Bethel Conservative Mennonite Church v. Commissioner, T.C. Memo. 1986-466

A church-sponsored medical aid plan that primarily benefits church members and lacks objective criteria for need may be considered a substantial non-exempt activity, jeopardizing the church's tax-exempt status under Section 501(c)(3) of the Internal Revenue Code.

Summary

Bethel Conservative Mennonite Church sought tax-exempt status under section 501(c)(3) of the Internal Revenue Code. The IRS denied the exemption for periods prior to January 20, 1981, arguing that the church's medical aid plan primarily served the private interests of its members and constituted a substantial non-exempt activity. The Tax Court upheld the IRS's decision, finding that the medical aid plan, while benevolent, lacked objective criteria for need and disproportionately benefited church members, thus failing the operational test for tax exemption. This case highlights the importance of ensuring that church activities, particularly member benefit programs, serve a public interest and not merely private interests to maintain tax-exempt status.

Facts

Bethel Conservative Mennonite Church operated since 1955, engaging in religious activities such as worship services, Sunday school, and missionary work. In 1964, the church established a medical aid plan for its members and their dependents, funded by voluntary offerings. The plan covered medical expenses after a $50 deductible, with some limitations added later. No objective criteria for need were established for receiving aid, and the plan was exclusively for church members. The church applied for tax-exempt status in 1980, which was initially denied by the IRS due to concerns about organizational documents and the medical aid plan.

Procedural History

The Bethel Conservative Mennonite Church applied to the IRS for recognition of exemption under section 501(c)(3). The IRS initially denied the application. After the church amended its constitution in 1981, the IRS granted exempt status from January 20, 1981, onwards but denied it for prior periods. The church then filed a petition for declaratory judgment in Tax Court challenging the IRS's denial of exemption for the period before January 20, 1981, after exhausting administrative remedies.

Issue(s)

1. Whether Bethel Conservative Mennonite Church was operated exclusively for religious or other exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code for the period prior to January 20, 1981.

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Holding

1. No. The Tax Court held that Bethel Conservative Mennonite Church was not operated exclusively for religious or other exempt purposes prior to January 20, 1981, because its medical aid plan constituted a substantial non-exempt activity serving the private interests of its members.

Court's Reasoning

The court focused on the operational test for tax exemption, which requires an organization to operate exclusively for exempt purposes. While acknowledging the church's genuine religious activities, the court found the medical aid plan to be a substantial non-exempt activity. The court reasoned that the plan:

- Served primarily the private interests of church members and their dependents, as it was exclusively for them and not the general public. The court cited Treasury Regulation §1.501(c)(3)-1(d)(1)(ii) which states that an exempt organization must serve a public rather than a private interest.
- Lacked objective criteria for determining need, making aid available to any member regardless of financial hardship, creating potential for abuse and undermining a charitable purpose.
- Constituted a substantial portion of the church's activities and expenditures, with medical aid disbursements representing a significant percentage of the church's total income in certain years (e.g., 64% in 1977) and 22% of all disbursements between 1965 and 1979.

The court stated, "Exclusivity in this instance does not mean 'solely' or 'without exception,' but rather contemplates that any nonexempt activities be only incidental and less than substantial." Because the medical aid plan was deemed a substantial non-exempt activity, the church failed the operational test for exemption. The court distinguished between incidental aid to needy members and a broad plan benefiting all members regardless of need.

Practical Implications

This case provides important guidance for churches and religious organizations operating member benefit programs, particularly medical aid plans. Key implications include:

- **Public Benefit vs. Private Benefit:** Churches must ensure that their activities primarily serve a public benefit rather than the private interests of their members to maintain tax-exempt status. Programs exclusively or primarily benefiting members are scrutinized.
- **Objective Criteria for Need:** If a church provides financial assistance, especially medical aid, establishing and applying objective, need-based criteria is crucial to demonstrate a charitable purpose serving a broader class than just

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members.

- **Substantiality of Non-Exempt Activities:** Even if a church engages in numerous exempt activities, a single substantial non-exempt activity can jeopardize its tax exemption. The size and scope of member benefit programs relative to overall church activities are critical.
- **Organizational Documents:** While not the primary basis for the decision here, the case also underscores the importance of having clear organizational documents that state exempt purposes and dedicate assets to exempt purposes upon dissolution, as initially raised by the IRS.

This case is frequently cited in IRS rulings and court decisions concerning church tax exemptions and unrelated business income, emphasizing the need for churches to carefully structure member benefit programs to align with exempt purposes and avoid substantial private benefit.

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