

IRS Revises Official Position on Church Audits

The IRS has revised their position on how the Church Audit Protection Act applies to any sort of audit the IRS might want to undertake of a local church, or church denominational organization. Up to this point, their official position has been that the Act was applicable only to income tax matters. However, in a recent internal memorandum the IRS issued “corrected” guidance. The memorandum specifies that Internal Revenue Code Section 7611 also applies to church employment tax inquiries and examinations. This means that the Church Audit Protection Act now covers payroll tax issues, something which had not previously been the case.

The practical impact of this new position is that the IRS will now have a much higher hurdle to step over whenever it wishes to perform a payroll tax examination of a church. This decision may also impact the IRS’s ability to address other payroll related items, such as a churches compliance with health care and retirement plan regulations, and by extension perhaps, even the classification of employees for payroll tax purposes. But that is yet to be seen.

This change in practice continues the long-standing position of the IRS of not involving itself in the internal matters of a church, unless the church is acting in an egregious manner. Below is some additional background information along with a link to the IRS website where you can learn more about this.

Church Tax Inquiries and Examinations

The Church Audit Protection Act (Code Section 7611 of the Internal Revenue Code) specifies that the IRS cannot initiate a church tax inquiry or examination unless certain criteria are met and written authorization received from an authorized Director in the IRS. This appropriate high-level Treasury official must document in writing the basis of their reasonable belief before the IRS can initiate a church tax inquiry. Internal Revenue Code Section 7611 (IRC Sec. 7611) defines an “appropriate high-level Treasury official” as “the Secretary of the Treasury or any delegate of the Secretary whose rank is no lower than that of a principal Internal Revenue Officer for an internal revenue region.” In 2009, the IRS released Proposed Regulations under Sec. 7611 which changed “appropriate high-level Treasury official,” for purposes of a church examination, from “appropriate Regional Commissioner” to “Director, Exempt Organizations.”

Examinations are limited in scope and may only be used to determine if a church: (a) qualifies for a tax exemption (e.g. is it really is a church?), (b) carries on unrelated trade or business activity that has gone unreported, or (c) is otherwise engaged in activity subject to tax or in violation of their exempt charter (i.e. election intervention and support of particular political candidates). *[Remember, however, that the IRS can inquire about and/or audit the activities of a church which have been reported to them (i.e. payroll reports and tax returns, unrelated business income (ubi) tax returns, etc.) so it is important to ensure that all mandatory activity and reporting is accurately handled and reported].*

The basic sequence of the church audit process

If the IRS determines that they have sufficient reason for an examination they must begin an inquiry by providing a church with written notice containing an explanation of its concerns. The church is then allowed a reasonable period of time in which to respond by furnishing a written explanation to alleviate

IRS concerns. If the church fails to respond within the required time, or if its response is not sufficient to alleviate IRS concerns, the IRS may, generally within 90 days, issue a second notice, informing the church of the need to examine its books and records.

After issuance of a second notice, but before commencement of an examination of its books and records, the church may request a conference with an IRS official to discuss IRS concerns. The second notice will contain a copy of all documents collected or prepared by the IRS for use in the examination and subject to disclosure under the Freedom of Information Act, as supplemented by IRC section 6103 relating to disclosure and confidentiality of tax return information.

Generally, examination of a church's books and records must be completed within two years from the date of the second notice from the IRS. If at any time during the inquiry process the church supplies information sufficient to alleviate the concerns of the IRS, the matter will be closed without examination of the church's books and records.

There are additional safeguards for the protection of churches under IRC Sec. 7611. For example, the IRS cannot begin a subsequent examination of a church for a five-year period unless the previous examination resulted in a revocation, notice of deficiency of assessment, or a request for a significant change in church operations, including a significant change in accounting practices.

Keep in mind that the IRS can obtain the information supporting a decision to begin an examination from many sources. The IRS must derive the facts and circumstances forming the basis for a reasonable belief from information lawfully obtained. If this information is obtained from informants, it must not be known to be unreliable. Failure of the church to respond to repeated IRS routine requests for information is a factor in determining if there is reasonable cause for commencing a church tax inquiry.

Potential Sources of Information may include:

- Newspaper or magazine articles or ads,
- Television and radio reports,
- Internet web pages,
- Voters guides created and/or distributed by the church,
- Documents on file with the IRS (e.g. a Form 990-T filed by the church),
- Reliable information reports from concerned members of the church or the general public, and
- Records concerning the church in the possession of third parties or informants.

[For a complete outline of the guidelines currently in place with the IRS click on the following link]

http://www.irs.gov/irm/part4/irm_04-076-007.html#d0e263

DISCLAIMER

This material is presented with the understanding that the author is providing basic information only, and assumes no liability whatsoever in connection with its use. Tax laws are constantly changing, are subject to differing interpretations, and the facts and circumstances in any particular situation may not be the same as those presented here. Therefore, we urge you to do additional research and make sure that you are fully informed and knowledgeable before using the information contained herein.