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A House on Solid Rock or A House of Cards?

By Justin R. Coleman, Esq.

Why proper incorporation in Virginia or any state is more than simply filing articles of incorporation with the state.

When the United States District Court of the Western District of Virginia struck down the portion of the Virginia Constitution denying churches the ability to incorporate as unconstitutional in 2002[1], Virginia became the 49th state to permit church incorporation and West Virginia followed suit in part making church incorporation in all 50 states and DC now possible . As a result of this historic decision, the Virginia Code was amended in 2005 to reflect this change and recognize incorporated churches.[2] Unfortunately, the 2005 amendments to the Virginia Code were not as comprehensive of a change as originally intended and, as a result, church incorporation in Virginia is not as straight-forward as it may be in those other states where religious corporations have been permitted for decades. This article will attempt to cover some of the more common missteps a church may take when it decides to incorporate in Virginia and the potential legal and liability problems they cause for the church.

I. USING TEMPLATE ARTICLES

"*We can just fill out the form Articles of Incorporation on the State Corporation Commission's website and submit them ourselves."*

This seems to be the most common misstep for churches that take on incorporation without first contacting an attorney knowledgeable in church and nonprofit law and could result in some of the most significant issues for the church in regards to its income tax exemption.

First, the form Articles of Incorporation ("Articles") found on the State Corporation Commission's (the "SCC") website is a sample template for Virginia non-stock corporations, which are subject to the Virginia Non-Stock Corporation Act (§13.1-801 *seq*) (the "Act"). However, Virginia church corporations do not incorporate solely under the Act. The 2005 amendments to the Virginia Code impacted other parts of Code, particularly §§ 57 and 58.1, but did not create an express religious corporation section under the Act. As a result, by solely incorporating the church under the Act without referencing these other areas of the Virginia Code, the church may lose out on those statutory protections provided to churches.

[1] *Falwell v. Miller,* 203 F. Supp. 2d 624 (W.D. Va. 2002).
[2] Senate Bill 1267.

Second, the form Articles of Incorporation available from the SCC also do not provide or identify the necessary IRS language to evidence that the church is operating at a §501c3 tax-exempt religious corporation. Although churches are granted §501c3 tax-exempt status by the IRS without having to submit a formal application for recognition, church activities are subject to the same restrictions as other §501c3 tax-exempt organizations.
When a church incorporates with a state, like Virginia, its Articles of Incorporation become public record. This means that any individual may obtain a copy of the church's Articles by requesting them from the SCC and paying a minimal fee. Thus, a church's Articles of Incorporation should contain not only the necessary language to evidence that it is validly incorporated under the correct Virginia statutory requirements, but also that its purposes and activities are consistent with its §501c3 tax-exempt status.

After reading the above you may be asking, "But why does that matter if my church is automatically granted §501c3 tax-exempt status" or "But my church falls under the group exemption from our association/denomination, so we're okay, right?" Unfortunately, the answer to either of those questions would likely be "No." The church's governing documents – the Articles of Incorporation, Constitution, and Bylaws – and written policies must be consistent. If the church's policies conflict with the Constitution and Bylaws, the Constitution and Bylaws will always supersede. If the Articles conflict with the Constitution and Bylaws, the Articles will always supersede.

Thus, if the church was ever sued or audited by the IRS, the copies of the church's governing documents and policies will be requested as part of discovery to verfiy that the church is a legally formed §501c3 tax-exempt church corporation. If the Articles of Incorporation do not contain the necessary language to evidence that the incorporated church's purposes and activities are those of a §501c3 tax-exempt religious corporation, it could potentially be found that the church is simply a Virginia non-stock corporation that is not exempt for federal and state income tax. Such a determination could subject the church to significant corporate income tax, along with penalties and interest, as well as denying the church the ability to invoke those religious protections provided churches in other areas, such as the ministerial exception in regards to employment matters.

If your church is considering incorporation or are already incorporated but did not have them reviewed by knowledgeable legal counsel prior to their submission to the SCC, we would strongly recommend you contact an attorney who in knowledgeable in church and nonprofit law to ensure that your Articles of Incorporation are legally compliant with Virginia law but also that they clearly evidence that your church is a §501c3 tax-exempt nonprofit church corporation.

II. CONSTITUTION AND BYLAWS

"Our Constitution and Bylaws are fine; all we have to do is add 'corporation' or 'Inc.' to the end of the church's name"

This is also a fairly common misstep for churches that are going through the incorporation process without knowledgeable legal counsel. Under the Act, a nonprofit corporation is required to adopt a written set of Bylaws to provide a clear governance structure. Most churches, whether incorporated or unincorporated, have adopted some form of written Constitution & Bylaws ("C&Bs") which outline matters like the church's statement of biblical beliefs, membership requirements and privileges, leadership structure (i.e. Elders, Deacons, Council, etc.), pastoral staff, etc. Unfortunately the outstanding majority of C&Bs for unincorporated church associations are inconsistent, outdated, and legally inadequate for purposes of protecting an incorporated church and its leadership.

Although the C&Bs are "private" documents (meaning the church is not required to make them available to the public), the C&Bs must still contain certain language, provisions, and policies for compliance with IRS regulations to evidence its §501c3 tax-exempt nature. Thus, if the church were ever audited by the IRS, its status as a §501c3 tax-exempt nonprofit corporation would be clearly evidenced. Incorporation is also an opportune time for churches to resolve ambiguities and conflicting statements in the C&Bs and adopt provisions and policies which evidence corporate best practices, particularly, in regards to the church's assets and finances, reassuring the church that the leadership are being good stewards and reducing potential liability.

"We will just change the name of the trustees to the 'Board of Directors.'"

The misstep of simply renaming the trustees as the board of directors often is the result of the church not knowing or understanding exactly what a corporate Board of Directors' responsibilities are or the duties imposed upon them. As you the reader likely already know, church trustees were a creation of the Virginia General Assembly because unincorporated church associations could not hold title to their real property. Thus, the churches were required to identify individuals to serve in this role of holding legal title to the church's real property "in trust" for the body of the church. Although the role of trustee in most churches is one typically of honor and respect among church members and leadership, it is, in reality, one of little actual authority and power. Under the Virginia Code and as determined by case law, church trustees hold only "mere title" to the church's real property and do not have authority to take action in regards to that real property without the church first directing such action.[3] Further, before any action in regards to the church's real property can be taken, the trustees must petition the local circuit court for authorization to act. This petition must sufficiently evidence to the circuit court that the requested action is the desire of the church body.

[3] *Rohr v. City of Richmond*, 20 Va. L. Reg. 260 (1914)

In contrast, the Board of Directors of a nonprofit church corporation has much greater responsibilities in terms of the operations of the church. The Board's primary responsibilities are oversight of the general operation and administration of the church, making policy decisions, and ensuring financial accountability. The Board is also responsible for carrying out those specific duties outlined under state law. Unless the C&Bs state otherwise, the Board may make decisions for the church without membership involvement or vote. However, because of this autonomy, these duties and responsibilities also carry with them a fiduciary duty to act in the best interests of the church corporation.[4] Thus, when reviewing and updating the church's C&Bs, the church should consider what representative body is, or would most likely be, responsible for those overall operations and administration of the church.

"The church down the street already incorporated; let's ask if we can use their Constitution & Bylaws for our church."

That neighboring church may have just as easily taken either of the above missteps in their incorporation. Further, no two churches, even churches of the same denomination, operate the exact same way and the use of another church's C&Bs may not fit your governance structure. For example, the other church may be Elder-governed and your church is Deacon-governed; or in your church, the pastoral staff is elected by the church congregation and in the other church, the Elders, Deacons, or some other group appoints pastoral staff. If a church does not operate in the same manner as outlined in its C&Bs, the church and its leadership could be subject to potential liability for failing to follow its own written policies and procedures.

Thus, the church should consult with a knowledgeable legal counsel to assist the church in tailoring the C&Bs to ensure that they are compliant with the Virginia statutes and IRS regulations, resolve any conflicting statements or ambiguities in the church's governance structure; and actually match your governance and organizational structure.

III. CORPORATE ORGANIZATIONAL MEETING

Once a Certificate of Incorporation is obtained from the State Corporation Commission and the Constitution & Bylaws have been updated for state and federal compliance as a §501c3 tax-exempt Virginia church corporation, the final and often overlooked step to incorporate the church is to hold an organizational meeting. The organizational meeting is essentially the "first" meeting of the incorporated church. The purpose of the meeting is more than have the church members (or Board of Directors, depending on the church's governance structure) adopt the Articles and C&Bs. The corporate officers are elected and empowered by the church carry out certain initial actions on its behalf, such as open bank accounts and obtain insurance policies.

[4] See Quarterly Newsletter Article, *Is My Church Being Overseen by Wise Counsel or Wise Guys?* for greater detail about church board composition, responsibilities, duties, and potential liability. www.simmsshowers.com/news/

For churches that own real property, a corporate officer would be authorized at the organizational to accept the real property on the church's behalf from the trustees of the unincorporated church association. Minutes of this meeting must be taken, signed by the individual who took them (generally a Secretary or Clerk), and preserved by the church with the Articles and Certificate of Incorporation and signed C&Bs.

However, many churches that incorporate without knowledgeable legal counsel often do not conduct an organizational meeting, fail to take proper minutes of that meeting, or do not make all the necessary resolutions to fully empower the church and its agents to operate.

The result of any of these scenarios would create significant potential liability on the church's leadership should civil action be brought against the church. If a civil plaintiff could prove that the church did not hold an organizational meeting or did not fully organize the church corporation, the plaintiff could request the court to judicially dissolve the church corporation. If judicially dissolved, the church would revert back to an unincorporated church association. This would mean that the church's leadership could potentially be personally joint and several liable for any judgments against the church that exceed its liability insurance and assets.

IV. CONCLUSION

The ability to now incorporate churches in Virginia created several huge benefits to churches and its leaders in terms of liability protection. However, failure to include the proper language and provisions in your governing documents evidencing your §501c3 tax-exempt status could potentially put your church at risk of being subject to income tax and loss of tax-exempt benefits offered by Virginia and the Federal government. Further, improper or incomplete incorporation of your church could potentially result in the collapse of your church's corporate structure and with it the personal liability protection provided to its directors and officers.

One of the best first steps for a church considering incorporation in Virginia is to contact an attorney who is knowledgeable in church and nonprofit law. A knowledgeable attorney can assist the church through this process, helping it avoid the missteps identified above. If your church has already incorporated but did not use knowledgeable legal counsel or if this article has raised questions about your incorporation, please feel free to contact our office to discuss any questions or concerns about church incorporation.

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not taken based solely on the content of this memorandum. Please contact Robert Showers at hrs@simmsshowerslaw.com or Justin Coleman at jrc@simmsshowerslaw.com for legal advice that will meet your specific needs.