

Audit Technique Guide – Apostolic Associations – IRC Section 501(d)

Introduction

This guide supplements the procedures contained in IRMs 4.75, Exempt Organizations Examinations Procedures. It's not intended to restrict agents in identifying issues or using examination techniques not included here.

IRC Section 501(d) provides exemption under IRC Section 501(a) for a specific type of communal organization that would fail to qualify under IRC Section 501(c)(3).

Organizations exempt under IRC Section 501(d) are religious or apostolic associations or corporations which have a common treasury or community treasury.

All of the organization's property is owned in community and, each member, upon leaving the organization, is not entitled to any part of the community assets.

Activities often consist of farming and manufacturing.

The income of the organization goes into a community treasury usually used to defray operating expenses and the cost of supporting and maintaining the members and their families, thus contributions and bequests to the organization are not deductible under IRC Section 170. See Rev. Rul. 57-574, 1957-2 C.B. 161.

Exemption Application

Organizations seeking exemption under IRC Section 501(d) should include the information in Rev. Proc. 72-5, 1972-1 C.B. 709, supplemented by Rev. Proc. 2017-5, updated annually. They must submit a letter application with Form 8718 (Rev. Proc. 2017-5, Section 4.02(6)). See Rev Proc 72-5 and 2017-5 for the required information and documents.

In order to establish that it meets the statutory and regulatory requirements for exemption, an organization should submit with its application:

- A copy, including any amendments, of the organization's articles of association, articles of incorporation, or other document authorizing its formation
- A copy of the bylaws or other code of regulations under which the organization operates or plans to operate
- A complete statement of assets and liabilities of the end of each annual accounting period (or as of the date of the filing of the application, if the organization has existed less than a year)

- A statement of receipts and expenditures for each annual accounting period (or for the period for which the organization has existed, if less than a year).

Organizations must include with the application a written statement showing:

- The character, purposes, and activities (present or proposed) of the organization
- Whether the organization maintains a common or community treasury
- Whether all members of the organization live in a communal manner
- Whether the members may own, in their own names, any real or personal property
- Whether the members must furnish their own support (food, clothing, and shelter)
- The requirements for membership, method of member admission, members' right to property owned at the time they're admitted, and terminating members' rights to share in the organization's property, or to a return of any property contributed.

A principal officer of the organization must sign the written statement, containing the following declaration, or a similar declaration: "Under penalties of perjury, I declare that I have examined this application, including accompanying statements, and to the best of my knowledge and belief it is true, correct, and complete."

Members aren't required to surrender their personal possessions when they join the organization. In *Twin Oaks Community, Inc. v. Commissioner*, 87 T.C. 1233 (1986), the Tax Court stated that whether or not a religious or apostolic organization requires its members to take vows of poverty and dispose of all of their property holdings outside of the organization is irrelevant to the meaning of the terms "common treasury" or "community treasury" as used in IRC Section 501(d).

Annual Return

Under Regulation section 1.6033-2T and the [Form 1065, U.S. Return of Partnership Income filing instructions](#), an IRC Section 501(d) organization is required to file a partnership return on Form 1065. Even though it's exempt from income tax, an IRC Section 501(d) organization must compute "taxable income" to determine the amounts its members include in their gross incomes. A religious or apostolic organization must figure its taxable income on an attachment to Form 1065 the same way a corporation does and can use [Form 1120](#) U.S. Corporation Income Tax Return, for this purpose.

Taxable income must be allocated to its members as a dividend, whether distributed or not. Treas. Regs. 1.501(d)-1(a).

Member can't deduct net operating losses, but the organization may carry them back or forward under the IRC Section 172 rules.

In computing a religious and apostolic association's or corporation's taxable income pro rata shares to be included in the members' gross income, determine the membership using applicable state law, the organization's rules, and the individuals' consent for their status as members. Parents may consent to their children's membership if allowed under applicable state law. See Rev. Rul. 77-295, 1977-2 C.B. 196.

IRC Section 262(a) prohibits deductions for personal, living, or family expenses.

Note: Apostolic organizations can have employees. These individuals are nonmembers of the organization, and receive [Forms W-2, Wage and Tax Statement](#). Members of the organization don't meet the tests and requirements to be treated as employees. For an analysis, see *Stahl v. Unites States*, (supra).

IRC Section 501(d) organizations are required to make their annual [Form 1065](#) returns available for public inspection for three years after the return is due. IRC Section 501(d) organizations are also required to make available a copy of their exemption application letters, any supporting documents, and their exemption letters.

Failure to make these documents available for public inspection may subject the organization to a penalty of \$20 per day for each day there is a failure to comply (up to a maximum of \$10,000 in the case of an annual return). See IRC Section 6104(d) and IRC Section 6652(c)(1)(C). Assessment procedures are in [IRM 20.1.8](#). However, the Form 1065, [Schedules K-1](#) don't have to be disclosed.

Pre-Audit Examination Procedures

Request the Form 1065

TE/GE has primary examination responsibility for examining Forms 1065, U.S. Return of Partnership Income, filed by religious and apostolic organizations described in IRC Section 501(d). Request help from Large Business & International (LB&I) if you need it. Contact Small Business and Self Employed (SB/SE) when the organization has assets less than \$10 million.

Refer examinations of [Form 1040, U.S. Individual Income Tax Return](#), having material adjustments to SB/SE. Notify SB/SE as early as possible in the examination so they can place the partner's return on the Partnership Control System, described in [IRM 4.29](#) and [4.31.5.8](#).

Forms 1065 properly filed by apostolic organizations (in other words, indicated that they were exempt under IRC Section 501(d) on the [Form 1065](#)) aren't subject to the TEFRA procedures of [IRM 4.31.2](#) or [IRM 4.31.5](#), however SB/SE uses those guidelines if they're requested to work the Forms 1040.

Forms 1065 aren't available via Online SEIN. Order them from files, by establishing a case on Reporting Compliance Case Management System (RCCMS), or using command code ESTAB on IDRS.

Limited transcripts of [Form 1065](#) are available via the TDS (Transcript Delivery System) application and IDRS. If electronically filed, Forms 1065 may be available from the MeF (Modernized e-file) application.

You can make adjustments to [Form 1065](#) using RGS NT. If you're unfamiliar with Forms 1065, ask coworkers experienced with using the program (former SB/SE or LB&I revenue agents), or with your manager's permission, submit a specialist request via SRS (Specialist Referral Service).

Request the Determination File

Obtain the determination application from Cincinnati Campus using the Form, "Request for EP or EO Determinations Administrative File." Submit the form by fax or email attachment:

- Fax #: (513) 263-3780
- Email: *TEGE DETERMINATIONS PROCESSING

If the application is unavailable from Cincinnati Campus, request the determination application and determination letter in the initial document request (IDR).

When you receive the file, review the application. If from Cincinnati, look at any notes the determination specialist made on the non-disclosable portion of the file.

Determine in the review of the application, whether:

- The organization is organized for the purpose of operating a religious or apostolic community with a common or community treasury.
- Upon leaving the organization, members are entitled to any part of the group assets.
- There is a communal business activity, such as farming, manufacturing, or other industry.

Determine whether the organization is incorporated.

- If incorporated, check the website of the state agency responsible for corporate registrations to determine if the organization has filed any amended documents.
- If unincorporated, request copies of any amendments to the articles of association, charter or other organizing document in the initial IDR.
- If amendments have been made, verify that they've been included in the determination file. Send copies of any amendments not previously included to Cincinnati.

Review the bylaws of the organization.

- Take note of the leadership structure, or lack of it.
- Determine how control of the organization transitions from person to person (election, inheritance, challenge, etc.)
- Determine who is permitted to be a member. (The IRS has ruled that parents may consent to membership on behalf of their minor children to the extent allowed under applicable state law. See Rev. Rul 77-295, 1977-2 C.B. 196.)
- If the organization provides voting rights, note the classes of membership and those who are permitted to vote.

Review the [Form 1065](#) to identify the source of the income reported.

- The income reported must be from a community operated business.
- A member of a religious organization who has taken a vow of poverty and is instructed by the organization's superiors to obtain outside employment must include the remuneration remitted to the organization in his/her gross income, and it's subject to FICA and income tax withholding. See Rev. Rul. 80-332, 1980-2 C.B. 34. However, if an organization is substantially dependent on wages earned by some of its members from outside employment rather than on internally operated business, it doesn't qualify for exemption under IRC Section 501(d). See [Rev. Rul. 78-100, 1978-1 C.B. 162](#).

Review the expenses and credits deducted on [Form 1065](#).

- The organization is entitled to take deductions regularly permitted to taxable corporations.
- Take note of any deductions for food, medical expenses, or other fringe benefits normally provided to employees.
- Determine whether any amount has been reported for payment of compensation to individuals.

Use command code PMFOL to determine whether any information returns were filed. If yes, use command code IRPTRR to request the [Forms W-2](#) and 1099 issued by the organization.

- When received from the Service center (approximately two weeks,) determine who received Forms W-2.
- Ask for a list of all members of the organization in the initial IDR.
- Compare the amounts reported on Forms W-2 (if any) to the [Form 1065](#).

Check to see if the organization has a website.

- Verify the business activity of the organization.
- Determine the current identity of the leaders of the organization, if provided.
- See if the organization's tenets are listed on the website.
- Review the organizing documents, if available online.

Field Examination Procedures

Tailor the initial interview questions to the organization.

- If the tenets/creed/statement of religious beliefs weren't provided either in the determination application or on a website, ask for them.
- Determine whether there is a central body of authority for the organization.
- Identify the internally operated communal business activities that generate the income of the organization.
- Ask about external (individually generated) sources of income and about how the organization treats that income.
- Request an explanation of the expenditures deducted on the [Form 1065](#).
- Ask about the organization's requirements for personal property owned before, during, and after a person's membership.
- Clarify whether the organization employs any non-member labor, and for what activities.

Tour the facilities and focus on whether the organization requires communal living.

- Request an explanation of how the organization operates as a communal organization.
- View the facilities where the community business activities are conducted.

Note: The organization is not subject to Unrelated Business Income Tax (UBIT). The organization must report all income generated as a dividend to members on a pro rata basis.

- Identify all the sources of income producing activities.

- If [Forms W-2](#) were filed, meet the persons who are employees, if present, to ask if they are also members of the organization.
- Obtain clarifications as to the type of labor that nonmembers perform.

Review the general ledger and/or check register.

- Reconcile the ledger (or adjusted trial balance) to the [Form 1065](#).
- Identify the dates, amounts, and source of income.
- Obtain substantiating documentation for questionable expenses (those deducted but appear to be for food, medical, and living expense of members.)
- Verify that the expenses reported are deductible.
- If available, view the retained check images (photocopies from the organization, or bank) to check for any earmarking or for checks not made out to the organization.

Concluding the Examination

Determine if the organization continues to qualify for exemption under IRC Section 501(d). Prepare a report of examination revoking the organization:

- If the organization lacks a religious or apostolic character.
Note: Consult Counsel because the “religious or apostolic character” is not defined in law.
- If the organization substantially relies on the wages members generated from activities external to the communal business activities.
- If the organization lacks a communal trust or bank account in which income is deposited and expenses disbursed.
- If the organization had income it failed to allocate to its members.

Note: In light of the PATH Act of 2015, apostolic associations have declaratory judgment rights under section 7428.

For an agreed revocation:

- Discuss the issue with the taxpayer fully to verify that taxpayer will agree.
- Issue the final report using Letter 3618, Forms 886-A, 4621-A, and 6018. Allow the taxpayer 30 days to respond.
- Prepare an administrative record in a separate folder. Refer to IRM 4.75.32
- Prepare Form 2363-A for a revocation. The filing requirement of a revoked IRC Section 501(d) organization remains the same. The organization will be subject to TEFRA rules under IRC Section 6233.
- Close the case to Mandatory Review.

For an unagreed revocation:

- If not otherwise excluded from Fast Track Settlement, issue a report of preliminary findings (draft RAR), with a drafted cover letter, Forms 886-A, 6018, and 14017, Application for Fast Track Settlement with Publication 4539, Fast Track Settlement Brochure. Allow 30 days for a response.
- For cases not entered into the Fast Track Settlement process, issue the final report using Letter 3618, Forms 886-A, 4621-A, and 6018. Allow the taxpayer 30 days to respond.
- Prepare an administrative record in a separate folder and an index to the administrative record. Refer to IRM 4.75.32
- Prepare Form 2363-A for a revocation. A revoked IRC Section 501(d) organization has the same filing requirement. The organization will become subject to TEFRA rules under IRC Section 6233.
- Close the case to Mandatory Review.

Identify any adjustments to be made to the [Form 1065](#) and the Schedules K-1.

- Ask SB/SE for help for adjustments to members' [Forms 1040](#), and if necessary, Forms 1065 adjustments in RGS.
- Prepare adjustments to the Form 1065 using RGS NT. See Training Publication 22801-104 Report Generation Software (RGS) Form 1065 Workshop (Participant Guide) for how to perform the adjustments.
- Prepare a report of examination to the organization explaining the adjustments.
- Coordinate with SB/SE to issue the report. SB/SE issues their own reports on the Forms 1040. Give them the RGS electronic file.
- Prepare a Form 4605, a Form 886-A, Explanation of Items, and a Form 886-S, Form 886-X, Form 886-W or Form 886-Z to show the corrected flow-through amounts for each investor. All are available on RGS.
- Issue the report with Letter 921.

If you're revoking the organization and adjusting [Forms 1065](#), ask SB/SE or LB&I for help on TEFRA procedures.

If you close the case as no change, prepare Letter 5452 and follow the procedures in [IRM 4.75.15](#) and [IRM 4.75.16](#).