court’s view, the plaintiffs had failed to establish the requisite “injury in fact”.

The Seventh Circuit cited Justice Kennedy’s opinion in Arizona Christian School Tuition Organization v. Winn that “[s]ome plaintiffs may demonstrate standing based on the direct harm of what is claimed to be an establishment of religion, such as a mandatory prayer in a public school classroom.” However, the court found that the FFRF plaintiffs “cannot rely on the direct harm doctrine, because § 107(2) does not require them to see or do anything.” Also, the court held that the plaintiffs could not rely on the Flast v. Cohen special rule granting taxpayer standing in certain Establishment Clause cases. That is because in Winn, the Supreme Court held that Flast only applies to taxpayers challenging government appropriations - not tax expenditures (such as the parsonage exemption).

Hence, plaintiffs’ remaining option for establishing standing was to show that “they have incurred a cost or been denied a benefit on account of their religion.” However, the court found that the plaintiffs had not been denied a benefit because they never requested one. In other words, the plaintiffs never attempted to claim the section 107(2) housing allowance exclusion, and thus the IRS never asserted a tax deficiency. Accordingly, the court concluded that “plaintiffs’ claim amounts to nothing more than a generalized grievance about §107(2)’s unconstitutionality, which does not support standing.” The court found this to be true despite the fact that it was “unlikely that §107(2) will be interpreted to apply to the plaintiffs in this case….”

American Atheists Lack Standing to Challenge Tax Preferences for Religious Organizations: American Atheists, Inc. v. Shulman, 21 F.Supp.3d 856, 2014 WL 2047911 (E.D. Ky.). The United States District Court for the Eastern District of Kentucky has dismissed the complaint filed by American Atheists (“Atheists”) seeking to enjoin the IRS from enforcing provisions of the Internal Revenue Code on the grounds that they are preferential to churches and other religious organizations.

The contested provisions of the Code include: (i) exemption of churches and integrated auxiliaries from the requirement to file Form 1023 in order to be treated as tax exempt under section 501(c)(3) [although certain non-religious organizations are also exempt from this filing requirement]; (ii) exemption of churches, integrated auxiliaries and religious orders (the latter with respect to their exclusively religious activities) from the annual Form 990/EZ/N filing requirement; (iii) exclusion from income under section 107 on the value of a parsonage or parsonage allowance provided to ministers of the gospel; and (iv) special procedural protections provided under the church audit provisions of section 7611.

Atheists contended that these tax preferences violated the Equal Protection, Establishment, and Religious Test clauses of the Constitution, relying heavily on the district court decision in Freedom from Religion Foundation v. Lew, 983 F.Supp.2d 1051, 2013 WL 6139723 (W.D. Wisc.) (subsequently overruled by the Court of Appeals for the 7th Circuit, 773 F.3d 815, 2014 WL 5861632 (7th Cir. 2014)), that the section 107(2) parsonage allowance exclusion was an unconstitutional violation of the Establishment Clause.

The court here distinguished FFRF because Atheists had not designated as housing allowances any portion of the salaries it paid, and never made any attempt to invoke the preferential tax preferences complained of – despite, as the government argued and the Atheists conceded, that some atheist organizations have obtained classification as churches or religious organizations under section 501(c)(3). The court declared that it could not presume that the IRS would not adopt a definition of “religion” akin to that in Kaufman v. McCaughtry, 419 F.3d 678 (7th Cir. 2005), namely that “when a person sincerely holds beliefs dealing with issues of ‘ultimate concern’ that for her occupy a ‘place parallel to that filled by…God in traditionally religious persons,’ those beliefs represent her religion.”

Atheists alternatively claimed to have representative standing on behalf of its members, but the court found that this argument failed for the same reason that Atheists did not have standing in its own right – any injury resulted from Atheists’ failure to seek classification as a church or religious organization. Finally, Atheists failed to persuade the court that it satisfied the requirements for taxpayer standing in Establishment Clause cases because the challenged tax code provisions did not involve direct government expenditures, but rather speculative financial injury resulting from exemptions provided for certain other section 501(c)(3) organizations.
Freedom from Religion Foundation Lacks Standing to Challenge Form 990 Filing Exemptions for Churches and Other Religious Organizations: Freedom From Religion Foundation v. Koskinen, 12-cv-946-bbc, 2014 WL 7215766 (W.D. Wisc. December 17, 2014). Late in 2012, Freedom from Religion Foundation and Triangle FFRF (“FFRF”) filed a complaint in the District Court for the Western District of Wisconsin, alleging that that certain tax code preferences for churches and other religious organizations violated the Establishment and Due Process Clauses, and requesting the court to enjoin IRS from enforcing these unconstitutional provisions.

One such provision was the exemption from the requirement to file an application for recognition of exemption (Form 1023). The other was the exemption available to churches, their integrated auxiliaries, conventions or associations of churches, and the exclusively religious activities of religious orders from filing an annual information return (Form 990/EZ /N).

The two FFRF organizations had already filed Forms 1023 and had been recognized by IRS as organizations exempt from federal income tax under section 501(c)(3). The FFRF organizations also filed, and intend to continue filing, annual information returns. The FFRF complaint did not seek exemption from the filing requirements for FFRF or for similarly situated organizations, but rather to impose the filing requirements on the exempt churches and religious organizations.

Initially, the Wisconsin district court (the same court that had ruled in favor of plaintiffs regarding the constitutionality of the section 107(2) housing allowance) denied IRS’ motion to dismiss, finding that FFRF had standing to challenge the Form 990 exemption. The district court concluded that the FFRF organizations had suffered injury because they were burdened with an ongoing requirement that was not imposed on churches and certain religious organizations. The Court noted that a party “need not engage in conduct [e.g., not filing a Form 990] clearly prohibited by a statute before challenging the statute” [citing Ezell v. City of Chicago, 651 F.3d 684 (7th Cir. 2011)]. The district court did, however, dismiss FFRF’s challenge to the Form 1023 filing requirement because any injury from such filing had occurred in the past.

Later, after this district court’s decision in the housing allowance case was reversed by the Seventh Circuit (see FFRF v. Lew above), the parties were asked to submit supplemental briefs addressing the standing issue with respect to the Form 990 filing issue. Although the plaintiffs’ strongest argument was the Ezell argument, in order to maintain a pre-enforcement challenge, a plaintiff must express “an intention to engage in a course of conduct arguably affected with a constitutional interest, but proscribed by a statute” [citing Babbitt v. United Farm Workers National Union, 442 U.S. 289 (1979)]. Because the FFRF organizations had indicated their intent to continue filing annual information returns and did not seek to take advantage of an exemption or risk sanction for failure to file without first seeking an exemption, but merely sought to void the exemptions for religious organizations, the district court concluded that the FFRF organizations lacked standing and dismissed their lawsuit.
EMPLOYEE BENEFIT ISSUES

CHURCH PLAN LITIGATION

The Employee Retirement Security Act of 1974 (“ERISA”) established minimum standards (vesting, participation, funding, etc.) for employee retirement plans and consistent reporting and disclosure requirements. It provided civil remedies to promote compliance, while simultaneously easing the burden on employers responsible for complying with multiple state regulatory schemes. Title IV of ERISA requires defined benefit plans to participate in the Pension Benefit Guaranty Corporation’s compulsory plan termination insurance program. However, “church plans” within the meaning of ERISA §3(33) are exempt from many ERISA provisions.

Under ERISA §3(33)(A), “[t]he term ‘church plan’ means a plan established and maintained...for its employees (or their beneficiaries) by a church or by a convention or association of churches which is exempt from tax under section 501 of [the Internal Revenue Code].” Section 3(33)(C)(i), added by the Multiemployer Pension Plan Amendments Act of 1980 (“MPPAA”), further provided that “[a] plan established and maintained for its employees (or their beneficiaries) by a church or by a convention or association of churches includes a plan maintained by an organization, whether a civil law corporation or otherwise, the principal purpose or function of which is the administration or funding of a plan or program for the provision of retirement benefits or welfare benefits, or both, for the employees of a church or a convention or association of churches, if such organization is controlled by or associated with a church or a convention or association of churches.”

This amendment was intended to ensure that plans maintained by church pension and benefit boards qualified as church plans. Pension boards are separate legal entities affiliated with religious denominations that maintain plans for many of their denominational church agencies. The amendment raised certain questions: (1) if a plan established and maintained by a church includes a plan maintained by one of these organizations, is the requirement that a plan be established by a church implicitly satisfied; and (2) what is contemplated by “organization, whether a civil law corporation or otherwise,” having a principal purpose of administering such a plan?

Soon after the amendment, IRS (and later the Labor Department) began issuing rulings that clarified that an agency controlled by or associated with a church (e.g., hospital), having a committee of persons charged with administering a plan for the benefit of that agency’s employees, constituted a church plan within the meaning of §3(33). Thus, for over 30 years, IRS has interpreted §3(33) to recognize church plan status for both plans established by churches and plans established by organizations controlled by or associated with a church, in reliance on the statutory provision defining an “employee of a church” to include “an employee of an organization, whether a civil law corporation or otherwise, which is exempt from tax under section 501 [of the Internal Revenue Code] and which is controlled by or associated with a church or a convention or association of churches.”
The Lawsuits. During 2013, five lawsuits were filed against Catholic health care providers alleging that their defined benefit plans violated ERISA’s minimum funding, notice, and fiduciary rules, notwithstanding the fact that these plans had been determined to qualify as church plans within the meaning of section 3(33), and thus not subject to these ERISA requirements. [Overall v. Ascension Health, filed March 28, 2013 (E.D. MI), Chavies v. Catholic Health East, filed March 28, 2013 (E.D. PA), Rollins v. Dignity Health, filed April 1, 2013 (N.D. CA), Kaplan v. Saint Peter’s Healthcare System, filed May 7, 2013 (D. NJ) and Medina v. Catholic Health Initiatives, filed May 10, 2013 (D. CO).] A sixth lawsuit was filed in 2014 against an Evangelical Lutheran Church in America/United Church of Christ-affiliated hospital [Stapleton v. Advocate Health Care Network and Subsidiaries, filed March 17, 2014 (N.D. IL)].

The arguments in these cases are virtually identical: that the hospitals’ defined benefit plans are not entitled to the church plan exemption from ERISA provisions, or alternatively, that church plan exemption for such plans violates the Establishment Clause.

On March 31, 2014, the district court in Kaplan v. Saint Peter’s Healthcare System, denied the defendant’s motion to dismiss.

On May 9, 2014, defendants in Overall v. Ascension Health (E.D. Mich. May 19, 2014) succeeded in having the plaintiffs’ claims dismissed on jurisdictional grounds. Overall v. Ascension Health is on appeal before the Sixth Circuit. An Amicus Brief has been filed in support of the plaintiff-appellant by the Pension Rights Center, and briefs have been filed in support of the defendant-appellee by GuideStone Financial Resources, the Catholic Health Association and the Becket Fund for Religious Liberty.

District Court Declares Catholic Hospital’s Pension Plan Not a “Church Plan”: Rollins v. Dignity Health, __ F.Supp. 2d __ (N.D. Cal. 2014). In a decision calling into question 30 years’ worth of IRS and Labor Department rulings to the contrary, on July 22, 2014, the District Court for the Northern District of California granted the plaintiff’s motion for partial summary judgment that a Catholic hospital’s defined benefit pension plan was not a “church plan” within the meaning of section 3(33) of ERISA, and enjoined the hospital to bring its plan into compliance with applicable ERISA provisions.

Plaintiffs’ primary argument was that two types of plans may qualify as church plans under ERISA: under §3(33)(A), plans established and maintained by a church or by a convention or association of churches; and under §3(33)(C)(i) as amended by MPPAA, plans maintained by an organization, whether a civil law corporation or otherwise, the principal purpose or function of which is the administration or funding of a retirement or welfare benefit plan for employees of a church. Plaintiffs contend, however, that the key requirement under of §3(33)(A) that church plans must be established by a church cannot be abrogated. Thus, according to plaintiffs, because the defendant hospitals are not themselves churches (or conventions or associations of churches), they cannot independently establish plans to satisfy §3(33)(A). Accordingly, their plans cannot
qualify as church plans under §3(33)(C)(i) because their plans were not established by churches. Further, plaintiffs argued that because the hospitals maintained their own plans, they did not satisfy the requirement that the principal purpose or function be administration of the plans.

**Grant of Partial Summary Judgment.** In view of the fact that the court denied defendants’ motion to dismiss on jurisdictional grounds because its plan was subject to ERISA, it was unsurprising that the court granted plaintiffs’ motion for partial summary judgment, holding that Dignity Health’s plan was subject to ERISA, and enjoining Dignity Health to bring its plan into ERISA compliance. Dignity Health had argued that the plan at issue had been established by its predecessor, Catholic Health West (“CHW”), which Dignity Health did not dispute was not a church. However, Dignity Health asserted that there was a genuine dispute over whether the plan had been established by the civil entity CHW or by multiple religious women’s orders (“Sponsoring Congregations”), arguing that the Sponsoring Congregations should be found to have established the plan by virtue of their control over CHW. The court was unconvinced, noting that any level of control by one or more religious orders or churches was “immaterial” once CHW was itself formed as a separate corporation prior to the establishment of the plan. Only corporate veil-piercing analysis demonstrating that the Sponsoring Congregations effectively abused CHW’s corporate form would support a finding that the plan was established by a church within the meaning of §3(33)(A).

In its previous opinion denying Dignity Health’s motion to dismiss, the court had found that Dignity Health’s interpretation of §3(33) violated the cardinal rule of statutory construction that every clause and word be given effect, whenever possible. Thus, the court concluded that the initial requirement of §3(33)(A) that a church plan be established and maintained by a church (or a convention or association of churches) would be vitiating by permitting a church agency to establish and maintain its own church plan. In the court’s view, §3(33)(C)(i) permits a separate civil organization to establish a church plan that is established by a church. Any broader reading of the statute would “entirely consume” §3(33)(A). The court believed that the primary rationale for enactment of §3(33)(C)(i) had been to recognize as church plans those plans that were established by churches but maintained by separate civil pension and benefit boards.

**Appeal to Ninth Circuit.** On November 26, 2014, the district court certified its July 22, 2014, order for interlocutory appeal to the Ninth Circuit, staying current proceedings until the Ninth Circuit decides whether to take the appeal. If the Ninth Circuit reverses the district court, and concludes that a church plan need not be established by a church, the district court would then need to address the issue whether the defendant Catholic hospital is “controlled by or associated with” a church. If the district court determines that it is, it would also have to address the alternative claim that church plan exemptions for such plans violate the Establishment Clause. [Rollins v. Dignity Health, No. 13-cv-01450-TEH, 2014 WL 6693891 (N.D. Cal. Nov. 26, 2014).]
Catholic Hospital Gets a Reprieve from District Court Regarding Whether its Pension Plan is a “Church Plan” Exempt from ERISA: Medina v. Catholic Health Initiatives, No. 13-cv-01249-REB-KLM, 2014 WL 4244012 (D. Colo. August 26, 2014). The United States District Court for the District of Colorado denied plaintiff’s motion for partial summary judgment, rejecting the contrary recommendation of the magistrate judge. The court’s opinion focused on the statutory language in §3(33)(C)(i) to the effect that a “plan established and maintained for its employees (or their beneficiaries) by a church or by a convention or association of churches includes a plan maintained by an organization, whether a civil law corporation or otherwise, the principal purpose or function of which is the administration or funding of a plan or program for the provision of retirement benefits or welfare benefits, or both, for the employees of a church or a convention or association of churches” (emphasis added). The judge found this language to be unambiguous in stating that a plan “maintained” by an organization (here, a Catholic hospital) described in §3(33)(C)(i) meets the requirement of §3(33)(A) that a church plan is one “established and maintained…by a church or by a convention or association of churches.” In other words, there is no additional requirement that a church plan be established by a church as long as the plan is maintained by an organization controlled by or associated with a church or a convention or association of churches.

Another District Court Declines to Recognize a Religiously Affiliated Hospital’s Defined Benefit Plan as a “Church Plan: Stapleton v. Advocate Health Care Network and Subsidiaries, 14-cv-1873, 2014 WL 7525481 (N.D. Ill. December 31, 2014). The United States District Court for the Northern District of Illinois, in agreement with Rollins and Kaplan, concluded that a hospital affiliated with both the United Church of Christ and the Evangelical Lutheran Church in America cannot establish and maintain its own church plan exempt from the requirements of ERISA.

The defendant hospital conceded that it was not a church, and that a church did not establish its plan within the meaning of §3(33)(A). Instead, the defendant argued that §3(33)(C)(i) expanded the definition of “church plan” to include plans established and maintained by organizations controlled by or associated with a church. The court, however, found that the word “includes” in §3(33)(C)(i) identifies a subset of church plans, namely, those plans that are maintained by church-related organizations, but which are nonetheless established by a church. The court suggested that to read the statute otherwise would render §3(33)(A) meaningless. Accordingly, the court denied the defendant’s motion to dismiss without need to address plaintiff’s constitutional arguments.

Medical Center LTD Plan Fails to Qualify as Church Plan: Hanshaw v. Life Insurance Company of North America, No. 3:14-cv-00216-JHM, 2014 WL 5439253 (W.D. Kent., October 24, 2014). In Hanshaw, the plaintiff, an employee of a Catholic medical center, brought various claims in state court against the underwriter of her employer’s group long-term disability ("LTD") insurance policy. The defendant removed the action to the U.S. District Court for the Western District of Kentucky, asserting that the cause of action was preempted by ERISA. The plaintiff then filed a motion to remand the case back to state court.
The plaintiff alleged that the LTD policy is not an “employee welfare benefit plan” subject to ERISA. The court was unpersuaded, finding that a reasonable person could ascertain the intended benefits (the LTD insurance), the class of beneficiaries (the medical center’s employees), the source of financing (premiums paid by the employer), and procedures for receiving benefits, all elements for determining the existence of an ERISA benefit plan. In addition, the group policy revealed that the employer established or maintained the plan with the intent of providing benefits to employees. The court then determined that the plaintiff’s state law claims were completely preempted by ERISA’s section 502 civil enforcement provisions.

Finally, the court addressed the plaintiff’s argument that the LTD plan was a church plan not subject to ERISA on the grounds that the Catholic medical center was “controlled by or associated with” the Catholic Church, a fact that was disputed by the defendant. The court did not resolve the issue, however, finding that it was not dispositive of the claim. In its analysis, the court seemed to acknowledge that a church plan need not be established by a church, but rather could simply be maintained by an organization associated with a church. The court instead focused on the statute’s requirement that such an organization must have as its principal purpose or function the administration or funding of a retirement plan or program for the employees of a church. Since the principal purpose of the Catholic medical center was the provision of health care, it did not satisfy this requirement for status as a church plan. The judge denied the motion to remand the case back to state court, finding that it had subject matter jurisdiction to decide the case.

SAME SEX SPOUSE COVERAGE UNDER EMPLOYER HEALTH PLANS

Plaintiff’s Title VII Claim for Employer’s Denial of Health Coverage for Same-Sex Spouse Survives Motion to Dismiss: Hall v. BNSF Railway Company, No. C13-2160-RSM, 2014 WL 4719007 (W.D. Wash. September 22, 2014). Two employees of the defendant railway company legally married same-sex spouses in Washington State. Both employees sought to add their spouses to the employer’s health care plan and were denied pursuant to terms of the plan defining “marriage” as between one man and one woman. Plaintiffs brought claims against the employer under the Equal Pay Act (“EPA”) and ERISA. One plaintiff, Michael, asserted an additional claim under Title VII of the Civil Rights Act of 1964 on the basis of sex discrimination. The defendant employer moved to dismiss the complaint.

The court began with a discussion of Michael’s Title VII claim, with the defendant arguing that the claim was a discrimination claim based on his sexual orientation, not his sex. The court acknowledged that “it is often difficult to distinguish sex discrimination claims made by people identifying as homosexual from those claims based solely on alleged sexual orientation discrimination,” but disagreed with the defendant’s characterization of Michael’s claim. Michael, legally married to another male, claimed that he was discriminated against in comparison to female coworkers who are also legally married to males whom they may include in their health insurance coverage. The court
declined to comment on the validity of Michael’s Title VII claim, but found it to be “plausible on its face,” and denied the defendant’s motion to dismiss with respect to that claim. Because, as the defendant acknowledged, the plaintiffs’ EPA claims are “co-extensive” with the Title VII claim, the court similarly allowed those claims to proceed.

As for plaintiffs’ claims that the defendant violated ERISA §514(a), the court focused on defendant’s argument that if a state law discrimination claim is not prohibited by Title VII, then it will be preempted by ERISA (citing Shaw v. Delta Airlines, Inc., 463 U.S. 85 (1983)). However, as the court found that plaintiffs met their initial burden in making plausible Title VII and EPA claims, the court declined to dismiss plaintiffs’ ERISA claims at this stage, presumably because ERISA did not “preempt the field” on this issue.

Court of Appeals Affirms that Health Plan Which Expressly Excludes Same-Sex Spouses Does Not Violate ERISA: Roe v. Empire Blue Cross Blue Shield, No. 14-1759-cv, (2nd Cir. December 23, 2014). The District Court for the Southern District of New York dismissed plaintiffs’ claim that a Catholic health facility’s exclusion of same-sex spouses from coverage under its healthcare plan constituted unlawful discrimination under ERISA. [No. 12–cv–04788-NSR, 2014 WL 1760343 (S.D. N.Y. May 1, 2014)]

Defendant St. Joseph’s Medical Center sponsored a self-insured group health plan; co-defendant Empire Blue Cross Blue Shield served as third-party administrator. The plan did not define “spouse,” but expressly stated that “[s]ame sex spouses and domestic partners are NOT covered under this plan.” During open enrollment, employee Jane Roe sought to add her legal spouse, Jane Doe, to her coverage. Coverage was denied; Roe’s employment was not terminated. Plaintiffs then filed a class action lawsuit alleging that defendants were “unlawfully and discriminatorily interfer[ing] with the attainment of benefits” in violation of ERISA §510, thus violating their fiduciary obligations under ERISA §404.

Plaintiffs argued that the Supreme Court’s decision in Windsor created a vacuum regarding the status of same-sex marriage under federal law, and that ERISA therefore required plans to follow state law, namely, New York’s Marriage Equality Act, which mandated equal treatment of same-sex spouses under ERISA plans. Defendants countered that ERISA’s broad preemption provision trumped New York law, an argument left unaddressed by the court, which addressed the merits of the plaintiffs’ claims under ERISA: Does a plan violate ERISA by excluding same sex couples from beneficiary status? The answer was “no.” (It is not clear from the record how the Catholic facility made an express election to treat its health plan as an ERISA plan rather than a church plan, but the court stated that “ERISA governs the Plan and thus clearly applies to this case.” Defendants conceded that ERISA applied, presumably to preempt any claims under New York law.)

ERISA §510 provides that “[i]t shall be unlawful for any person to discharge, fine, suspend, expel, discipline, or discriminate against a participant or beneficiary for exercising any right to which he is entitled under the provisions of an employee benefit plan…or for the purpose of interfering with the attainment of any right to which such
participant may become entitled under the plan....” In considering the plaintiffs’
discrimination claim under §510, the court found that the provision was intended to
protect an employee from his or her employer taking adverse employment action on
account of the employee’s attempted exercise of rights under a plan, but did not create a
cause of action for wrongfully withheld benefits. Other circuits have interpreted §510 to
prohibit discriminatory plan modification that intentionally benefits or injures employees,
even in the absence of adverse employment action.

The court noted that ERISA permits employers to freely modify their welfare plans
without mandating the provision of certain benefits or prohibiting discrimination in the
provision of benefits. ERISA was not intended to mandate a plan’s terms, particularly
where other federal laws (e.g., Title VII) prohibit discriminatory benefit plans. In the
instant case, the defendant Catholic hospital did not discharge the employee plaintiff, and
therefore she suffered no adverse employment action within the meaning of §510.

Nor was the court persuaded by plaintiffs’ characterization of Windsor as a “landscape
2013), the undefined term “spouse” in a defined contribution plan had been interpreted
under ERISA to include the beneficiary’s same-sex spouse, but only because the plan at
issue contained an ambiguity in regard to the definition of spouse. The instant health
plan contained no such ambiguity. Contrary guidance by federal agencies, particularly
DOL and IRS, does not impact plaintiffs’ claim in the absence of adverse employment
action. Finally, because the plan did not violate §510, the defendants did not violate any
fiduciary duties by lawfully carrying out the terms of the plan. Defendants’ motion to
dismiss was granted.

On appeal, the United States Court of Appeals for the Second Circuit upheld the district
court’s decision. The court of appeals, after de novo review, issued a summary order
stating that the “District Court properly dismissed plaintiffs’ section 510 claim [because
plaintiffs] failed to adequately allege any right to which they are entitled or may become
entitled under the plan at issue...” and agreed that plaintiffs failed to allege adequately
that defendants had breached any fiduciary duty under ERISA.

SELECT AFFORDABLE CARE ACT (ACA) COMPLIANCE ISSUES

IRS Issues Final Instructions for Health Care Reporting Forms. On February 4, 2015,
the IRS released final instructions for ACA reporting Forms 1094-B, 1095-B, 1094-C and
1095-C, which implement the provisions of sections 6055 and 6056 of the Internal
Revenue Code. Generally, employers (or their health insurance issuers or carriers in the
case of insured coverage) that provide minimum essential coverage must file Forms
1094-B and 1095-B (Form 1094-B is a transmittal form). The purpose of the “B” forms
is to help the IRS determine whether an individual had minimum essential coverage in a
given month for purposes of the individual mandate under section 5000A. Health
insurance issuers or carriers file the B forms for insured employer coverage, and the plan
sponsor or employer files the B forms for self-insured coverage.
Employers that are either “applicable large employers” (“ALEs”) or “ALE members” must file Forms 1094-C and 1095-C (Form 1094-C is a transmittal form). The “C” forms will assist the IRS in determining whether an employer is liable for the employer mandate penalty under section 4980H. Generally, applicable large employers or ALE members filing Forms 1094-C and 1095-C that provide self-insured coverage must complete section III of Form 1095-C in lieu of reporting using the B forms. If an employer offers self-insured coverage to non-employees, such as retirees, then the employer may file Forms 1094-B and 1095-B for those individuals in lieu of completing Form 1095-C, Part III.

Employers are required to file Forms 1094-B, 1095-B, 1094-C and 1095-C for 2015. The forms must be filed with the IRS by February 28, 2016 (or March 31, 2016, if filed electronically), and Forms 1095-B and/or 1095-C, as applicable, must be sent to employees and covered individuals by January 31, 2016. Applicable large employers and ALE members are required to report using the C forms in 2016 even if they are eligible for transition relief with respect to the employer mandate penalty for 2015 because they have fewer than 100 full-time employees (including full-time equivalents).

IRS Information Letters Remind Employers that Health Care Reimbursement Arrangements Could Be Costly; Transition Relief Provided to Small Employers: Notice 2015-17. Prior to the enactment of ACA in 2010, many (particularly smaller) employers that did not offer group health plan coverage to their employees instead provided health reimbursement arrangements or employer payment plans under which the employer would reimburse employees for substantiated medical expenses or the cost of premiums for individual health insurance policies. In late 2014 IRS released two information letters to members of Congress advising them that such reimbursement arrangements may violate the ACA market reform provisions for group health plans, specifically, the prohibition on annual limits on coverage and the requirement to provide preventive services without imposing any cost-sharing. Employers (even small employers that are not subject to the employer mandate provisions of section 4980H) that offer group health plans that violate one of these requirements are subject to a penalty of $100 each day with respect to each individual to whom a failure relates. Certain market reform provisions do not apply to a group health plan that provides only excepted benefits, such as a limited-scope dental or vision plan.

In Notice 2013-54, published in September 2013, IRS clarified that a health reimbursement arrangement, or HRA, in which an employer funds an account to reimburse an employee for substantiated medical care expenses, is generally considered to be a group health plan within the meaning of section 9832(a). If an HRA is integrated with an employer’s group health plan, the combined benefit may satisfy ACA’s group health plan requirements, depending on the terms of the group health plan. However, an HRA will be considered integrated with an employer’s group health plan only if the employee eligible under the HRA is in fact enrolled in the group health plan. The notice provided that an HRA could not be integrated with an individual health policy, because such an arrangement violates the annual dollar limit prohibition. Thus, standalone HRAs
or HRAs “integrated” with individual health policies are group health plans which violate the requirements of ACA.

Similarly, arrangements in which an employer reimburses an employee for substantiated premiums for non-employer sponsored health insurance are considered to be group health plans and, when used to purchase individual market coverage, violate the requirements of ACA.

In Information Letter 20140037, IRS stated that a standalone HRA violates the prohibition against annual and lifetime dollar limits on essential health benefits, even though the reimbursements to the employees remain tax free under section 105(b). In Information Letter 20140039, IRS stated that a nonprofit organization that reimburses employees for premiums for their individual health insurance policies also violates the prohibition against annual and lifetime dollar limits on essential health benefits, even though reimbursements also remain tax free to employees. This is because an employer that does not offer a group health plan cannot combine the reimbursement arrangement with any other coverage to determine if it satisfies ACA’s market reform provisions. In both cases, an employer becomes liable for the $100 per day excise tax under section 4980D, which is reported on Form 8928, although the tax will not be imposed if the failure was due to reasonable cause and not to willful neglect and is corrected within a certain time period, depending on whether the plan is a church plan.

On November 6, 2014, subsequent to issuance of the two information letters (September 22, 2014), the Departments of Health and Human Services, Labor, and Treasury jointly issued Frequently Asked Questions clarifying, among other issues, that HRAs and employer payment plans are considered group health plans and violate ACA provisions even if the reimbursements are made after tax. Therefore, employers should not use such arrangements with pretax or after tax payments to employees.

On February 18, 2015, IRS released Notice 2015-17 providing transition relief for employers that are not applicable large employers (within the meaning of Treas. Regs. §§ 54.4980H-1(a)(4) and -2) that offer health care arrangements described in Notice 2013-54 that either reimburse employees for some or all of their premium expenses incurred for individual health policies or directly pay premiums for employees’ individual health insurance policies. An “applicable large employer” (“ALE”) is one that employs an average of 50 or more full-time employees (including full-time equivalent employees) with respect to a calendar year. The Notice provides that employers that were not ALEs for 2014 will not be liable for the section 4980D excise tax and will not have to file Form 8928. In addition, employers that are not ALEs for 2015 will not be liable for the section 4980D excise tax or have to file Form 8928 for the period January 1 through June 30, 2015. The Notice warns that after June 30, 2015 “such employers may be liable for the Code § 4980D excise tax.” An employer may use any consecutive six calendar month period in 2013 to determine whether it is classified as an ALE for 2014, and any consecutive six calendar month period in 2014 for determining whether it is classified as an ALE for 2015. According to the Notice, employers are not eligible for transition relief for offering stand-alone HRAs (such as the one described in Information
Letter 20140037) or other arrangements in which an employer reimburses employees for medical expenses other than insurance premiums.

According to the Notice, an arrangement in which an employer reimburses (or pays directly) some or all of an active employee’s share of Medicare Part B or Part D premiums also constitutes a group health plan and violates ACA’s market reform provisions unless (i) such an arrangement is integrated with a group health plan offered by the employer that provides minimum value and does not consist solely of excepted benefits, (ii) the employee participating in the arrangement is actually enrolled in Medicare Parts A and B, (iii) the arrangement is available only to employees who are enrolled in Medicare Part A and Part B or Part D, and (iv) the arrangement is limited to reimbursement of Medicare Part B or Part D premiums and excepted benefits, including Medigap premiums. Finally, the Notice confirmed that employers can increase compensation to assist employees with acquiring and paying for individual health insurance policies, but the payments cannot be conditioned on the purchase of such coverage. Employers are permitted to provide information about the Marketplace or the availability of a premium tax credit under section 36B.

Employers May Amend Cafeteria Plans to Permit Revocations of Elections in Two Additional Situations: Notice 2014-55 (September 18, 2014). A cafeteria plan is a separate written plan that complies with the requirements of section 125 of the Internal Revenue Code, that is maintained by an employer for the benefit of its employees, and that actually operates in compliance with the requirements of section 125. Under a cafeteria plan, employees are offered a taxable benefit (e.g., “cash” in the form of a greater salary) and at least one qualified non-taxable benefit (e.g., a contribution toward employer-provided health insurance or contributions to a flexible spending account). Employees make salary reduction elections to exchange part of their taxable wages toward nontaxable healthcare premiums or a flexible spending account.

Salary reduction elections made by employees are generally irrevocable during the plan year with certain exceptions that align with enrollment changes in the employers’ health plan. The permitted election changes are set forth in Treasury Regulations section 1.125-4. New elections are permitted if they satisfy a “consistency rule,” such that the election change is consistent with a change in status that affects an employee’s eligibility under an employer’s health plan.

IRS added two additional exceptions resulting from complications in implementation of ACA, under which employers, pursuant to written amendments to their cafeteria plans, may permit employees to revoke elections for coverage under an employer’s health plan (but not under a flexible spending arrangement), despite the fact that employees will not lose eligibility under the employer’s health plan.

Situation One. An employee who has been “full-time” under ACA, working 30 or more hours per week, may reduce or have reduced his or her hours to fewer than 30 hours per week. Such employee may or may not lose eligibility under the employer’s health plan. However, the employee may continue to be considered “full-time” for a period of time
(i.e. during a “stability period”) because the employer uses a look-back measurement period to determine whether or not an employee is considered “full-time.” The employee whose hours are reduced may find the employer’s health coverage too costly and may prefer to join a spouse’s plan or enroll in a plan through an ACA Marketplace.

Accordingly, in reliance on reasonable representation of the employee, an employer may amend its cafeteria plan to permit an employee to revoke an election if both:

1) The employee has been in an employment status under which the employee was reasonably expected to average at least 30 hours of service per week and there is a change in that employee’s status so that the employee will reasonably be expected to average less than 30 hours of service per week after the change, even if that reduction does not result in the employee ceasing to be eligible under the group health plan; and

2) The revocation of the election of coverage under the group health plan corresponds to the intended enrollment of the employee, and any related individuals who cease coverage due to the revocation, in another plan that provides minimum essential coverage with the new coverage effective no later than the first day of the second month following the month that includes the date the original coverage is revoked.

Situation Two. Although an employee may wish to leave an employer’s group health plan in order to enroll in a Qualified Health Plan through an ACA Marketplace, the employee may have difficulty moving seamlessly from the employer’s plan having a non-calendar plan year to a Qualified Health Plan during a Marketplace’s annual open enrollment period. In addition, if an employee experiences a special enrollment event because of marriage or the birth of a child, the employee may prefer to obtain family coverage through an Exchange rather than add one or more family members to the employer’s group health plan.

Accordingly, in reliance on reasonable representation of the employee, an employer may amend its cafeteria plan to permit an employee to revoke an election if both:

1) The employee is eligible for a Special Enrollment Period to enroll in a Qualified Health Plan through a Marketplace pursuant to guidance issued by the Department of Health and Human Services and any other applicable guidance, or the employee seeks to enroll in a Qualified Health Plan through a Marketplace during the Marketplace’s annual open enrollment period; and

2) The revocation of the election of coverage under the group health plan corresponds to the intended enrollment of the employee, and any related individuals who cease coverage due to the revocation, in a Qualified Health Plan through a Marketplace for new coverage that is effective beginning no later than the day immediately following the last day of the original coverage that is revoked.
Employers may elect to amend their cafeteria plans to adopt one, both or neither of the above changes. Cafeteria plans must be amended before the last day of the plan year in which elections are permitted. Employers must amend plans by the last day of the plan year that begins in 2015 with respect to changes for plan years beginning in 2014. Plan amendments may be retroactive to the first day of the plan year, but amendments may not permit retroactive elections to revoke coverage.

**PCORI Fee for Health Policies and Plans Announced for 2014-2015: Notice 2014-56 (September 19, 2014).** As part of ACA, Congress imposed a fee on issuers of health insurance policies and plan sponsors of self-insured health plans. The fee is based on the average number of covered lives. Employers who sponsor self-insured health plans can use one of three methods to determine the average number of covered lives. This so-called “PCORI” fee (the proceeds of which help fund the Patient-Centered Outcomes Research Institute) was $1 for policies and plan years ending before October 1, 2013, and $2 for policies and plan years ending on or after October 1, 2013 and before October 1, 2014. Until 2019, when the PCORI fee is supposed to sunset, the fee will be adjusted annually based on the prior year’s fee and the increase in the projected per capita National Health Expenditures. In Notice 2014-56, the IRS announced that the PCORI fee for policies and plan years ending on or after October 1, 2014, and before October 1, 2015, is $2.08.

Religious employers with self-insured health plans, regardless of whether the employer is an applicable large employer (“ALE”) or ALE member, should report and pay the PCORI fee by filing Form 720 by July 31 following the end of the prior plan year. Filing Form 720 is obligatory, although employers can pay the fee using the Electronic Federal Tax Payment System. The PCORI fee is separate from the transition reinsurance fee.

**IRS Adjusts Healthcare FSA Limit: Rev. Proc. 2014-61 (November 17, 2014).** IRS announced the inflation adjusted limit on contributions to employer-sponsored healthcare flexible spending accounts (FSAs). The contribution cap for 2015 is $2550, up from $2500 in 2014.

**MISCELLANEOUS RETIREMENT PLAN DEVELOPMENTS**

**Notice 2014-54 (September 18, 2014).** IRS provided guidance to simplify the treatment of distributions (other than in the form of annuity payments) from qualified plans under section 401(a) or 403(b) that include both pre- and after-tax amounts. Previously, the IRS position was to treat each distribution from a plan with pre and after-tax balances to multiple destinations (e.g., direct rollovers to a traditional and Roth IRA, a taxable distribution, etc.) as consisting of a pro-rata share of both pre- and after-tax amounts. Under Notice 2014-54, to the extent the pre-tax amount of total aggregated distributions exceeds the amount of direct rollovers, the direct rollovers are treated as being comprised entirely of pre-tax amounts. Any excess of pre-tax amounts is allocated next to any 60-day rollovers before being treated as a taxable distribution to the taxpayer. Taxpayers are
permitted (prior to the distributions) to allocate amounts of direct rollovers and 60-day rollovers among multiple plans.

**IRS Announces 2015 Retirement Plan Limitations:** [IR-2014-99, October 23, 2014.](#)

IRS has announced cost of living adjustments for various dollar limitations on defined benefit and defined contribution plans effective January 1, 2015. The elective deferral limit for employees in 401(k) and 403(b) plans is increased to $18,000 (from $17,500). The catch-up contribution limit for employees 50 years of age and over is increased to $6,000 (from $5,500), and the limitation for defined contribution plans under section 415 is increased to $53,000 (from $52,000).

[Employee participants in section 403(b) church plans are permitted an alternative contribution limitation or “10/40” rule permitting up to $10,000 per year in excess of the section 415(c)(1) limitation (which is $53,000 in 2015), up to an aggregate maximum of $40,000. These amounts are not adjusted for inflation.]

**Employers May Need to Update Participant Tax Notices Regarding Eligible Rollover Distributions:** [Notice 2014-74 (November 24, 2014).](#)

The Internal Revenue Code requires plan administrators of section 401(a) qualified retirement plans and section 403(b) plans to give notice to recipients prior to making an “eligible rollover distribution”. An “eligible rollover distribution” is a distribution that may be rolled over to an eligible retirement plan, such as an individual retirement account (IRA) or another eligible employer plan. Eligible rollover distributions generally do not include required minimum distributions, hardship distributions or certain annuity payments. The required notice must be given a reasonable period of time prior to making the distribution (i.e. no less than 30 and no more than 180 days prior to the distribution), and must describe the direct rollover rules, how mandatory income tax withholding applies to distributions that are not directly rolled over, and the tax treatment of such distributions.

IRS provides model special tax notices intended to provide a safe harbor for satisfying these requirements. An employer who uses the model notices will be covered by the safe harbor as long as the explanations accurately describe the law. Updated model notices reflect new rules for allocating pre-tax and after-tax amounts distributed from a plan to multiple destinations (see Notice 2014-54 above), as well as the ability to roll over payments to an in-plan designated Roth account. As with prior iterations, there are two model notices, one for distributions from designated Roth accounts, and one for distributions from all other accounts.

**MINISTERS’ COMPENSATION ISSUES**

**Pastor and Wife’s Joint Bank Account Not a Religious Order:** [Cortes v. Commissioner, T.C. Memo 2014-181 (U.S. Tax Court September 3, 2014).](#)

Salomon Cortes, pastor of a Seventh Day Sabbath Church, received bi-weekly compensation from the Church that was paid directly to a bank account held in the name of Living Waters Ministries, Cortes’ corporation sole. He and his wife were each signatories on the
account, from which they paid their personal living expenses. Cortes and his wife filed income tax returns for several years, reporting only his wife’s income, excluding Cortes’ compensation from the Church.

Mr. Cortes had taken a vow of poverty, the sincerity of which was not questioned by the Tax Court. Pursuant to this vow of poverty, the Church could have paid Cortes’ compensation to a religious order of which Cortes was a member with payment not subject to federal income tax withholding or self-employment tax. Cortes mistakenly assumed that he had no tax liability merely because he had taken a vow of poverty and the payor of his compensation was the Church. Unfortunately, the Cortes’ Wells Fargo Bank account, notwithstanding its designated name, did not constitute a section 501(c)(3) religious order. Accordingly, the Tax Court ruled in favor of the IRS with respect to unpaid taxes, as well as accuracy-related penalties for failure to demonstrate reasonable cause and good faith.

Cortes may have learned of this corporation sole scheme from Frederic and Elizabeth Gardner, financial planner and prophetess/certified paralegal respectively. The Gardners had been enjoined by a federal court from promoting their scheme during the timeframe of the Cortes income tax return filing. [See, United States v. Gardner, 2008 WL 906696 (D. Ariz. 2008) and Gardner v. Commissioner, T.C. Memo 2013-67 (U.S. Tax Court Mar. 11, 2013).] Suffice it to say that prophetess Gardner’s predictions that simply notifying IRS “that you are a corporation sole” would end the inquiry turned out to be nothing more than wishful thinking.

**Pastor Entitled to Deduct Unreimbursed Travel Expenses, But Not Meals and Entertainment: Monsalve v. Commissioner, T.C. Summary Opinion 2014-91 (U.S. Tax Court September 11, 2014).** Mr. Monsalve, a pastor of the Seventh Day Adventist Church, was employed by its Central California Conference (“Conference”). While serving as the senior pastor for two congregations, he used his personal automobile for travel to attend Conference meetings and for other pastoral duties, including visits to congregants and other meetings. The Conference’s travel reimbursement policy entitled employees to reimbursement for “necessary and reasonable travel expenses incurred for properly authorized conference business.” The Conference reimbursed Mr. Monsalve pursuant to its accountable reimbursement plan for his Conference meeting travel, but not his pastoral duties travel.

In addition to claiming these unreimbursed travel expenses on his federal tax return, Mr. Monsalve also claimed $15,000 in unreimbursed expenses for meals, entertainment, gifts and aid for others, which the IRS disallowed.

Taxpayers are permitted to deduct ‘ordinary’ and ‘necessary’ expenses in connection with operating a trade or business, including performing services as an employee. An expense is ‘ordinary’ if it is of common or frequent occurrence in the business, and is ‘necessary’ if it is appropriate and helpful. An employee who incurs unreimbursed expenses required as a condition of employment is entitled to deduct those expenses.
Notwithstanding that the Conference did not reimburse Mr. Monsalve for travel expenses related to his pastoral duties, the Tax Court found that his testimony regarding these duties was deemed credible and concluded that he was entitled to deduct these unreimbursed travel expenses, using the applicable standard mileage rate, but only to the extent they were substantiated. Mr. Monsalve failed to produce substantiation for approximately one-fourth of his unreimbursed travel expenses, which were disallowed.

The Tax Court sided with the IRS and disallowed all of Mr. Monsalve’s unreimbursed expenses for meals, entertainment, gifts and aid for others. Notwithstanding any obligation the pastor may have felt to entertain members of his congregation and provide gifts and aid, it was clear from the record that “he was not required to incur the expenses for doing so as a condition of his employment.”

UBIT DEVELOPMENTS

IRS Says Income Derived Through Short Sale Transactions Not UBTI: Private Letter Ruling 201434024 (May 29, 2014). Tax-exempt organizations are required to pay income taxes on their unrelated business taxable income, or UBTI. Commonly invoked exclusions from UBTI include dividends, interest, and gains from the sale of property that is not held primarily for sale in the ordinary course of a trade or business. Equally well-known, however, is the exception to the exceptions when the otherwise nontaxable income is derived from debt-financed property as defined in section 514 of the Internal Revenue Code.

IRS had occasion to revisit its position that income produced from short sales of securities is not UBTI, because entering into short positions does not result in “acquisition indebtedness” so as to trigger the debt-financed property rules.

In the ruling, a charitable remainder unitrust intended to invest in funds through a partnership that would borrow stock through a broker, creating an obligation to return an equal amount of stock when each short sale is closed. Upon the commencement of a loan, the broker sells the stock. A fund always provides cash and long position stocks (frequently acquired from gains on prior short sales) equal to at least 100% of the amount of its obligations on outstanding short sale contracts. In all cases, however, the collateral provided is owned by the fund and none of it is debt-financed property. The fund pays a lending fee for each transaction. While a short sale contract is outstanding, the fund is entitled to earnings on its cash or securities collateralizing its obligation. When a transaction is closed, if successful, an amount of stock equal to the amount originally borrowed is purchased and returned to the broker. The selling fund keeps its gain earned from the original sale of the stock.

The IRS held that the borrowing of stocks to enter into short positions, while an obligation, did not result in acquisition indebtedness—“it constitutes the borrowing of property rather than money.” Therefore, the gain from successfully closed short sales, and any income earned from collateral, is not UBTI. In addition, a fund’s use of short
sale proceeds to purchase long positions in other stocks, some of which were used as collateral for subsequent transactions, were not considered debt-financed and therefore did not “taint” that stock.

Tax-exempt organizations, including pension trusts, that do not want to have to file Form 990-T, do not, therefore, need to require their investment managers to abstain from taking short positions. By contrast, purchasing stock on margin is treated as acquisition indebtedness and income derived therefrom constitutes UBTI. See Bartels Trust v. U.S., 88 Fed.Cl. 105 (2009).

Private Letter Ruling Illustrates How 501(c)(3) Charity Can Avoid UBIT on Dividends from Wholly Owned For-Profit Subsidiary: Private Letter Ruling 201503018 (Oct. 24, 2014). A section 501(c)(3) organization that operated as an educational institution developed its own software for use in an online educational program that, rather than requiring students to pass a predefined array of classes to graduate, required students to demonstrate core competencies related to the degree. Other organizations began inquiring about licensing the software for their own use, and the section 501(c)(3) organization created a for-profit subsidiary to further develop the software and license it to other educational institutions and businesses. Accordingly, the organization requesting the ruling contributed the software to the for-profit subsidiary in exchange for 100% of the stock and retained a royalty-free license to continue using the software. A majority of the directors serving on the subsidiary’s board will consist of persons other than directors (or persons related or employed by those directors) or employees of the 501(c)(3) organization. The subsidiary will reimburse its nonprofit parent for the fair market value of all office space and administrative services that it receives and distribute dividends to the parent.

The IRS ruled that the 501(c)(3) organization’s ownership of the for-profit subsidiary would not adversely affect its tax-exempt status because the 501(c)(3) organization would not actively participate in its subsidiary’s day-to-day affairs except as a shareholder, and would maintain separate books and records, bank accounts and financial records and other indicia of “separateness” such that the subsidiary is not a mere instrumentality of its owner for federal income tax purposes. Consequently, even though the subsidiary would be a “controlled organization” within the meaning of section 512(b)(13), any dividends paid to the 501(c)(3) “controlling organization” would not be subject to UBIT because dividends are not “specified payments” (such as interest, annuities, royalties and rents) and so are excluded from the calculation of the 501(c)(3) organization’s unrelated business taxable income under the normal modification rules of section 512(b)(1).

POTLUCK

Where are the Section 7611 Church Tax Audit Regulations? Who is Responsible for Initiating Church Tax Audits? Tax Analysts Interview with Commissioner Koskinen (October 17, 2014). As we reported at the Georgetown CLE Conference last year, the
regulations identifying the appropriate high-level Treasury official authorized to initiate church tax inquiries and church tax examinations remain unfinished more than five years since the January 20, 2010, hearings on the proposed regulations (August 5, 2009), which had designated the Director, Exempt Organizations, as the authorized official.

Since last year’s session, Freedom from Religion Foundation settled its litigation concerning IRS’ alleged failure to enforce the political campaign intervention prohibition against churches. Despite the fact that the identity of the authorized official for initiating church tax inquiries/examinations remains unknown, IRS asserted in a June 27, 2014, letter to DOJ attorneys that it had “processed several cases” under section 7611 procedures. In an October 27, 2014 Tax Analysts interview, IRS Commissioner John Koskinen was asked about the identity of the appropriate high-level official under section 7611. His response? “That's a question I don't know the answer to. I pride myself in knowing the answer to most things. I can't tell you who that person is at this point because I actually don't know.” Neither do we.

**FEC's Disclosure Requirements Apply to Issue Advocacy, Not Just Express Advocacy: Independence Institute v. Federal Election Commission, 1:14-cv-01500-CKK, 2014 WL 4959403 (D.D.C., Oct. 6, 2014).** Independence Institute (“Institute”) was recognized as exempt from federal income tax under section 501(c)(3) of the Code. Its mission was “to empower individuals and to educate citizens, legislators and opinion makers about public policies that enhance personal and economic freedom.” The Institute intended to produce a radio advertisement asking listeners to contact Colorado senators, Mark Udall and Michael Bennet, and urge them to support certain legislation. The Institute planned to run the advertisement within 60 days of the November 4th federal election in which Udall (who ultimately lost his seat) was a candidate.

Prior to the election, the Institute filed a motion for preliminary injunction with the United States District Court for the District of Columbia against the Federal Election Commission (“FEC”), and on agreement of the parties, the court agreed to rule on the merits of the complaint rather than on the preliminary injunction. The issue was whether the Institute’s “electioneering communication” was subject to disclosure under the Bipartisan Campaign Reform Act of 2002 (“BCRA”). BCRA defines an electioneering communication as a broadcast, cable or satellite communication that refers to a clearly identified candidate for federal office within 60 days of a general election (or 30 days of a primary election). Any organization, whether for-profit or nonprofit, that makes electioneering communications in excess of $10,000 during a calendar year is required to report to the FEC the names and addresses of contributors who contributed $1,000 or more during that year through the disclosure date.

The Institute challenged these BCRA disclosure requirements as overbroad as applied to “genuine issue advocacy,” as distinguished from express advocacy or its functional equivalent. The Institute’s position was that the Supreme Court’s *Citizens United* opinion upheld disclosure requirements for express advocacy, but left open the question whether disclosure could be required for “non-pejorative” issue advocacy. The court disagreed, stating that the following language from *Citizens United* was a holding, not
dicta—“...Citizens United claims that...the disclosure requirements in § 201 must be
confined to speech that is the functional equivalent of express advocacy. The principal
opinion in [Federal Election Commission v. Wisconsin Right to Life, Inc.] limited 2
U.S.C. § 441b’s restrictions on independent expenditures to express advocacy and its
functional equivalent. Citizens United seeks to import a similar distinction into BCRA’s
disclosure requirements. We reject this contention.”

Further, the Institute failed to persuade the court that Citizens United was inapplicable
because the plaintiff in Citizens United was a section 501(c)(4) organization, while the
Institute was a section 501(c)(3) organization: “There is no reason to conclude that
Citizen United’s clear refusal to import the express advocacy-issue advocacy distinction
into the disclosure context should be limited to advocacy by certain types of nonprofit
organizations.” The Institute also argued unsuccessfully that the Citizens United decision
depended on the pejorative nature of the advertisements for the film, Hillary, which had
been at issue in that case.

Finally, the court disagreed with the Institute that Buckley v. Valeo and Federal Election
Commission v. Wisconsin Right to Life, Inc. were controlling. Buckley involved a distinct
Federal Election Campaign Act provision that was “impermissibly vague,” which the
Supreme Court construed as applicable only to express advocacy as a matter of statutory
construction, not as a constitutional command. Wisconsin Right to Life found that BCRA
section 203, a prohibition against corporate expenditures from general treasury funds for
electioneering communications, was unconstitutional as applied to the plaintiff’s issue
advocacy. That case did not suggest that such distinction would apply with regard to
disclosure provisions.

IRS released inflation-adjusted figures for 2015, several of which are of interest to
religious organizations, including the “low cost articles” exception of unrelated business
income tax under section 513(h)(2) of the tax code. For 2015, a “low cost article” is
defined as one that costs the charity distributing it $10.50 or less.

In addition, under section 170, payments to a section 501(c)(3) organization are
deductible charitable contributions only to the extent they exceed the fair market value of
goods or services received in return. However, certain “insubstantial benefits” may be
disregarded in determining whether anything of value was received in return. Under the
2015 inflation-adjusted figures, if a donor makes a contribution of $52.20 or more to a
charitable organization, low cost token items (having a cost to the organization of $10.50
or less, see above) received in return may be disregarded, so that the full amount of the
payment would be deductible as a charitable contribution. Likewise, if in return for a
contribution, a donor receives benefits the fair market value of which is not more than 2%
of the amount of the payment, up to a maximum of $105, such benefits will be considered
insubstantial and may be disregarded in determining deductibility under section 170. [As
an interesting historical note, when these insubstantial benefit amounts were first
introduced in Rev. Proc. 90-12, the $10.50, $52.20, and $105 limits were $5, $25, and
$50, respectively.]
Optional Standard Mileage Rate Increases from 56 to 57.5 Cents per Mile for 2015: Notice 2014-79 (December 10, 2014). IRS increased the standard mileage rate for transportation or travel expenses in 2015 to 57.5 cents per mile, up from 56 cents per mile in 2014. Taxpayers who choose not to use this optional standard mileage rate may instead substantiate their actual allowable expenses. The standard mileage rate for use of an automobile in rendering gratuitous services to a charitable organization under section 170 is 14 cents per mile.

IRS Issues Annual EO Procedural Updates. As expected, early this year IRS issued a series of revenue procedures dealing with such administrative matters as determination letters, private letter rulings, user fees, etc. The 2015 series is distinguished from past years’ updates because they reflect the recent realignment of the Exempt Organizations Division, pursuant to which legal work previously performed by the Division (e.g., private letter rulings and technical advice memoranda) has been transferred to the Office of Chief Counsel. The EO Division will continue to review applications for recognition of exemption and issue exemption determination letters.

Rev. Proc. 2015-1 (January 2, 2015) provides guidance concerning how taxpayers can request private letter rulings (“PLRs”) from the Office of Chief Counsel. Because the EO Division no longer issues PLRs, this guidance now applies to PLR requests from churches and other religious organizations. The user fee for such requests is no longer contained in Rev. Proc. 2015-8, which applies only to determinations issued by the EO Division. After February 1, 2015, a sliding scale PLR user fee will apply: $2,200 for organizations with gross receipts less than $250,000; $6,500 for organizations with gross receipts between $250,000 and $1,000,000; $28,300 for all other organizations. Previously, the user fee for PLR requests had been $10,000.

Rev. Proc. 2015-4 (January 2, 2015) updates procedures concerning private letter rulings and determination letters to clarify that the EO Division will continue to issue exemption determination letters (e.g., responses to applications for exemption), but it will no longer issue private letter rulings. The Office of Chief Counsel will henceforth issue rulings on exempt organizations matters in accordance with Rev. Proc. 2015-1 above and its successors. Employee Plans Rulings and Agreements will continue to issue rulings concerning employee plans matters as described in Rev. Proc. 2015-4 and its successors.

Rev. Proc. 2015-5 (January 2, 2015) provides information about using Form 1023-EZ, Streamlined Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code. This revenue procedure updates and supersedes Rev. Proc. 2014-40. The eligibility criteria for organizations filing Form 1023-EZ have not changed. Rev. Proc. 2015-5 attempts to allay reliance concerns expressed by large institutional donors regarding organizations recognized as tax-exempt under Form 1023-EZ determination letters. This revenue procedure clarifies that donors may rely on Form 1023-EZ determination letters to the same extent they can rely on Form 1023 determination letters. Under general reliance rules, of course, donors who know or have
reason to know about submission of inaccurate application information are not entitled to rely on exemption determination letters.  (See Rev. Proc. 2015-9 below.)

*Rev. Proc. 2015-8 (January 2, 2015)* updates the user fee amounts for letter rulings, determination letters, etc., for employee plans and exempt organizations matters. The user fee for filing Form 1023 remains $850 ($400 for organizations with receipts averaging not more than $10,000). The user fees for Form 1023-EZ and for Form 8940 determination requests (change in public charity status, determination of Form 990 filing requirement, etc.) also remain at $400.

*Rev. Proc. 2015-9 (January 12, 2015)* updates procedures for organizations that file applications for recognition of exemption, such as Form 1023, Form 1024, or letter applications. Procedures for filing Form 1023-EZ are addressed in *Rev. Proc. 2015-5 above*. If an applicant organization or the reviewing EO Determinations Unit believes an application raises an issue on which there is no clear precedent, either party may initiate a request for technical advice from the Office of Chief Counsel as provided in *Rev. Proc. 2015-2*.

*Rev. Proc. 2015-10 (January 12, 2015)* updates procedures for requesting Form 8940 determinations, such as public charity status (e.g., §170(b)(1)(A)(i) church status, §170(b)(1)(A)(vi) or 509(a)(2) public support status, or §509(a)(3) supporting organization sub-classifications) and exemption from Form 990/EZ/N filing requirements. Organizations exempt under church group rulings are entitled to use Form 8940 to obtain a formal IRS determination of such issues. (See Section 7.)