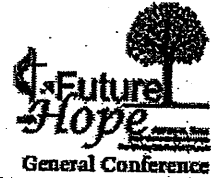




General Council on Finance and Administration  
The United Methodist Church



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## MEMORANDUM

TO: Interested Parties

FROM: Mary Logan, General Counsel Dave Ullrich, Associate General Counsel

RE: Incorporation of United Methodist Child Care Centers and Preschools

DATE: June 1, 1999

The purpose of this memorandum is to address the most commonly asked questions about the legal aspects of incorporation of a child care, early childhood development center or a preschool as an entity separate from the local church. The term "Center" will be used to cover preschools, day care centers, extended care (latch-key) programs, nursery schools, "Parents' Day Out" programs, early childhood development centers, and other child care and development centers. The term "Church" refers to the local United Methodist Church.

While there may be advantages to separate incorporation, GCFA's legal department is not advising every United Methodist local church child care center to -- or not to -- separately incorporate. Each local church, in consultation with local legal counsel, needs to evaluate this issue.

Each local church will have its own policy, missional and legal considerations that must be considered and evaluated in making the important decision of whether to form a separate corporation for the operation of its Center.

In making the decision about whether, and how to, incorporate a Center, the Church and church council must consider whether it would want the Church to give up control over the day to day operations of the Center; whether it would want the Church to act as a "parent" corporation to the Center, keeping certain control over the structure and organization of the Center and its assets; and how the Center would fit in with the mission and ministry of the Church. This memo starts with a basic assumption that a Church typically will want to retain some control over the structure and organization of the Center, and have the Center serve the Church in fulfillment of its mission and ministry. However, each situation is unique and each local church needs to make some basic policy decisions about its own Center before making the decision to incorporate (or not) and how to structure and set up the corporation.

### Why Some Churches Consider Separate Incorporation of Their Center

The most significant reason that many churches incorporate is limitation of liability. An advantage of separate incorporation is that if the incorporation is properly structured, the Church should be able to limit its liability with respect to matters for which persons may seek to hold the Center liable, such as accidents occurring at the Center or alleged unfair treatment of the Center's employees. Also, the Center should be able to limit its liability for matters for which persons may seek to hold the Church liable.

What is meant by a limitation of liability is that the Church should be able to protect its bank accounts and other property if the Center is sued and the Center should be able to protect its bank accounts and other assets if the Church is sued. This does not mean that the Church will never need to defend itself in a lawsuit involving activities of the Center, especially if the suit results from an accident on Church property. However, the defense will be made easier with the properly structured, separate incorporation and operation of the Center.

In addition, if the incorporation is not properly structured, or, if the operation of the Center continues to function as an integral part of the Church, the limitation of liability probably will not be accomplished. If separately incorporated, the Center must truly operate separately from the Church so as not to appear to be, and function as, a part of the Church.

### The Incorporation Process

Incorporation is the legal process where the state approves the "charter" of the corporation. Articles of incorporation of the Center must be prepared, approved, signed, and filed with the secretary of state of the state in which the Center is located. These should be prepared by a local attorney experienced in corporate law and familiar with the structure and *The Book of Discipline* of The United Methodist denomination.

The Church can "control" the structure and organization of the Center corporation by a number of provisions in the Center's articles of incorporation and bylaws, and the appropriate use of such control provisions is determined by state law. The basic means of control is the ability of the Church to elect and remove the board of directors of the Center.

The articles of incorporation of the Center normally, under most state laws, can provide that the Church, represented by its Church Council, will be the only member of the Center corporation. The member of a nonprofit corporation elects its board of directors and approves or makes the most important decisions about the structure, existence and property of the corporation. Members of a nonprofit corporation are, in this sense, comparable to shareholders of a business corporation.

The Center's articles of incorporation can state that only the Church, as the sole member of the Center, has the right to appoint and remove the members of the Center's board of directors.

The articles of incorporation or bylaws might require that only members of the Church may be directors of the Center or state that a majority must be members of the Church. It is important that the Center's articles of incorporation or bylaws include a statement that the Center is required at all times to comply with *The Book of Discipline*. The articles of incorporation or bylaws also can provide that any sale or purchase of assets over a certain dollar amount must be approved by the Church, that the Center cannot go out of business or change its mission and purpose without Church approval and that reports are given to the Church on a regular basis. Another provision in the Center's articles and bylaws should require all of the Center's assets to be distributed to the Church on any dissolution of the Center. Finally, in order to assure the continuation of these control provisions, the articles and bylaws can require Church approval of any changes in them.

By structuring the Church's relationship to the Center in this manner, the Church will be able

ultimately to control the mission and purpose of the Center, because the board of directors of the Center is selected by the Church. Also, if the Center takes actions that the Church finds inconsistent with its mission and ministry, the Church can remove any or all of the directors of the Center and appoint a board that will act consistent with Church policies.

However, the Church cannot control the day to day operations of the Center that is separately incorporated, such as hiring, discipline and termination of staff, the hours and dates of operation, payroll issues, etc. A court is likely to ignore the separate corporate status of the Center if the church is controlling the day to day operations.

#### Federal Tax-Exempt Status

A Center is not automatically tax exempt. The Internal Revenue Code requires application for exempt status to be made with the IRS within 15 months of incorporation. United Methodist local churches are exempt from federal income tax under the IRS Group Exemption ruling for The United Methodist Church. The General Council on Finance and Administration maintains this Group Ruling exemption. However, the Ruling does not provide for the automatic inclusion in the Group Ruling of separately incorporated organizations, such as Centers, even those

"controlled" by the Church. GCFA ordinarily permits Centers that are clearly a part of the mission and ministry of the Church to be included in the Group Exemption Ruling if they choose to request inclusion.

If a Center wishes to rely on inclusion in the denomination's group Ruling, the Center must request and authorize inclusion in the Ruling. To do so, the Center should contact the General Council on Finance and Administration, 1 Music Circle North, Nashville, TN 37203, Attn: Legal Department, to obtain information about inclusion in the Group Ruling. A Center may prefer to seek tax-exempt status by filing a separate Form 1023 application with the IRS. However, the cost and work involved in filing such an application may not be worthwhile if the Center can be included in the Group Ruling.

Before it is decided whether to separately incorporate the Center, it should be determined whether tax-exempt status is likely to be obtained, either under the denomination's Group Ruling or a separate exemption for the Center. The three possible categories for exemption are for an entity organized and operated exclusively for one or more of the following purposes: (1) religious, (2) educational, or (3) charitable. To qualify as exempt due to the Center's religious purpose, the Center must, both in its purpose and activities, function for the promotion of religious beliefs, attempting to a significant degree to impart religious beliefs to the children in its care. To qualify as an educational organization, either (1) substantially all of the care provided must be for the purposes of enabling individuals to be gainfully employed and the services of the Center must be available to the general public, or (2) the Center must demonstrate that its activities and goals are aimed at educating the children in its care. For a Center to meet the second test for educational organization status, the environment of the Center should be designed with an educational purpose, the teachers should be highly trained in education, and the children's schedule should be planned to maximize the educational value of their play and other activities. To qualify as a charitable organization, the Center must be primarily geared toward caring for children from low-income families at reduced fees or without charge or toward caring for children from dysfunctional families or who are otherwise disadvantaged and in need of special care.

### State Tax-Exempt Status

The requirements of the particular state in which the Center is located for obtaining an exemption from state income tax (and, in some states, sales tax) must be determined. The exemption from state income tax may be conferred automatically once the exemption from federal income taxation is obtained. If the exemption is not conferred automatically, the required application necessary for state income tax exemption (and sales tax) must be filed with the appropriate state agency.

### Other Important Steps

1. **Employer Identification Number.** The incorporated Center must obtain an Employer Identification number (EIN) separate from the Church, by completing and filing the appropriate form with the Internal Revenue Service (Form SS-4).
2. **Center Bylaws.** Bylaws must be drafted for the incorporated Center.
3. **Church Bylaws.** The Church's bylaws will need to be changed to show the relationship between the Church and the Center. The Church should consider having a bylaw provision stating its purpose in operating a Center as apart of its mission and ministry and describing the manner in which it will elect Directors, consistent with Center 's bylaws. Other provisions can describe the duty of the Center' s board of directors to provide reports to the Church. (This provision should also be in the Center' s bylaws).
4. **Assets Transfer .** Since the main purpose of incorporating the Center would be to protect church assets from any liabilities of the Center and to protect Center assets from any liabilities of the Church, it is appropriate, but not required, that assets owned by the Church for the operation of the Center be transferred to the Center corporation, (e.g., bank accounts that relate to the Center). For real property , it is advisable that a lease should be written and rent be charged the separately incorporated Center by the Church. (Consider real estate property tax issues in the lease.) The Lease should include appropriate indemnification of the Church by the Center in the event of third party or employee claims and suits. The Lease should be prepared by a qualified local attorney and should spell out in detail any financial arrangements, times of operation, and term s of access t o the property. If a separate corporation is to own real property, remember t he *Disciplinary* requirements for inclusion of the Trust Clause in the deed.
5. **Insurance.** Separate liability and property insurance must be obtained by the Center with the Center as the insured. This policy should also name the Church as an additional insured. Directors and Officers' Liability Insurance should be considered.
6. **Worker's Compensation.** Depending on state law, the Center may need to pay for worker's compensation insurance coverage of its employees.
7. **Separate Board of Directors .** The board of directors of the Center must elect officers, hold meetings, keep minutes, and maintain other appropriate records.
8. **Separate Annual Report .** Generally, an annual report (and possibly a fee) must be filed by the Center corporation with the Secretary of State of the state in which the Center is located. (This varies from state to state.)

9. **Separate Books and Records** . The Center will be required to keep books and records, including minutes, separate from the books and records of the Church. What this means is that the actual books or binders used should contain only records of the Center. It is desirable for these records to be stored separately from Church records.

10. **Federal Unemployment Tax** . Presently, the local Church is not required to make federal unemployment tax payments on behalf of its employees, including its employees who work at the Center, because, as a United Methodist church, it is exempt from the Federal Unemployment Tax Act. If the Center is incorporated separately, the Center still may be exempt from the Federal Unemployment Tax Act as an organization that is operated primarily for religious purposes and that is controlled by a church. (If the Center qualifies under the Group Ruling, it should be exempt from federal unemployment tax.) However, a state exemption from paying state unemployment tax may not exist or state tax authorities may not consider the Center to be an organization operated primarily for religious purposes and may decide that the Center must make state unemployment tax payments on behalf of its employees.

11. **Payroll and Employment Taxes** . A separate payroll must be established for the Center's employees and all federal and state employment tax returns and tax information reporting for Center employees and for any other purposes in connection with the operation of the Center must be filed separately by the Center.

12. **Form 990** . If a Center has applied for tax-exempt status outside of the denomination's group ruling, a federal tax Form 990 may be required if Center receipts exceed \$25,000 in any year. No tax is payable, assuming the Center is found to be exempt from federal income taxation, but the return may be required. (If the Center has unrelated business income, a return must be filed and tax may be due.)

13. **Personnel Policies** . It is essential that Centers have comprehensive, well-written personnel policies that may be very different from the Church's own personnel policies. Examples of issues that should be covered in these policies are: at-will employment, hiring, salary and benefits, vacation and sick leave, religious requirements, work hours, requirements for the safety of children, performance reviews, discipline, sexual and racial harassment policies and termination and resignation.

14. **Special Child & School Concerns** . If you already have a Center in operation, you will be aware of the federal, state and local regulations that you must comply with including: zoning and building codes for schools or child care, regulations for how the Center's property must be maintained, accessibility for disabled persons, screening of workers, child abuse regulations and reporting requirements and transportation regulations, to name a few. If you are starting up a Center, these are all topics to review with your legal counsel.

**Disclaimer:** This memorandum explores general incorporation issues. There will be other issues or concerns not addressed here. The General Council on Finance and Administration is not engaged in providing legal, tax or accounting advice or services. Please consult a competent local attorney for legal advice or a tax professional for tax advice.

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