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UNRELATED BUSINESS SURVEY IN THE DIOCESE OF PROVIDENCE

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The attitude of the Diocese of Providence toward the unrelated business tax takes a position that there are few applications of it, although there are a great many operations which Internal Revenue might wish to examine to determine whether an unrelated business exists. From the passage of the Tax Reform Act of 1969, it was known that the Diocese would be subject to the tax. None of us expected that we had any unrelated business.

At our 1974 meeting, Father Whelan made a presentation on the subject that, in my opinion, was the most complete to that time. Father Whelan provoked those of use in attendance from Providence* into discussion of the matter as applied to the Diocese of Providence. We knew of no activity that could be considered in competition with normal business, trade or industry, at least in the sense of a business that would be involved with the Chamber of Commerce or a trade or industrial association. But there were operations of a minor nature, that could be unrelated business as described by Father Whelan. We asked ourselves if we really knew everything that was going on in the Diocese. Our conclusion was that we did not, and that really no one did.

Every parish and organization within the Diocese filed an Annual Financial Report with the Chancery, but that report was so lacking in detail and in descriptions and classifications that it would not be of any assistance in answering our question. We resolved to find the answer.

Operation of the Diocese resembles the organization frequently found in the business world where you have a Chief Executive Officer, an Executive Vice-President and Vice-Presidents for various phases of the business operation. The Vicar for Financial Administration is similar to a Vice-President for finances in business. Under the Vicar for Financial Administration is the Fiscal Office headed by a C.P.A., who is Financial Advisor to the Bishop, and a Public Accountant, as Assistant Controller, with a bookkeeping staff.

The legal structure finds a multitude of corporations. There are 156 parish corporations organized under a General Law that sets the membership as the Bishop, Vicar-General and Pastor of the Roman Catholic congregation, ex-officio, and two lay members of the congregation. The Bishop is a corporation solely by an act of the General Assembly. Many other institutions also have legislative charters that cover a wide spectrum of operation, such as an infant's home, convalescent home, home for the aged, hospitals, diocesan high schools and so forth. Other operations are organized under the general State non-business corporation

* In attendance from the Diocese of Providence at the 1974 meeting was the Vicar-General of the Diocese of Providence, who is now Most Reverend Daniel P. Reilly, Bishop of Norwich, Connecticut.

law. Although there is a general similarity in all of these corporations, there is no uniformity. In some cases, the corporate charter provides for ex-officio membership of the Bishop, Vicar-General and possibly one or more other officials and in some cases the ex-officio status is set in by-laws. In other instances there is no ex-officio membership.

On our return to Providence in 1974, Father Whelan's presentation was reported to the Controller, as well as our conclusions. Over a period of months, we decided to prepare a questionnaire to be sent out by the Vicar for Financial Administration. By early Fall of 1974 that questionnaire was finalized. (See Appendix A). It contained an opening statement of the problem and the purpose and was as far as possible drawn along lines of an objective-type examination. We felt that our chances for response were greater if it were only necessary to check:

Yes ____ No ____

Volunteer worker ____ Paid Worker ____

Bingo ____ Weekly ____ Monthly ____ Quarterly ____ Annually ____

and likewise with other categories. We decided on limiting the subject matter to a single page, single spaced, on the concept that it would seem to be shorter and that the response would therefore be more likely.

What we sought was a general idea of what existed, with whom, and on what a follow-up would be necessary. We planned for the necessity of seeking more information in the particular cases. The questionnaire went out in April 1975. Response was slow and often required later requests. There are six who have not as yet responded. However, by early December the vast majority had returned the questionnaire and we were able to examine it for analysis.

Some of the questionnaires returned carried comments. A few said "What do you mean - unrelated? This is fund raising." Others said "This bingo is for the school, not the Church." Still others of the nature that "This 20-week club was the Parents' Association, not the Parish." I am sure that you have run into that type distinction in your experience. The Parish Corporation is responsible for the school as well as for the Church. The Parents' Association can only be considered an agency of the parish. They have no independent standing. In fact, they rely on the parish tax exemption.

The questionnaire which we used has been modified and revised by USCC in light of what is now known that I did not know in preparing our original issue. That revision is a sample questionnaire which was made available to you today (see Appendix B).

This questionnaire is more thorough than the one we used, because it contains questions that for us require follow-up in specific instances. However, if you feel as we did that the first step was elimination of those operations and facilities which would require no further attention and concentrate on those which were questionable or definite, you probably will want to consolidate this questionnaire. For example, on Question 4 you might prefer to ask the general question and ask that particular facilities be specified. The questions under A in Item 4 could probably be eliminated initially, although they would be necessary as a matter of further attention to those instances where you found that in reply to the general Question 4 there would be necessity to obtain additional detail. Unless you know that there are widespread rentals, I would much prefer to eliminate these questions under that paragraph A in the beginning. A like observation can be made relative to Question

5 and to its paragraph A. It may be possible to consolidate Question 5 and to use the questions under paragraph A as a matter of subsequent attention in the situations where they could apply. When it comes to Question 6, I am afraid that most of our Pastors and Administrators will fail to understand what you mean by debt-financed real property. If it is possible not to have to ask them about debt in any form, because your records in the Chancery Office can readily show that to you, I would recommend it. After you relate the debt to the income-producing facility, it is time enough to follow through on the gain from sale of the debt-financed property. Facts are sought. Based on them, judgments can be made more objectively by you or other advisors. There should be no room in the questionnaire for any opinion responses.

Division of analysis into the categories of unrelated business, debt-financed income and controlled corporation seems appropriate.

Under the category of normal unrelated business, we include such things as advertising, bazaars, socials, raffles, carnivals, bingo, 20-week clubs and similar activities. The Diocesan newspaper will be treated separately under a controlled corporation. We found advertising in church calendars, programs, booklets and in various Sunday bulletins. Although we must still make further inquiry on that subject, for the most part these sources of revenue appear either excluded or actually revenue to someone else. For example, there were parishes with advertising in the church bulletin distributed each Sunday, but that advertising was obtained by an individual who prepared the bulletin and provided it free of charge without additional compensation to the parish. The individual received any profit from the advertising. The programs for events such as shows, dinners, plays, sporting events, appear excluded. No parish revenue was received from any of the calendars.

We then draw our attention to the 20-week club and bingo-type operations, the business of games of chance. In some cases we find two 20-week clubs in operation in succession in the course of a year. In that, therefore, \$1.00 a week is being obtained from the members each of 40 weeks of the 52 weeks. Each week some prize is given during those 40 weeks. We determined that this is regularly carried on. On the other hand, we are told that in all cases there are no paid workers—all are volunteers. This feature, therefore, removes it from the classification of unrelated business.

As we are told this, however, a Pastor talks to me about a problem he has with his 20-week group sponsored by a Parents' Association for the parish school. The Association retained control of the 20-week club proceeds, and at the conclusion of the year, they threw a party, paid for from the proceeds, for the officers and members of the governing body of the Association—and their families. The expense was computed at approximately \$50.00 per officer or member of the governing body. Immediately we raised the question as to whether there was volunteer activity or whether there was substantially paid activity in the work of this club. This particular situation is listed for further attention, both for revision of control of finances and elimination of the party. The practice was one that the Pastor had inherited from his predecessor and the present Pastor is faced with the commonly experienced problem of taking away from the parishioners something that they had come to see as their right.

In the area of bingo-type functions, we found those with annual, semi-annual or quarterly bingos all with unpaid workers and were able to dismiss them as

concerns because we felt that they were not regularly carried on and also covered by the exemption relating to volunteer workers. When we came to more frequent bingo operations, however, we concluded that we should treat weekly, monthly or any operation more frequent than quarterly as regularly carried on. In a few cases we found at least one paid worker. Here we are insisting on having a listing of all workers to provide a record of the degree of service provided by paid and by volunteer workers.

In many cases, some parish hall or facility was rented for weddings, social activities and the like, on occasions. We did not originally extend ourselves to inquire whether any services were required at the same time. Services such as a catering by the parish, included as part of the rental, would involve unrelated business. On our follow-up inquiry to those who made such rentals, we have not yet found any instances where services were performed or provided.

In our question on leases, we found many different situations. Our initial concern was in the area of debt-financed income. We have yet to follow up in an effort to determine whether any of these leases included services and to what extent they might include personal property. For example, we find school buildings and sometimes convents being leased by a parish without debt. At least in some cases, convent furnishings were included. In many cases, the desks and equipment of the school were included in the lease. I expect to find that the rent attributable to the personal property will be less than 10% and will not result in an unrelated business on the rental of personal property.

Some of these school leases contain provisions for occupancy by the parish at times when the school is not in session. In many of those cases, the parish provides all of the janitorial service for the building. The regulations recognize that services performed in common areas, such as halls, and building approaches are considered incidental to the real estate rental and not the rental of the service. At the same time, maid service to a room or apartment provided as part of the rental is designated as a rental of service. Where we stand in the case of janitorial service in these buildings, room by room, I am not yet sure.

The Vicar for Financial Administration, the Financial Advisor to the Bishop, and I agreed that a uniform system of record keeping was necessary and that it would have to be handled by persons trained in bookkeeping and accounting. Workers in every activity would be listed in the records with reflection of volunteer or paid status. The system is expected to limit the extent to which Internal Revenue could go into the books of any organization. For record purposes, we assume that Internal Revenue would investigate any activity that might be unrelated business. We have not decided what to do about filing any return. That will depend on the particulars. A uniform record system has been developed. It is currently being presented to the various groups of Pastors and their bookkeeping and accounting personnel.

When it came to the issue of debt-financed income, our questionnaire merely asked about lease, rental or similar type income that might arise from debt-financed situations. We also have asked generally for other sources of income. There was interest income, some instances of dividend income, and many instances of lease income. In most cases where we found interest and dividend income of any significant amount, there was no debt. Such income, as well as income from real property in general, is not unrelated business income. It would only be our concern

if it were debt-financed. We did find interest income and perhaps occasionally dividend income in small amounts where there was debt. However, the dividend income in every instance was the result of a bequest or gift. Where there was debt, the interest income arose from savings accounts that represented either reserve funds, seasonal funds, or those already allocated to and charged with particular projects or purposes. No borrowed funds were involved in producing these items of income.

Lease and rental income became another matter. One parish received rental income from two residential properties and had a debt. Follow-up investigation revealed that the residences were owned before the debt existed. The debt was directly attributable to the construction of the parish school. There was no rental income from the school, which was supported by tuitions, augmented by general parish support. Rental income was reported from a parish which has debt but on investigation the rental comes from a parish community hall which was fully paid for before the debt was incurred. That debt related entirely to the school. This is not debt-related income. We find a parish that rents its hall routinely on a first-come, first-served basis. The parish has debt. However, we find that the hall was the original temporary parish church, and that it was fully paid for before the church was constructed and the debt related to the construction of the church. We eliminated debt-financed income.

The vast majority of our instances of income from real estate concerned school leases or rentals. Generally, these were schools built and originally operated by the parish for the parishioners. The circumstances of the times resulted in a discontinuance or curtailment of use, and subsequent lease or rental of the unused facilities. In most cases, the lease or rental was to public school or regional parochial school resulting from the consolidation of several parishes into the educational facilities of a lesser number of schools. Leases for other parochial school uses were eliminated from further consideration because we classed such uses as related. At this point we found that we must look to the nature of the debt as well as the nature of the tenant.

The Diocese, through the Chancery office, had the records on which parishes and organizations had debt. These records showed the amount and type as well. The debt falls into four general categories. We have bank debt, debt to the Diocese, debt to other parishes within the Diocese, and debt to parishioners on the basis of a borrowing program of notes issued to parishioners as general parish obligations. Because the debt that exists between one arm and the other in the Church, between one parish and another, between a parish and the Diocese, between the parish and another organization within the Church, is considered internal debt and therefore not the regular debt envisioned by the law, we eliminate all of such situations. While we are doing this, at the same time, we are protecting the accounting aspects.

The debt-financed income application comes where there is indebtedness to bank, insurance company or any other lending institution or on a program of loans from the parishioners—from the public. Where that type of financing appears and there is income from real estate, we then turn to determine whether the debt arises out of the particular real estate. In most cases, it does. Now we are faced with an accounting problem. The school and convent may have been built at the same time. We have to make a cost determination and apportionment. We have this

phase in progress now. At any rate, our record systems include provision for this source of income.

Income from a controlled corporation is also our concern. It constitutes unrelated business income in general. Either a stock corporation or a member type corporation can be a controlled corporation. Eighty per cent is the turning point. In the normal business corporation, if eighty percent or more of the stock is owned by an exempt organization, we have a controlled corporation. Income received from it is basically taxable. In Providence, the corporation solely owns 100% of the outstanding stock of the Diocesan newspaper company. If necessary, to avoid consequences of the controlled corporation, more than 20% of the stock can be transferred to another corporation which would not meet the status of controlled corporation.

For a long period of years, this newspaper has operated at a loss and we are not seriously concerned with this operation because the Diocese subsidizes it. The paper has some subscriptions and advertising. However, the advertising does not pay for itself and its subscriptions do not pay for the balance of the content of the paper. From that account, I have no income which could be taxable to the controlling corporation, the corporation sole.

With the non-business corporations, a test of control is the feature of whether the members serve at the pleasure of the controlling authority or are employees, agents or such of the controlling authority. The Bishop, Vicar-General and Chancellor, wherever they serve, are controlled members. In most cases, there are other members of these non-business corporations—and I am talking about the parishes at this point — who serve for a term. They are elected at the meetings annually for one year. They therefore eliminate the element of control, as long as they constitute over 20% of the membership. Actually, this is not much of a concern except for the parishes because there is no cash flow, no income flow from the controlled corporation to the controlling corporation. In fact, if anything, it is the other way. But, in the instance of the parishes, we have the Bishop, Vicar-General, Pastor and two laymen. The Bishop and Vicar-General are controlled members. In my own parish, I am one of the lay members. As Attorney for the Bishop and the Diocese, I am a controlled member. The other lay members are not controlled. We then come to the status of the Pastor. Under our system, he is a permanent Pastor and cannot be removed at the pleasure of the Bishop. In the situation that exists at this time, therefore, the Parish is not a controlled corporation. However, if there should arise a vacancy in the office of Pastor, an Administrator would be appointed and he would serve at the pleasure of the Bishop. In that circumstance, my Parish would have four of the five members being controlled, an 80% control. Therefore, the Parish corporation would be a controlled corporation. This is a concern because the parishes are assessed for support of the Diocese and make annual payments to the Diocese. If the parish has unrelated business income, debt-financed income, then I believe a portion of the amount paid as the assessment would be considered to have the same character in the hands of the controlling corporation. We are watching the membership closely, but I fear that at some point we are going to miss out and have some kind of a problem.

Our main concern is to protect the Diocese from audit, and when that cannot be done, in any case, to limit the extent to which Internal Revenue can look into the books. I believe that knowledge of the details of our operations can lead to control. To protect religious freedom, we consider it essential to limit access of all government to our financial details.

APPENDIX A

DIOCESE OF PROVIDENCE
 Cathedral Square
 Providence, Rhode Island
Office of Vicar for Financial Administration

April 5, 1975

TO: PASTORS, DIRECTORS AND ADMINISTRATORS

RE: QUESTIONNAIRE: UNRELATED INCOME OF TAX EXEMPT INSTITUTIONS

Recent changes in the Internal Revenue Code include carefully drawn definitions related to Federal Income Taxes on unrelated income of tax exempt institutions. The areas of concern need to be studied initially, and thereafter specific counsel may be provided as to the complex aspects of the tax law on this topic. Whether there is a tax consequence to our Parishes or Institutions can only be assessed if the answers to the following are given and *returned to my office*.

1. Does your Parish or Institution run "bingo games"? Yes ___ No ___
 How often: Weekly ___ Monthly ___ Annually ___
 In Church facilities: Yes ___ No ___
 Private facilities: Yes ___ No ___
 Help provided: Volunteer ___ Paid ___
2. Does your Parish or Institution run bazaars, auctions, rummage sales, paper salvage, 20/20 Clubs, etc.? Yes ___ No ___
 How often: Weekly ___ Monthly ___ Annually ___
 Help provided: Volunteer ___ Paid ___
3. Do you have paid advertising in your Parish Bulletin? Yes ___ No ___
4. Does your Parish or Institution have social activities with booklets or programs that include paid advertising? Yes ___ No ___
5. Does your Parish or Institution have calendars with paid advertising? Yes ___ No ___
6. Does your Parish or Institution have any leases with any tenants who use Parish or Institutional facilities for rent? Yes ___ No ___
7. Does your Parish or Institution rent space for weddings, dances, social activities, school activities, etc.? Yes ___ No ___
8. Does your Parish or Institution have printing with paid advertising, such as, school book covers, etc.? Yes ___ No ___
9. Does your Parish or Institution have any other income, other than contributions, tuitions and offerings, not covered by the questions above? Yes ___ No ___
 Please indicate the nature of such income. (USE OTHER SIDE IF NECESSARY.)

PARISH/INSTITUTION _____ BY _____

PLEASE RETURN TO: Rev. Edward J. McGovern, Vicar for Financial Administration AS SOON AS POSSIBLE.

APPENDIX B

TO: PASTORS, DIRECTORS AND ADMINISTRATORS

FROM:

SUBJECT: UNRELATED INCOME OF TAX EXEMPT INSTITUTIONS

Recent changes in the Internal Revenue Code include carefully drawn definitions relating to Federal Income Taxes on Unrelated Income of Tax Exempt Institutions. It is imperative, in view of the prospect of required reports or responses, that all Pastors, Directors and Administrators be fully informed as to any possible consequences to our Institutions or Parishes.

The areas of concern need to be studied initially, and thereafter specific counsel may be provided as to the complex aspects of the tax law on this topic. Whether there is a tax consequence to our Parishes or Institutions can only be assessed if the answers to the following survey are promptly received.

Please mark the answers for your Parish or Institution by checking the answer for each question listed.

1. Does your parish or institution run "bingo games"? Yes ____ No ____
 How often: Weekly ____ Monthly ____ Annually ____
 In church facilities: Yes ____ No ____
 Private facilities: Yes ____ No ____
 Help provided: Volunteer ____ Paid ____
2. Do you have paid advertising in your Parish Bulletin? Yes ____ No ____
 If so, please furnish a copy of such paper.
3. Does your Parish or Institution have social activities with booklets or programs that include paid advertising? Yes ____ No ____
4. Do you receive compensation or rental for the use or occupancy of any one or more of the following facilities:

[Circle the applicable number(s)]

1. Parish Halls
2. Classrooms or schools
3. Residences
4. Office Buildings
5. Farms
6. Parking Lots
7. Other Buildings
8. Motor Vehicles
9. School or office equipment
10. Household Goods
11. Oil or mineral leases
12. Other goods, merchandise or equipment
13. We do not receive rental from any facilities.

If your answer to one or more facilities numbered 1 through 12 is affirmative, identify by the appropriate number those facilities which relate affirmatively to the following questions. (If your answer is negative, proceed to the next Part.)

What facilities did you *acquire* by incurring a money debt (other than a debt to the Diocese)?

What facilities did you *improve* by incurring a money debt (other than a debt to the Diocese)?

What facilities have a rental structure based on NET profits from production or sales from the leased facilities?

What facilities have a rental structure which includes or combines your building facility as well as your furniture, your equipment, or other personal property belonging to you?

What building facilities would not be rented or rentable by you BUT FOR the furniture, equipment, or other personal property which is included in the building?

5. Do you (or any related sub-group of your organization) receive all or any part of the revenues or earnings of any one or more of the following types of activities:

[Circle the applicable number(s)]

1. Bingo
2. Bazaars
3. Suppers
4. Raffles
5. Dances
6. Monte Carlo Nights
7. Card Parties
8. Athletic Events
9. Concession Stands

If your answer to one or more of the activities numbered 1 through 9 above, is affirmative, identify by the appropriate number those activities which relate affirmatively to the following questions:

What activities do you manage or control, directly or indirectly?

What activities are employers of labor for money or money's worth?

What activities include the purchase of goods or services for resale at these activities?

Specify the regularity of the activity in a calendar year.

[Circle a, b, or c and identify the applicable activity by its number, above.]

- a. One or more times per week.
- b. One or more times per month.
- c. Less than 12 times per year.

Comments: