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ASSET MANAGEMENT STRATEGIES REVISITED

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This article consists of three short discussions. First, special legal issues concerning the arts, antiquities, and historical property of religious organizations will be addressed by Charles Reynolds. Second, Daniel Wintz will focus on retirement assets, including the legal requirements for and advantages of qualified pension plans. Finally, Deirdre Halloran, Associate General

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Counsel to the United States Catholic Conference, will focus on the requirements needed for Section 501(c)(3) tax-exempt status and Section 509(a) public charity status.

SPECIAL LEGAL ISSUES CONCERNING THE ARTS, ANTIQUITIES,
AND HISTORICAL PROPERTY OF RELIGIOUS ORGANIZATIONS

At the Archdiocese of Santa Fe, one of the major projects that has taken place over the last ten years is the creation of an organization by Archbishop Sanchez entitled "The Archbishop's Commission for the Preservation of Historic Adobe Churches." By employing structural engineers and people in the fields of history and archeology, the Commission has created a very comprehensive record concerning the old churches in New Mexico. Some of these churches were built as early as the 1600's and 1700's.

The Commission, working with an organization in New Mexico called "The New Mexico Community Foundation," has begun the process of preserving these churches. The Foundation takes the word "community" in its title very seriously and it has had remarkable projects that are community based. Small rural communities in northern New Mexico, together with the help of the Foundation and the Commission, have restored and rebuilt many of these churches. It is a miracle in progress watching these groups of people restore their churches. There is a wonderfully spiritual dimension to it.

While the historic adobe churches are in very good shape as far as asset management is concerned, they are all still owned or titled in the corporation sole, leaving these assets potentially at risk. When this project began, very little thought was given to transfers made with the intent to hinder, delay, or defraud creditors or to the concept of inadequate consideration,¹ or to transfers made for less than reasonable equivalent value.² There is a

¹ Such transfers are generally referred to as fraudulent conveyances, commonly defined as "[a] conveyance or transfer of property, the object of which is to defraud a creditor, or hinder or delay him, or to put such property beyond his reach." BLACK'S LAW DICTIONARY 662 (6th ed. 1990) (citing *Dean v. Davis*, 242 U.S. 438 (1917)).

² Fraudulent transfer law applies when transfers are made where a debtor receives less than a "reasonably equivalent value." Jack F. Williams, *The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System*, 15 CARDOZO L. REV. 1403, 1412 (1994).

big question as to what to do in terms of trying to separately incorporate the Commission. Transferring title to those pieces of real estate is not simply a matter of preparing deeds. Many of these old churches are sitting adjacent to the new church. This new church would have been built, for example, in 1850, whereas the old church was built in 1720. Thus, it is going to be very expensive because it would require considerable surveying work.

In addition to the churches, New Mexico also has a beautiful assemblage of Spanish colonial art and antiquities. The state was a colony of Spain from the year 1540 until the year 1821. During that time, there was a tremendous Spanish influence in the arts, especially religious art. There are *retablos*, *votos*, *santos*,³ and altar screens. With the little wooden *santos*, for example, there is a deeply felt devotion. In the year 1680, there was a Pueblo revolt in New Mexico where the Pueblo Indians challenged Spanish authority and ultimately sent them south. Twelve years later in 1692, an event called "The Reconquest," which was supposedly bloodless, although historians differ a little bit on the realities, occurred. The Reconquest involved a Spaniard by the name of Don Diego De Vargas who marched back into Santa Fe with a *santo*—a statue of Our Lady. Her name for many years was La Conquistadora—the conqueror. She was greatly admired, and the *santo* itself—the physical object—still exists. In a beautiful gesture Archbishop Sanchez, who did not feel that the name La Conquistadora was appropriate for modern times, renamed her Santa Maria de La Paz—Our Lady of Peace. There is a beautiful new church in Santa Fe, built about two years ago, which is the parish of Santa Maria de La Paz. It is here that the woman formerly known as La Conquistadora resides. What is her value? Who knows? Neither the *santos* nor the altar screens have been appraised. In terms of dollars, of course, they are valueless.

For many years, thought was given to separately incorporating the arts and antiquities and, again, there is concern about transfers made with the intent to hinder, delay, or defraud creditors. One of the challenges is to articulate exactly what the consideration is for transferring these objects into a separate corporation. One idea is that the new corporation would agree to

³ Santo is the Spanish word for saint; *retablos* are painted panels that picture Catholic saints. See Joanne Ditmer, *Scholar and Cowboy*, DENVER POST, Jan. 22, 1994, at 10.

preserve them.

There are at least two United Nations Conventions—one from 1970 and another one from 1972—that are of importance here. The 1970 Convention was on the means of prohibiting and preventing the illicit import, export, and transfer of ownership of cultural properties.⁴ The 1972 Convention concerned the protection of world cultural and national heritage.⁵ As previously mentioned, one thought is that adequate consideration be given for the transfer from the corporate sole to a new corporation in the form of a commitment to preserve these cultural properties. There is more research to do. There is more thinking to do.

RETIREMENT ASSETS

A retirement plan that is not properly protected from a diocese's creditors can have dire consequences for both the priests and the bishop of the diocese. Over at the Alamo, there is a painting of Colonel Travis taking his saber out and drawing a line in the sand; he is asking all those who are willing to stand, fight, and give their lives for freedom to come forward. This famous painting is called *The Decision*. Many bishops are also faced with their own "decision."

The 189 men at the Alamo made the decision to give their lives to something that they felt was of the utmost importance. The decisions that many bishops are being asked to make do not involve the loss of life, but they are likely just as difficult to make because they are decisions as to whether they are going to give up some control. The reason that they may need to give up their control is for the purpose of protecting retirement plan assets from the claims of the diocesan creditors. If a bishop makes a decision to try to protect the retirement plan assets from the claims of creditors, the bishop must create a separate legal entity, under both civil law and canon law, for the purpose of holding those assets.

For a plan which is subject to federal pension law, the legal entity usually will take the form of a trust. If a plan is not sub-

⁴ Convention on the Means of Prohibiting and Preventing the Illicit Import, Export and Transfer of Ownership of Cultural Property, Nov. 4, 1970, 823 U.N.T.S. 231, *reprinted in*, 10 I.L.M. 289 (1970).

⁵ United Nations Educational, Scientific and Cultural Organization Convention for the Protection of the World Cultural and National Heritage, Nov. 16, 1972, UNESCO Doc. 17/c/106 (1972).

ject to federal regulation, then the legal entity can take the form of either a trust or a corporation. If a trust is used and the plan is subject to federal law, there is good news for an archbishop or bishop. The bishop alone, if he so chooses, can serve as the sole trustee and the assets of the trust will still be exempt from the claims of creditors. There is a price to be paid, however, for the ability to retain this kind of control, or for any plan that is subject to federal law. The plan will be subject to certain vesting requirements, funding requirements, reporting requirements, and certain claims procedures by plan participants. Bishops may not find the idea of vesting their priests in retirement benefits acceptable because, again, they prefer to retain control.

The lay employees' pension plans in most dioceses have been properly established or are very nearly properly established. The focus of this discussion will be on the priests' retirement plans because, in many cases, the assets of these retirement plans have not been segregated from the assets of the diocese. In these cases, unseparated assets remain subject to the claims of creditors. A bishop, by virtue of his position, is subject to a unique duty to provide for the benefit and support of the priests who are incardinated in his diocese for their lives. This includes their retirement income.

Federal law defines retirement plans very broadly. The Employee Retirement Security Act of 1974,⁶ commonly referred to as ERISA, states that any plan, scheme, or arrangement that is intended to defer the receipt of income for periods of time extending to the termination of employment or beyond is a retirement plan.⁷ There are eight types of arrangements which are exempt in whole or in part from the provisions of ERISA.⁸ One such exempt arrangement is a church plan; which is exempt,

⁶ Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1461 (1994)).

⁷ 29 U.S.C. § 1002(2)(A). ERISA refers to such a plan as an "employee pension benefit plan" or "pension plan." *Id.*

⁸ Exempted plans include church plans, governmental plans, 403(b) arrangements, IRAs and SEPPs, plans to which no employer contributions have been made since 1974, unfunded excess benefit plans, plans covering only persons who are not employees, and unfunded top-hat plans. 29 U.S.C. § 1003(a) & (b). The concept of "church plan" is defined at 29 U.S.C. § 1002(33)(A):

The term "church plan" means a plan established or maintained ... by a church or by a convention or association of churches which is exempt from tax under section 501 of the Internal Revenue Code of 1986

Id.

unless an election to be covered is made.

In practice many dioceses have not elected to be covered by federal law. However, they have used a retirement plan document provided to them, by a bank, an insurance company, or a mutual fund. These are known as prototype plans. Within these plans, there are all types of contractual rights created in plan participants which do not ordinarily apply to church plans and would not apply to a diocesan plan but for the fact that they chose to use an off-the-shelf plan document. The selection and design of the plan document is very important, so as not to inadvertently create rights or duties where none are intended.

The ERISA definition of church plan is virtually identical to the definition of church plan that found in the Internal Revenue Code⁹ (IRC). Both ERISA and the IRC initially focus on the existence of a plan. Neither is initially concerned about funding for the purpose of finding the existence of a plan. Thus, it is important to determine (1) whether there is a retirement plan, and (2) whether it is a church plan. If it is a church plan, it is automatically exempt from ERISA, unless an election is made.¹⁰ Most of the plans that are maintained in the dioceses are church plans as long as they cover only priests or only priests, religious, and/or lay employees employed by the diocese.

What is an example of a non-church plan? The Christian Brothers Retirement Plan that is maintained for employees working in their winery is not a church plan. The reason for this is that the Internal Revenue Service has held that their winery operation is an unrelated trade or business. Thus, if there is an unrelated trade or business offering a retirement plan, it will not be considered a church plan, even though it is connected with a church.

Assuming that there is a church plan, there are three elections that can be made. First, an election can be made under IRC Section 410(d). Second, by virtue of making this election, an organization is permitted to opt into coverage under Title I of ERISA, which relates to employee rights, funding requirements,

⁹ See I.R.C. § 401 (1996) (referring to church plan); see also I.R.C. § 3121(w)(3)(A) & (B) (defining church and qualified church-controlled organization).

¹⁰ The election refers to the choice of a church to "have participation, vesting, funding, etc., provisions apply" for tax purposes. I.R.C. § 410(d). Once a church so elects, it is treated as if no exemption for church plans under ERISA existed, and such an election is irrevocable. *Id.*

vesting requirements, reporting requirements, and fiduciary duties. This election is made either by filing an application for determination or by filing Form 5500.¹¹

A third election is available for employers which offer defined benefit pension plans. A defined benefit pension plan would, for example, pay \$600-a-month for life to the beneficiary upon retirement. If coverage is elected under Title I of ERISA, additional coverage is available under Title IV of ERISA. Title IV relates to the Pension Benefit Guaranty Corporation¹² (PBGC), which is a quasi-governmental entity similar to the Post Office. The PBGC's purpose is to provide insurance for the payment of retirement benefits to employees of bankrupt employers which are unable to meet their pension obligations.

It is probably worthwhile to be covered by Title I of ERISA and by the IRC. There is very little advantage, however, in electing coverage under Title IV of ERISA, especially for lay employees' pension plans.

Coverage under Title I of ERISA is not terribly onerous. In order for dioceses to be competitive, they may have to offer retirement benefits equivalent to those being offered by for-profit employers. Therefore, a rapid vesting schedule is necessary. Due process rights must be followed for benefit claims and the plan must be sufficiently funded. For priests' plans, however, many bishops have been reluctant to provide for adequate funding and vesting over a period of less than seven years. The bishops generally wish to retain more control over the priests' plan than an electing plan permits.

There is very little benefit in making the defined benefit pension plan election under Title IV of ERISA. If the diocese makes this election, it is subject to both funding requirements of ERISA and the requirement to pay PBGC premiums for the insurance that is provided. If the employer goes bankrupt, the PBGC is the second priority creditor after the Internal Revenue Service. The PBGC is the 1800-lb. gorilla that can come in and make life absolutely miserable. The PBGC does not care about

¹¹ Form 5500 must be filed by the employer or plan administrator of a defined benefit plan that is subject to the minimum funding standards of ERISA. 29 U.S.C. § 1082.

¹² Pension Benefit Guaranty Corporation is a government owned corporation which administers the termination rules and establishes the mechanism for insuring benefits under Title VII of ERISA. 29 U.S.C. § 1302. See also STEVEN J. KRASS, *THE PENSION ANSWER BOOK* Sec. 219 (10th ed. 1995).

religious art and antiquities or what their value is in the pastoral sense. They are only looking for assets to liquidate to pay off retirement benefits.

While one election requirement is that the plan must be in writing,¹³ many informal arrangements exist. One example is a retirement benefit plan description that simply advises a priest that he will be provided a benefit at age 70 of \$400-a-month for life. That does not come close to meeting ERISA's requirements for what must be in a qualified retirement plan.¹⁴ Additionally, in this type of plan, there must be a prohibition against any type of reversion to the diocese, unless all of the assets have been used to provide and satisfy the benefits promised by the plan.¹⁵ Only then may there be any reversion of the assets back to the diocese. There is also an absolute prohibition against engaging in certain transactions.¹⁶ Another thing often found is that some priests' or lay employees' retirement plans are being invested in the building and loan fund. Thus, the money leaves the diocese and enters the retirement plan only to return to the diocese because it is invested in the building and loan fund. This is a prohibited transaction which subjects the diocese to incredibly onerous excise taxes if it occurs.¹⁷

To be considered a "qualified plan" for tax purposes, a plan must meet the requirements of the IRC.¹⁸ Again, the plan must satisfy all of the requirements of the Code applicable to church plans.¹⁹ About half of the requirements that apply to for-profit employers apply to church plans that do *not* elect to be covered by ERISA. Though the bishop can be the sole trustee, there can be no reversion.²⁰ There must be vesting.²¹ There must be appropriate funding.²² There may be no prohibited transactions.²³

¹³ 29 U.S.C. § 1024.

¹⁴ See 29 U.S.C. 1022(b) for the full list of requirements.

¹⁵ 29 U.S.C. § 1344(d)(1).

¹⁶ See 29 U.S.C. § 1106.

¹⁷ Under the Internal Revenue Code, a penalty tax equal to 5 percent of the transaction is imposed. I.R.C. § 4975. Under ERISA, the employer is personally liable for any losses and must restore to the plan any profit made through use of the plan's assets. ERISA 29 U.S.C. § 1109(a).

¹⁸ See generally I.R.C. §§ 410-412.

¹⁹ *Id.* §410(d).

²⁰ *Id.* §410(d)(2).

²¹ *Id.* § 411.

²² *Id.* § 412.

²³ *Id.* § 4975(c).

The primary advantage is that the plan may voluntarily elect to include a provision under Code Section 401(a)(13), which prohibits reversion back to the diocese. Using this provision, the diocese may be able to argue that the plan constitutes a spendthrift trust under state law.²⁴ As such, under the laws of thirty-eight of the fifty states, the assets contained in a spendthrift trust, even though created by the diocese and subject to the one-year transfer rule, would be exempt from the claims of the creditors of the diocese. Another benefit of electing solely under the Code is that there are no reporting requirements. The plan is not subject to Department of Labor oversight, PBGC regulations, or ERISA claims procedures. There is a major additional benefit to a tax qualified plan: participants are assured that their benefits will not be subject to constructive receipt when they vest in the plan assets.

There are two arrangements a diocese might use to set up a retirement plan. However, they create significant risks of causing constructive receipt on the part of the employees when they vest in their benefits because there is a transfer of property to a trust under IRC Section 83. Unless there is a risk of forfeiture in the employees or the priests, there would be constructive receipt of income under the following two types of arrangements when employees or priests vest in their benefits.

The first arrangement is a simple spendthrift trust which can only be created under state law. As previously mentioned, thirty-eight states recognize this type of arrangement, either by statute or at common law. Again, there should be no self-dealing in this arrangement and the diocese should retain no reversionary interest in the spendthrift trust. The advantage of this kind of arrangement is that it is not subject to *any* of the federal laws, including those dealing with minimum distributions²⁵ or funding mandates.²⁶ But under this arrangement, the bishop should not be the sole trustee of the plan. There is also tension between the employees and the dioceses concerning when there is a constructive receipt of income. One way of avoiding constructive receipt

²⁴ A spendthrift trust bars the voluntary or involuntary alienation of the beneficiary's interest in the right to receive the trust income. In re Martin, 119 B.R. 297, 307 (M.D. Fla. 1990).

²⁵ 29 U.S.C. § 1054 (requiring elaboration for accruals due to employee vesting in plan).

²⁶ 29 U.S.C. § 1082 (mandating adherence to minimum funding standards).

is to create a risk of forfeiture under IRC Section 451.²⁷ This may be accomplished by holding the assets of this trust subject to the claims of the creditors of the diocese. Of course, this defeats the purpose we are discussing.

The second type of arrangement is a charitable trust under IRC Section 501(c)(3).²⁸ The provision of retirement benefits for religious or lay employees is clearly recognized as a charitable purpose under Section 501(c)(3). This type of arrangement may be a good alternative to be used in the twelve states which do not recognize spendthrift trusts. This is also a good arrangement to use if the diocese conducts an annual priests' retirement solicitation, where parishioners and donors are asked to make gifts to the priests' retirement fund.

Ironically for me, the leading case in this area was decided by the Nebraska Supreme Court, in *Hobbs v. Board of Education of Northern Baptist Convention*.²⁹ Here, the court traced the history of charitable trusts and the protections they are afforded from the claims of the beneficiary's creditors.³⁰ Among the important holdings, the court found that third party gifts to charitable trusts were immune from the reach of the trust creator's creditors.³¹

Thus, there are the non-ERISA arrangements for which a church plan may choose an IRC Section 401(a)(13) plan, a spendthrift trust, or an IRC Section 501(c)(3) charitable trust. All present options which a diocese can consider instead of opting for a plan under Title I of ERISA.

Nevertheless, all retirement plans are subject to the bankruptcy laws. Principally, a bankruptcy trustee can reach contributions made to any type of retirement plan, if such contributions were made within one year of the declaration of bankruptcy and the contribution was made with the intent to hinder, delay, or defraud creditors.³² In addition, there is case law which says that if the contributions were made in a manner that is not consistent with the written terms of a plan, the plan itself is void *ab*

²⁷ I.R.C. § 451 (requiring taxation of income for year such income was accrued).

²⁸ I.R.C. § 501(c)(3) (1994). Notably, this section of the tax code exempts specified organizations from taxation. *Id.*

²⁹ 253 N.W. 627 (Neb. 1934).

³⁰ *Id.* at 632-34.

³¹ *Id.* at 635-36.

³² 11 U.S.C. § 548(a)(1)(1994).

initio.³³ In the latter case, all of the retirement plan assets would return to the debtor's estate and would be subject to the claims of creditors.³⁴

Finally, each one of these arrangements, while they may be created civilly, also require canonical approval in order to be a juridic person. In other words, they should be created by a decree of the bishop. This means that, under canon law, the fund will own its own property and the diocese does not have a claim on the property of this separate juridic person. Since transfers by the diocese to these funds would constitute an alienation, contributions may require either consultation or consent. Consent is required when a single sum amount transferred to the trust fund would exceed three million dollars. Today, many of the priests' retirement plans have not yet been funded. Because of accrued past service liability, when created as separate entities, the required funding transfer could easily exceed three million dollars and thus require consent.

TAX EXEMPTION AND PUBLIC CHARITY STATUS

Once the decision has been made to establish a separate organization, one of the first considerations will be whether and how that organization is going to be able to qualify for tax-exempt status under I.R.C. Section 501(c)(3). If there is interest in avoiding the Chapter 42 private foundation excise taxes³⁵ and having an organization listed in the Official Catholic Directory, it is necessary to decide how the organization will qualify as a public charity under section 509(a). The rules that apply to public charity status, particularly the 509(a)(3) supporting organization rules, may involve elements that run counter to some other asset management goals. Accordingly, an organization will need to balance its desires and realize that there is no simple fool-proof way to achieve all results in every case.

To qualify for Section 501(c)(3) status, an organization "must

³³ In re Bell & Beckwith, 5 F.3d 150, 153 (6th Cir. 1993), *cert. denied*, 510 U.S. 1114 (1994).

³⁴ *Id.*

³⁵ I.R.C. § 4940.

There is hereby imposed on each private foundation which is exempt from taxation under section 501(a) for the taxable year, with respect to the carrying on of its activities, a tax equal to 2 percent of the net investment income of such foundation for the taxable year.

Id. § 4940(a).

be both organized and operated exclusively for exempt" purposes.³⁶ Those purposes must be limited specifically in the articles of incorporation or other organizing document.³⁷ Furthermore, the organization must have a dissolution clause in its organizing document which specifically directs payment of assets upon dissolution to another Section 501(c)(3) organization.³⁸ The organization must also be operated exclusively for exempt purposes. Thus, it cannot operate for purposes which are either illegal or contrary to fundamental public policy. Next, it must operate for public purposes rather than private benefit³⁹ and it cannot permit inurement of net earnings to insiders.⁴⁰ Finally, it cannot engage in more than insubstantial lobbying⁴¹ and it cannot engage in *any* political campaign activity.⁴²

If an organization meets all these requirements, it can qualify for Section 501(c)(3) status in one of two ways. The organization can file Form 1023, Application for Recognition of Exemption, directly with the IRS. Alternatively, the organization can apply to the diocese for inclusion in the USCC Group Ruling.

All organizations that are exempt under I.R.C. Section 501(c)(3) fall into one of two sub-categories: public charities or private foundations. For a variety of reasons, it is better to be a public charity, and, if an organization is going to qualify for the USCC Group Ruling, it *must* be a public charity. It cannot wait until the end of the process to decide the issue. It must decide up front.

There are three basic ways in which an organization can avoid being classified a private foundation. The first is by definition. The I.R.C. provides that certain types of organizations are not private foundations by definition, including churches, schools, and hospitals.⁴³ The second way to avoid being a private foundation is based upon the amount of financial support an organization receives from members, the general public, governmental sources, and the like. There are two different public

³⁶ 26 C.F.R. § 1.501(c)(3)-1(a)(1). If the organization fails either requirement, it cannot be considered an exempt organization. *Id.*

³⁷ *Id.* § 1.501(c)(3)-1(b)(1)(i).

³⁸ *Id.* § 1.501(c)(3)-1(c)(1).

³⁹ *See* 26 C.F.R. § 1.501(c)(3)-1(c)(2).

⁴⁰ *Id.*

⁴¹ *See id.* § 1.501(c)(3)-1(c)(1).

⁴² *Id.* § 1.501(c)(3)-1(c)(3)(iii).

⁴³ I.R.C. § 170(b)(1)(A)(i)-(iii).

support computations available under I.R.C. Sections 509(a)(1) and 509(a)(2). The third method of qualifying as a public charity involves the infamous “supporting organization” under Section 509(a)(3).⁴⁴ Section 509(a)(3) regulations are, perhaps, the most notorious in the entire Code. Supporting organizations include things like diocesan endowment funds, various fundraising organizations, and organizations that provide services solely to other diocesan organizations.

To qualify as a “supporting organization” under Section 509(a)(3), an organization must meet one of three relationship tests. First, its organizing document must state that the organization is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the functions of one or more specified publicly-supported organizations.⁴⁵ Publicly-supported organizations typically will be the diocese, parishes, or other subsidiary diocesan corporations that are themselves considered publicly-supported under Sections 509(a)(1) or (a)(2). Second, it is important to remember that one Section 509(a)(3) organization *cannot* support another Section 509(a)(3) organization.⁴⁶ The third major requirement is that the organization must not be controlled by disqualified persons.⁴⁷ Qualification under Section 509(a)(3) is neither automatic nor simple, and it is insufficient for organizations to state generally that they are “supporting the Church.”

The three different relationship tests that are permitted under Section 509(a)(3) have decreasing levels of relationship and control. The more control an organization has, the fewer burdensome application requirements it must meet. If the supported organization has less control over the supporting organization, complex attentiveness and responsiveness tests must be met on an ongoing basis.

The first relationship test is the “operated, supervised, or controlled by” test. This is comparable to a parent-subsidiary

⁴⁴ *Id.* § 509(a)(3).

⁴⁵ I.R.C. § 509(a)(3)(A).

⁴⁶ I.R.C. § 509(a)(3)(B).

⁴⁷ I.R.C. § 509(a)(3)(C). Under Section 4946(a)(1) of the Code, a disqualified person includes one who is (1) a substantial contributor to the foundation; (2) a foundation manager; (3) an owner of more than twenty percent of the voting power of a corporation, the profit interest of a partnership, or the beneficial interest of a trust which is a substantial contributor to the foundation; and (4) a family member of one of the foregoing.

relationship. This test is satisfied when a publicly-supported organization actually elects or appoints a majority of the supporting organization's officers, directors, or trustees.⁴⁸ The second test is the "supervised or controlled in connection with" test. This is the equivalent of a brother/sister relationship. The key requirement is common supervision or control. The management of the two organizations—the supporting organization and the supported organization—must be vested in the same individuals.⁴⁹ Self-perpetuating boards can be problematic under both of these tests. For example, although the first board may meet the requirements that the majority of the board members be elected by the supported organization, subsequent self-perpetuating boards will not. That will force the organization into the Byzantine requirements of the "operated and connection with" test.

There is an example in the regulations, which indicates that the "supervised or controlled in connection with" test can be met where all of the trustees are members and leaders in a church and office holders in its related institutions, and where successor trustees are chosen by the remaining trustees. However, and this is a very important caveat, the successor trustees must also be members of the church, church leaders, and office holders.⁵⁰ Thus, you cannot simply put your first board in place and let that board select subsequent boards, assuming that the organization will continue to meet the requirements of these first two tests.

The third alternative test is the "operated and connection with" test.⁵¹ This test is the loosest of the three in terms of control requirements, but is incredibly detailed and intricate in its actual application. To qualify, an organization must meet both responsiveness and integral part tests, each of which has several subparts.

The responsiveness test has two alternative subparts. First, the supporting and supported organizations must be in close operational conjunction so that (1) at least one of the directors, as opposed to a majority, are elected or appointed by the supported organization; (2) at least one of the directors serves in a governing position in the supported organization; or (3) the officers of

⁴⁸ Treas. Reg. § 1.509(a)-4(g).

⁴⁹ Treas. Reg. § 1.509(a)-4(h).

⁵⁰ Treas. Reg. § 1.509(a)-4(h)(iii), Example 3.

⁵¹ Treas. Reg. § 1.509(a)-4(i).

the two organizations maintain a close and continuous relationship.⁵² In addition, by reason of one of these relationships, the officers, directors, or trustees of the publicly-supported organization must have a significant voice in the investment policies, the timing of grants, the making of grants, and otherwise directing the use of the income and assets of the supporting organization. The alternative test relates to charitable trusts that have enforceable rights under state law.

There are also two alternative subparts to the integral part test. The first alternative is applicable to organizations that conduct activities that are functions of the publicly-supported organization.⁵³ That is, *but for* the involvement of the supporting organization, these are activities that the supported organization otherwise conducts. The second alternative sub-part involves organizations paying “substantially all” of the income of the supporting organization.⁵⁴ It requires that eighty-five percent of the income of the supporting organization be paid to the supported organization. However, a problem frequently arises in connection with endowment funds. During the period when the corpus of the endowment fund is being built up, it very often will not be able to pay over eighty-five percent of its income to the supported organization. IRS concluded in a revenue ruling that a trust that was required by its terms to pay over seventy-five percent of its income to a specified church and to retain twenty-five percent to build up its corpus until that original corpus doubled, did not meet the “substantially all” requirement of Section 509(a)(3) and, therefore, did not qualify as a supporting organization.⁵⁵

An organization generally has fifteen months after formation either to become qualified pursuant to the USCC Group Ruling or to submit its application to the IRS. In addition, most charitable organizations are required to make an annual Form 990 submission to the IRS. Churches, which include the diocese and parishes, are not required to file. If a diocese is organized as a corporation sole, the Form 990 exemption applies to the entire diocesan operation. A newly-created organization must qualify independently for any available Form 990 exemption. It does

⁵² Treas. Reg. § 1.509(a)-4(i)(2)(ii).

⁵³ Treas. Reg. § 1.509(a)-4(i)(3)(ii).

⁵⁴ Treas. Reg. § 1.509(a)-4(i)(3)(iii)(a). “Substantially all” is not defined in this section.

⁵⁵ Rev. Rul. 76-208, 1976-1 C.B. 161.

automatically qualify for the same exemption applicable to the parish or diocese.

Related concepts include Section 502 "feeder organizations" and the integral part theory of tax exemption.⁵⁶ The concept of "feeder organizations" is that an organization that is providing ordinary commercial services does not automatically qualify for Section 501(c)(3) status simply because it is providing those services to Section 501(c)(3) organizations. More is required than simply saying "Okay, I am providing accounting services to other 501(c)(3) organizations; they pay me a fee; therefore, I am charitable."⁵⁷ However, an organization that is providing commercial-type services *can* qualify for Section 501(c)(3) status if it is providing these services (1) to related organizations or (2) at rates that are substantially below cost. The IRS looks at it this way: If you are providing a service that is substantially below cost, there is a donative element that makes the service charitable.⁵⁸

Organizations which are established to provide services *solely* to other diocesan entities could also qualify as charitable. However, if they start to sell their services to other unrelated Section 501(c)(3) organizations, at a minimum they are going to have unrelated trade or business problems. If this becomes a significant portion of their activities, they could lose their tax-exempt status.

The feeder organization regulations apply where one organization is providing services to another. The regulations indicate that if these services are provided to unrelated charitable organizations then the organization is a feeder organization and, therefore, is not tax-exempt.⁵⁹ Rather, structural relatedness is required to obtain tax exempt status. Structural relatedness means a single parent organization and one or more of its subsidiaries or subsidiary organizations having a common parent organization.⁶⁰ Thus, it is permissible to create an organization that will provide services to other subsidiaries of the diocese or

⁵⁶ Section 502 states that "[a]n organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501." I.R.C. Sec. 502(a).

⁵⁷ See Rev. Rul. 72-369, 1972-2 C.B. 245.

⁵⁸ See Rev. Rul. 71-529, 1971-2 C.B. 234.

⁵⁹ Treas. Reg. § 1.502-1.

⁶⁰ Treas. Reg. § 1.502-1(b)(1) & (2).

that will provide services to the diocese and several of its subsidiaries.

There is another theory that has been popular in tax-exempt circles for a number of years—the “integral part theory.” In applying this theory recently, the Third Circuit has required that a subsidiary’s relationship to its parent organization somehow “enhances the subsidiary’s own exempt character to the point that, when the boost provided by the parent is added to the contribution made by the subsidiary itself, the subsidiary would be entitled to Section 501(c)(3) status.”⁶¹ If you do not know what that means, take comfort in the fact that nobody knows what it means. It is somewhat counter-intuitive, because most of us think of the supporting organization as providing a “boost” to the supported organization.

The classic “integral part” example is a trust that is created by a hospital to pay its malpractice claims as directed by the hospital. The IRS has held that this trust is operating as an integral part of the hospital and is performing a service that the hospital could have done itself. Therefore, because there was both control and a service that was an integral part of what the hospital could otherwise have done, this organization qualified as charitable.⁶² What you are looking at is an organization that standing on its own could not qualify under Section 501(c)(3), but which, because of its relationship to another charitable organization and the assistance it provides to the exempt purposes of that organization, does in fact qualify.

⁶¹ *Geisinger Health Plan v. Comm’r of Internal Revenue Svc.*, 30 F.3d 494, 501 (3d Cir. 1994).

⁶² Rev. Rul. 78-41, 1978-1 C.B. 148.

