

# White Paper No. 1

## Why a Religious Corporation?

*By John C. Peiffer II, President and General Counsel of NLI*

This white paper examines some of the reasons why nonprofit organizations in California that are animated by Catholic values and/or formed to engage in apostolic endeavors should consider incorporating as Nonprofit Religious Corporations, even if such organizations are not directly tied to the hierarchy or a religious order.

Before determining the appropriate form of corporation for your organization, you should consult with an attorney who is licensed in California and familiar with nonprofit corporate law.

Under California law, there are three basic forms of nonprofit corporation:

1. Nonprofit Public Benefit Corporation, which may be formed “for any public or charitable purposes” (Cal. Corp. Code § 5110);
2. Nonprofit Mutual Benefit Corporation, which may be formed “for any purpose” (§ 7111) (and which are generally used for organizations such as homeowners’ associations, clubs, and chambers of commerce); and
3. Nonprofit Religious Corporation, which may be formed “primarily or exclusively for any religious purposes” (§ 9111).

## Nonprofit Religious Corporation vs. Corporation Sole

Regarding the question of who may form a nonprofit religious corporation in California, California Corporations Code § 9120(a) simply states that “one or more persons may form a corporation under this part.” By contrast, under § 10002, a corporation sole (which is a specialized form of nonprofit religious corporation in California) may be formed “by the bishop, chief priest, presiding elder, or other presiding officer of any religious denomination, society, or church, for the purpose of administering and managing the affairs, property, and temporalities thereof.”

The distinction between the *who* and *why* of corporation sole formation and the *who* and *why* of nonprofit religious corporation formation is important: a California corporation sole is a manner of civilly organizing an ecclesiastical organization (*e.g.*, a diocese, parish, or religious order) **by the senior ecclesiastic or religious superior** of the “denomination, society, or church”, while a nonprofit religious corporation is an organization that can be formed **by one or more persons** (whether clergy, lay, or “religious” in the Catholic sense) “primarily or exclusively for religious purposes.” Thus, while an organization such as a diocese, parish, or religious order *may* organize as a nonprofit religious corporation, a lay-run apostolate faithful to the Catholic Church (whether officially recognized by the local bishop or not) generally may *not* organize as a corporation sole.

## **“Religious Organization” and “Church” are not Synonymous**

The California Corporations Code does not define what constitutes “religious purposes”. As discussed in more detail below, the California Attorney General, which generally has oversight of charitable organizations in the State, has limited oversight of nonprofit religious corporations. However, the California AG is authorized to

institute an action or proceeding to obtain a judicial determination that a corporation is not properly qualified or classified as a religious corporation.<sup>1</sup>

California courts have not articulated what constitutes “religious purposes” in the context of § 9111 or § 9230. The IRS does not provide a neat definition of what constitutes “religious” purposes, either. Instead, the IRS often will look at the organization’s activities (including, for example, if the organization is engaged in private inurement or private benefit) to discern whether the organization’s purpose is religious. Thus, if the organization’s activities are primarily religious, it may be tax-exempt as a religious organization.

The IRS distinguishes between a § 501(c)(3) organization that is generically established for “religious” purposes and an organization that is a “church”. Because neither the Internal Revenue Code nor the Treasury Regulations define what a “church” is, the IRS uses a “facts and circumstances” test to determine whether a religious organization is a church based on some combination of fourteen (non-exclusive) criteria.<sup>2</sup> A number of federal court cases have applied these criteria and additional facts to evaluate whether a particular religious organization qualifies as a “church” or not. Churches are a subset of religious organizations that enjoy certain additional benefits from an IRS perspective (such as not being required to file a Form 990 annual information return with the IRS), but the category of religious organizations is much broader and can encompass a variety of organizations with varying degrees of connection to an established church or denomination.

Additionally, it is worth noting that a “religious organization” for § 501(c)(3) purposes is not synonymous with a “religious order” in the Catholic context. In fact, for IRS purposes, Catholic religious orders are treated like churches once they have been established as bona fide religious orders.<sup>3</sup>

## What is a “Religious” Purpose?

*Schoger Foundation v. Commissioner*<sup>4</sup> involved a lodge established by several members of a family as a place for Christian families to relax and recreate. The tax court denied their petition to be treated as “religious” organization under § 501(c)(3) because the family had not shown sufficient evidence that religious activities, in the form of religious services, education, etc. would be the primary focus of the organization rather than recreation. There needed to be more content, such as religious services, religious education, structured spiritual guidance, etc. for the organization to be operated for religious purposes. The court’s analysis focused on whether the *activities* of the organization were primarily religious in nature, rather than whether the individuals who established or were leading the organization were clergy, members of a religious community, etc. Since the activities were primarily recreational rather than religious in nature, the organization failed to establish a religious purpose.

*Junaluska Assembly Housing, Inc. v. Commissioner*<sup>5</sup> involved a standalone nonprofit corporation established to plan, develop, contract, sell, and lease condominiums for single and multifamily housing for those involved in the activities of a conference and retreat center property owned by an affiliate of the United Methodist Church. In that case, the court did not look at the activities of the organization (which, on their face, were not

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1 See Cal. Corp. Code § 9230(b).

2 Internal Revenue Manual 7.26.2.2.4 (3-30-1999); these criteria are as follows: “(a) a distinct legal existence; (b) a recognized creed and form of worship; (c) a definite and distinct ecclesiastical government; (d) a formal code of doctrine and discipline; (e) a distinct religious history; (f) a membership not associated with any other church or denomination; (g) a complete organization of ordained ministers ministering to their congregations; (h) ordained ministers selected after completing prescribed courses of study; (i) a literature of its own; (j) established places of worship; (k) regular congregations; (l) regular religious services; (m) Sunday schools for religious instruction of the young; (n) schools for the preparation of its ministers.”

3 See Rev. Proc. 91-20 for a description of characteristics the IRS generally looks for in an organization wishing to be characterized as a religious order.

4 76 T.C. 380 (1981).

5 86 T.C. 1114 (1986).

exclusively religious) but instead they looked at “the end for which those activities are undertaken.”<sup>6</sup> Because the housing was essential to the religious purposes of the affiliated corporation, the tax court determined that the standalone corporation’s purpose also was religious.

The bottom line is that organizations can be “religious” on several different bases and these need not necessarily involve sponsorship or affiliation with the hierarchy or a religious order (*i.e.*, in the Catholic context, even if the organizations are not officially “Catholic”, their purpose still may be religious in the general sense). Illustrating this, in California, one will be able to find grant-making foundations, educational institutions, social service organizations, film companies, publishing houses, and, of course, churches, among the kinds of organizations that are organized as Nonprofit Religious Corporations.

## What are Some Benefits of Being a Nonprofit Religious Corporation vs. a Nonprofit Public Benefit Corporation?

While not an exhaustive list, some of the benefits of being a nonprofit religious corporation include the following:

1. For nonprofit religious corporations, transactions involving conflicts of interest and self-dealing may consider whether such transactions are just and reasonable to the corporation taking into account the organization’s religious purposes or whether such transactions further the organization’s religious purposes.<sup>7</sup>
2. Directors of nonprofit religious corporations must act in good faith, in a manner believed to be in the best interests of the corporation, and with the care appropriate under the circumstances, but the directors also may rely on reliable and competent religious authorities, among others, when determining what is in the corporation’s best interests.<sup>8</sup>
3. Directors of nonprofit religious corporations enjoy the protection of a more generous indemnification standard than applies to directors of nonprofit public benefit corporations.<sup>9</sup>
4. Unlike nonprofit public benefit corporations, nonprofit religious corporations are not required to register with the California Attorney General or to comply with ongoing reporting obligations to the California Attorney General.<sup>10</sup>
5. The California Attorney General’s investigative powers with respect to nonprofit religious corporations are generally limited to criminal matters, whereas nonprofit public benefit corporations are subject to investigation at any time with respect to its internal affairs and compliance with its purposes.<sup>11</sup>
6. Nonprofit public benefit corporations must have audited financial statements if they have

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<sup>6</sup> *Id.* at 1121.

<sup>7</sup> See Cal. Corp. Code §§ 9243 and 9244 for the standards applicable nonprofit religious corporations. Contrast these standards to those applicable to nonprofit public benefit corporations set forth in §§ 5233 and 5234.

<sup>8</sup> See Cal. Corp. Code § 9241. Contrast Cal. Corp. Code § 5231, which requires that directors exercise the care of an ordinarily prudent person in like position under similar circumstances and lacks a specific authorization to rely on religious authorities when determining what is in the best interests of the corporation.

<sup>9</sup> *Cf.* Cal. Corp. Code § 9246 to Cal. Corp. Code § 5238.

<sup>10</sup> See Cal. Govt. Code § 12583; Cal. Corp. Code §§ 9212 – 9213; §§ 5212, 5213, and 6324. Note, however, that nonprofit religious corporations still must submit to the California Franchise Tax Board (“FTB”) Form 3500 or 3500A to obtain an exemption from California income and franchise tax in addition to filing IRS Form 1023 or 1023-EZ to obtain an exemption from federal income tax (see [https://www.ftb.ca.gov/businesses/Exempt-organizations/Applying\\_for\\_tax-exemption.shtml](https://www.ftb.ca.gov/businesses/Exempt-organizations/Applying_for_tax-exemption.shtml) for more information). Additionally, a nonprofit religious corporation may be required to file an annual Form 990 with the IRS and an annual Form 199 with the FTB.

<sup>11</sup> See Cal. Corp. Code § 9230(a); § 5250; Cal. Govt. Code § 12588.

\$2 million or more in gross revenue.<sup>12</sup> Nonprofit religious corporations are not subject to this requirement.

7. For purposes of the California Fair Employment and Housing Act (Cal. Government Code § 12900 *et seq.*), nonprofit religious corporations are generally permitted to consider an individual's religious commitment (such as whether he or she practices the Catholic faith and conforms to Catholic moral teaching) when making hiring and firing decisions.<sup>13</sup>

## Our organization already is incorporated as a California nonprofit public benefit corporation. Is it too late for us to become a religious corporation?

No. You should consult with a licensed attorney familiar with California corporate to determine whether it makes sense for your organization to file amended articles and carry out the other steps necessary to change the organization's status from a public benefit corporation to a religious corporation.<sup>14</sup>

For more information, please contact the Napa Legal Institute at [info@napalegalinstitute.org](mailto:info@napalegalinstitute.org), including referrals to practicing lawyers who may be able to assist you. Additionally, please visit our website, [napalegalinstitute.org](http://napalegalinstitute.org), for additional resources.

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Mr. Peiffer serves as President and General Counsel of NLI. He is also CEO of the Busch Firm. Mr. Peiffer advises for-profit and nonprofit clients on business transactions, entity structures, and corporate formation and governance. He has advised Catholic dioceses, religious orders, private religious schools, and other religious organizations on mission-focused corporate structuring and governance, tax exemption issues, and charitable planning structures. Mr. Peiffer obtained a B.A. in Classical Studies and English from Santa Clara University, an A.M. in Religious Studies from the University of Chicago Divinity School, and a J.D. from the University of Notre Dame Law School.

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<sup>12</sup> See Cal. Govt. Code § 12586.

<sup>13</sup> *Cf.* Cal. Govt. Code §§ 12926.2(d); 12940(a), (d). In addition to California employment laws, religious employers also must consider the extent to which they may be required to comply with federal employment laws. See *Hosanna-Tabor Evangelical Lutheran Church & School v. EEOC*, 565 U.S. 171 (2012) and, more recently in the Ninth Circuit Court of Appeals, which has federal jurisdiction in California, *Biel v. St. James School* 911 F.3d 603 (2018). *Due to the complexity of employer issues and applicable exemptions for religious employers, employment counsel should be consulted on your organization's employment policies and practices.*

<sup>14</sup> See Cal. Corp. Code § 5813.5.