Space-sharing Arrangements in Houses of Worship: 
Federal and Illinois Tax and Legal Implications 
By Michael P. Mosher

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Space-sharing Arrangements in Houses of Worship: Federal and Illinois Tax and Legal Implications
By Michael P. Mosher

Congregations have traditionally served as resources to people in need throughout their communities. As an extension of their mission, churches and synagogues have expanded beyond traditional worship services by providing food, shelter, clothing, counseling and education ministries throughout their neighborhoods and the world. Houses of worship have served as a center of community, responding to essential human and spiritual needs.

In recent years, congregations have increasingly extended their community ministries by entering into partnerships with other agencies, ministries and service providers. They have shared their space and resources with other organizations in order to both expand their ministry and minister to their neighborhoods more extensively. Building maintenance costs have been supplemented through these arrangements as well. These houses of worship have taken on another role as community centers with the laughter of children and the activities of senior citizens throughout the week. Once used primarily on weekends for services and fellowship, the facilities bustle with activity daily, serving a greater variety and number of people, their spiritual vitality supplemented by the physical presence of the community they serve.

Increasingly, these partnerships have become formalized, long term relationships requiring greater management responsibilities for congregations. This publication provides an overview of federal and Illinois tax and legal regulations affecting the space-sharing agreements of houses of worship and other charitable ministries. Guidance is also provided in reducing the potential risk of tax and associated problems.

Just as needs have multiplied beyond food, shelter, and clothing, the implications of sharing space have become more complex. Legal questions arise. Will renting to a day care center affect tax status? Who is responsible for maintenance? What insurance is necessary? Which forms should be filed? These issues have all become factors in mobilizing space and other resources to the owners simply need to be aware of potential problems and take action to avoid them.

The materials consulted within this publication are intended strictly for general information and the guidance of congregations and does not constitute legal advice. When developing leases or space-sharing agreements for houses of worship, a lawyer specializing in such arrangements should always be consulted.

Definitions

Use of the term "houses of worship" in this guide refers to buildings and tangible property used by most churches, synagogues, temples, or mosques in pursuit of their religious purposes. The organizations themselves are collectively referred to as "religious institutions." The problems described above are shared by Christians, Jews, Muslims and others alike.

Some of the sections describe complex tax laws where the government distinguishes "churches" from other "religious organizations." Under most tax laws, churches enjoy special privileges not available to other tax-exempt entities.

In general, the term "churches" includes all houses of worship as well as the organizations directly "in control of" or "controlled by" churches. However, since the U.S. Constitution protects religious freedom, the government cannot clearly define what a church is without cutting...
someone out. The U.S. courts have therefore described churches but have never defined one. The Internal Revenue Service regularly struggles with the difference between churches and other religious organizations, and although it cannot define a church, its handbook for revenue agents provides a list of 14 criteria describing a church.

OVERVIEW OF SPACE-SHARING AGREEMENTS

Space-sharing of houses of worship is a complex matter. In addition to the basic exemption from real estate taxes, there are matters of income tax, sales tax, and local fees attached to the use of land. Properly understood, tax-exempt status is a valuable asset to houses of worship and can be used to great advantage.

Many different situations exist in which religious institutions can share the use of real estate with other entities. One of the most common involves two churches that use the same facility at different times of the week.

Usually a "host" church owns the worship facility and permits a "guest" church to use it during off-hours. The guest church usually remunerates the host church for the privilege. However, if care is not given to these financial arrangements, the host church could jeopardize the tax-exempt status of the facility.

It is also common for houses of worship to develop auxiliary social programs that share the worship facility. Many churches operate schools, day-care programs, food pantries or homeless shelters. These programs are often separately incorporated to protect the church from civil liability. The church may control the corporation, or it may set up the new entity to be controlled by community representatives.

In any case, the terms and conditions of the shared use of the facility should be articulated in a document that helps both parties understand the rights and responsibilities of each. Again, care should be given to these space-sharing agreements so the church's tax-exempt privileges are not adversely affected.

Occasionally houses of worship have potential commercial applications. For example, a congregation may acquire a storefront building used for religious worship on week-
ends and as a restaurant on week-
days. Even if the restaurant is oper-
ated by a religious institution it is
not tax-exempt. However, if pro-
perly structured and documented, the
real estate may still qualify for sub-
stantial tax benefits.

A religious institution is not prohib-
ited from engaging in a commer-
cial activity if it pays its taxes and the un-
related business does not become its
primary purpose.

PHILOSOPHICAL AND
PROGRAM ISSUES

Most successful space-sharing agree-
ments are between organizations
with a similar world view and com-
plementary program objectives. It is
not essential participants be like-
 minded, but they must understand
and respect each other’s differences and
share similar expectations.

Different social/political agendas or
management styles make some or-
ganizations fundamentally incom-
patible. However, differences can
be worked on so they complement
each organization. If the parties are
willing, many differences can be
shaped into benefits. The key to
avoiding potential conflicts is to con-
front them during the negotiation
stage.

CORPORATE
STRUCTURE AND
AUTHORITY UNDER
ILLINOIS LAW

The first rule in all real estate trans-
actions involving corporate entities
should be to check on each party’s
corporate structure and the legal
authority of the respective repre-
sentatives to enter a binding con-
tact.

Many religious and charitable or-
ganizations operate with an inade-
quate understanding of their legal
structure. As a result they may act
without proper legal authority. The
organization’s bylaws or constitu-
tion should be carefully reviewed be-
fore it is committed to any
significant contractual obligations.
Each party to a potential space-sharing
agreement should have access to
the other’s authorization docu-
ments. If these documents are inade-
quate or do not exist, the contract
negotiations should be postponed
until the authority issues are clari-
fied.

One of the first tasks negotiators
should do is request evidence of cor-
porate authority from all parties in-
volved. A space-sharing agreement
without authorization is generally
not binding upon the corporate en-
tity, but under Illinois law may be
binding upon the individuals who
acted without authority. The people
who negotiate real estate contracts
should understand the nature of
their respective organizations and
the limitations of their authority.

Religious, charitable and educa-
tional organizations in Illinois are 1)
incorporated under the General Not-
For-Profit Corporation Act of 1986; 2)
an Illinois Religious Corporation; or
3) an unincorporated association.
Each of these three legal structures is
affected differently in agreements in-
volving real estate.

Not-for-Profit Corporations

The most common legal structure
for Illinois religious and charitable
organizations is the not-for-profit
corporation. Illinois has one of the
best state corporation statutes in this
regard.

It gives corporations maximum flexi-
bility and authority while providing
a clear and effective legal structure
within which to operate. This pro-
vides the optimum legal structure
for any religious or charitable orga-
nization planning to operate under a
space-sharing agreement.
Unincorporated Associations

Many worshipping congregations and neighborhood charitable organizations have no formal legal structure. They are unincorporated associations, for legal purposes, and under Illinois law members are treated as partners in a partnership whether or not they have a legal agreement. Each member is liable for the actions of the group, but the organization cannot sue or be sued as a legal entity.

This form of organization is suitable for a group with no significant tangible property, no employees and minimal financial activity. This structure is not suitable for an organization that owns or leases real estate.

Caution should be exercised when planning a space-sharing agreement with such informal organizations. They should not be relied upon to be legally responsible partners, since they have questionable legal standing under the law. The members of the organization must all participate individually in a legal agreement for it to be enforceable.

Corporate Authority Issues

Regardless of which legal structure exists, an organization that owns or uses real estate must have a system to properly delegate legal authority to certain individuals who act on behalf of the group. When planning a space-sharing agreement between two or more organizations, it is essential to know the authorized representatives and the limit of their authority.

In many churches, a board of elders or trustees control the property. Usually, the pastor is not legally authorized to buy, sell or lease real estate. That authority is reserved to the board or to the membership as a whole. Pastors who take greater authority than legally permitted can get their churches into legal jeopardy. The Illinois law makes people who act without proper authority on behalf of a not-for-profit corporation personally liable for damages caused by their negligence.

In situations involving new or emerging organizations, care should be taken to see that the corporate formalities are satisfied before signing a contract. Occasionally, a religious institution contracts with its own emerging program in an effort to encourage the new entity toward independence. Since an organization cannot enter into a contract with itself, the agreement will not be effective until the new entity is legally formed.

FEDERAL AND STATE INCOME TAX EXEMPTION

As a general rule, religious institutions are automatically tax-exempt under the U.S. Internal Revenue Code of 1986. Religious institutions are one of many types of tax-exempt organizations. Schools, hospitals, social service charities and other types of religious organizations are among the other common exempt organizations. The latter types of organizations must file with the IRS and obtain a determination letter stating the organization is tax-exempt.

Some religious institutions operate unrelated businesses within their facilities which may or may not be separately incorporated. A wide range of choices exists for religious institutions planning the enhanced or shared use of their facilities that will not adversely affect their tax-exempt status.

However, care must be taken to ensure the institution continues to operate primarily for religious purposes, and it reports and pays any necessary unrelated business income taxes. It is important to note issues affecting income tax exemption are often very different from property tax issues, and may cause confusion for people who manage houses of worship.

Tax Exemption: A Privilege not a Right

A factor in tax law often misunderstood by religious institutions is that tax exemption is only a privilege, not an absolute right. True, the U.S. Constitution guarantees religious freedom, but this does not guarantee total freedom from taxation.

The U.S. Supreme Court and many federal and state courts have held that the government may require churches to pay taxes where such imposition does not directly curtail religious worship or the freedom to communicate religious beliefs.

The Internal Revenue Code as well as most state tax laws provide exemption from income taxes on activities that are religious in nature. However, unrelated activities of religious institutions may be subject to income tax while the organization remains otherwise tax-exempt.

The Illinois Constitution permits the legislature to pass laws exempting religious institutions from taxation, but such exemption is not mandatory. Therefore, religious institutions need to be aware of activities that can cause loss of their tax-exempt status.

The Internal Revenue Code

Benefits of tax-exempt status under the Internal Revenue Code of 1986 (referred to hereafter as IRC) are based upon a complex interaction of several tax code sections. At least 28 different types of tax-exempt organizations are listed under IRC section 501(c).

Churches and similar religious institutions are entitled to the greatest
benefits under the law. Like other charitable and educational organizations, their related income is tax-exempt, and donations are tax-deductible. In addition, religious institutions need not file annual reports with the IRS, nor can the IRS audit them except under special conditions. All other tax-exempt organizations are subject to closer IRS scrutiny.

If a religious institution fails to remain in full compliance with the various Internal Revenue Code provisions, it may lose its special status. Under some circumstances it may lose its tax-exempt status altogether. A poorly planned space-sharing agreement could put tax-exempt status in jeopardy. (A brief review of rules affecting religious, charitable and educational organizations may be found in Appendix 1.)

Unrelated Business Income Tax (UBIT)

Faced with a shortage of funds from public donations, many religious institutions turn to raising money through business activities unrelated to the organizations' exempt purposes. Space-sharing real estate in most cases is an unrelated business activity and under certain conditions may be subject to unrelated business income tax (UBIT). For example, some congregations serve a "Sunday Dinner" after worship services every week to which the public is invited, but must pay for each meal. Other churches operate religious bookstores throughout the week, selling religious books to the public. Since tax-exempt organizations must operate exclusively for a qualified exempt purpose, too much unrelated business activity could threaten their tax status.

The Internal Revenue Code at Section 512 provides that:

"...unrelated business taxable income" is the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business."

The language of this section seems fairly clear, but "unrelated trade or business" and "regularly carried on" require definition.

According to IRC Section 513 "unrelated trade or business" means "...any trade or business, the conduct of which is not substantially related (aside from the need of such organization for income or funds, or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501."

Whether a business is substantially related to the organization's exempt purposes must be determined after reviewing the facts and circumstances of each case. For example, construction and sale of 80 homes would seem to be a trade or business not substantially related to an exempt purpose. However, if the builder is organized to help train unemployed workers and provide shelter to homeless people, the situation changes.

A significant factor in determining that an activity is a trade or business is whether it is conducted in a commercial manner and is competing with other non-exempt businesses. For example, a large religious publishing house began publishing Sunday school curricula as a tax-exempt activity. Several years later, the IRS revoked the organization's exempt status because it operated like other commercial publishers, earning significant profit from its sales.

The term "regularly carried on" must be considered in light of comparable frequency and continuity of similar commercial business practice(s). If a church operates a pancake breakfast open to the public...

The Willow Creek Community Church operates a religious bookstore throughout the week.
once or twice a year it would not be treated as a regular business. However, a pancake breakfast that is conducted every Sunday and open to the public would be subject to UBIT if the congregation charged.

Exceptions to the Rule of UBIT

Obviously, a business activity substantially related to an organization's tax-exempt purpose is not covered by UBIT. Whether income-producing commercial activity is substantially related to an exempt purpose is difficult to answer, and the complex issues are beyond the scope of this publication. A study of the IRS's revenue rulings on the subject would be helpful to the reader who works with an organization that has commercial activities.11

The most significant exceptions to UBIT are:

• Business Activity Involving Passive Assets

Real estate, unencumbered stocks, bonds, annuities, copyrights and trademarks are passive assets that may be invested, sold or otherwise used for income-producing purposes without being subject to UBIT.15 This exception is most important to people planning a space-sharing agreement which otherwise would be an unrelated business activity, i.e. real estate rental.

Debt financed passive assets are the exception to the exception. If a tax-exempt organization acquires income-producing property that was acquired with borrowed funds, the income may be subject to UBIT.16 This exception is based upon the notion that tax-exempt organizations should not be permitted to go into debt to acquire income-producing property which then produces tax-free unrelated business income.

This debt-financed property rule is very significant to religious institutions sharing space with other organizations. If the facility being shared is subject to a mortgage, the rental income is taxable, unless it is subject to the "substantial use" or "neighborhood land acquisition" exceptions.

If debt-financed property is substantially used in the performance of the owner's exempt purposes, it would not be treated as income-producing property. Therefore, income from such property would not be subject to UBIT.17

The IRS has determined that the "substantial use exception" applies "if 85% or more of the use of property is devoted to the organization's exempt purposes".18 Under this rule, if a religious institution leased 15% of the available floor space in its house of worship to a commercial entity, the income would not be taxable even if the property is debt-financed.

Furthermore, there will be no taxable income under a lease if up to 50% of the facility is rented to an organization controlled by the owner or the tenant is using the space essentially in the performance of the owner's exempt purposes. For example, a church shares 50% of its debt-financed facility with a missionary society. The religious activity of the tenant satisfies the IRS's "substantial use exception" since it advances the religious purpose of the church.19

Another important UBIT exception concerns debt-financed real estate acquired by a tax-exempt organization located within the "neighborhood" and intended to be used for its exempt purposes within ten years.20 A religious institution expecting to enlarge its worship facility could use borrowed funds to purchase an adjacent house and lease the property at fair market value without creating taxable income, provided it demolished the house and constructed the new facility within ten years. Any organization expecting to benefit from this rule must notify the IRS before proceeding.

Federal Reporting Requirements for UBIT

Unrelated business income tax is calculated using the same formulas and tax tables that apply to ordinary commercial income. The definition of gross income and the allowable business deductions are similar.

The calculation of taxes on income from debt-financed property is complex and should be handled by an experienced accountant or attorney.

UBIT is reported each year on IRS Form 990T, which must be filed and paid by the fifteenth day of the fourth month after the end of the tax-
It is important to understand that qualified tax-exempt purposes are more restricted under Illinois law than under federal income tax laws. Many tax-exempt organizations must pay property taxes regardless of their status under the Internal Revenue Code. Any Illinois property "used or otherwise leased with a view to profit" is taxed even though the property is used for a qualified exempt purpose.

Laws pertaining to ownership and use of tax-exempt property are complex. The Illinois Constitution provides that: "The General Assembly by law may exempt from taxation only the property of the state, units of local government and school districts and property used exclusively for agricultural and horticultural societies, and for school, religious, cemetery and charitable purposes." 22

Note that this constitutional language concerning property exemption is permissive and not mandatory. The Illinois Legislature has since enacted several additional statutes which give religious, charitable and some educational organizations the privilege of owning and using tax-free real estate (Excerpts from these statutes are located in Appendix #2).

Houses of worship easily qualify for tax exemption, provided there is no substantial non-exempt use.

The federal tax exemption laws also recognize a wide variety of qualified educational organizations. In Illinois, property exemption is available only to schools and the property necessary to their educational activities.

Qualified schools usually have a regular faculty, an identified student body, an established curriculum and classrooms. Other educational or-

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payer’s fiscal year. If gross income is more than $1,000, the organization must prepare and file Form 990T. The form must be filed even if the taxpayer calculates expenses exceed income so no tax is due (which is often the case). There are penalties for failure to file Form 990T, even if no tax is due.

Illinois Income Taxes Affecting Tax-exempt Organizations

Illinois income tax laws generally conform to federal income tax provisions affecting tax-exempt organizations. If an organization is tax-exempt under the Internal Revenue Code of 1986, the same treatment is given under Illinois law. Likewise, UBIT is reported and taxed as if the taxpayer were a regular business enterprise.

Most Illinois tax-exempt organizations required to file IRS Form 990 are also required to send an IL-AG 990 (with a copy of the IRS Form 990 attached) to the Charitable Trust Division of the Illinois Attorney General’s office. This form should be filed within six months after the end of the organization’s fiscal year.

In regard to UBIT, the taxpayer must file an IL-990T with the Illinois Department of Revenue and pay taxes like any other taxable corporation.

ILLINOIS LAWS AFFECTING TAX-EXEMPT REAL ESTATE

For people concerned about the impact of space-sharing agreements on houses of worship, state laws affecting real estate tax exemption may be even more important than federal income tax laws. Real estate taxes on commercial property are significant, and tax exemption is an important benefit. Space-sharing agreements always affect the tax status of real estate, but in most circumstances negative tax results can be avoided with proper planning.
organizations may qualify as charitable organizations or not at all.

As with educational property, the concept of tax-exempt charitable property in Illinois is far more restrictive than under federal tax law. The concept of a tax-exempt charitable organization has been examined in several Illinois court cases. As a result, charitable organizations seeking to remove real estate from the tax rolls must satisfy the following conditions: 23

a. The organization has no capital, stock or shareholders and no profits or dividends;

b. The organization derives its funds mainly from private and public charity;

c. The property is held in charitable trust e.g. by a nonprofit or religious corporation to serve the objectives and purposes expressed in the organization’s charter; and

d. The organization’s charitable services are available to all who need them.

These conditions do not apply to property used for religious or educational purposes.

Effect of Shared Use Agreements on Tax-exempt Property

The privilege of property tax exemption is a valuable asset and should be carefully protected. Since space-sharing agreements always impact the tax-exempt status of property, they should be seriously considered.

Two or more tax-exempt organizations can share a facility without unfavorable tax consequences if their agreement is well-planned and clearly articulates their respective expectations. In cases where the shared use is intended to generate a profit for the owner, or where the tenant is an individual or a commercial entity, special steps must be taken to preserve partial tax exemption for the property.

Exempt Organizations with Shared Exempt Purposes

If two or more organizations sharing exempt property complement or otherwise enhance each other’s delivery of exempt services, the space-sharing agreement should be structured to retain the full tax-exempt status of the property.

Financial contributions (considered “rent” in a commercial lease) must be made in a manner that clearly precludes generation of profit for the owner. This is done by calculating the tenant’s financial contribution in relation to the cost of operating the facility.

An owner intending to share space for religious and charitable purposes needs to give careful attention to identifying the tax-exempt purposes of the “guest” organization. The following four statements will help planners evaluate whether a particular agreement would qualify as tax-exempt:

1. The primary use of the shared exempt property must be in furtherance of a qualified exempt purpose.

2. The more similar or complementary the exempt activities of the owner and the tenant are, the less likely the agreement will be declared to have been entered with a view to profit.

3. The smaller the percentage of the owner’s space that is shared, the less suspect the agreement will be that it was negotiated with a view to profit. (A similar criteria is used by the IRS to determine possible UBIT liability.)

4. The more the shared uses are similar to commercial activities, the more likely the agreement will be perceived to have a view to profit.

Exempt Organizations Sharing Space with a View to Profit

It is appropriate for an exempt organization to share its facility with another exempt organization in order to generate revenue to support its exempt programs. In this case, the organization should clearly identify which parts of the facility are used for exempt purposes and which are not. Common use areas should be avoided since all such use will then be taxable. For example, when a tax-exempt owner leases an office to a commercial tenant and allows tenants to use the parking lot without restriction, not only will the office area be subject to real estate taxes, but the whole parking lot as well. The organization should clearly articulate its objectives so that tax exemption can be preserved for the remaining part of the property.

Furthermore, if the intent is principally to generate revenue, a simpler commercial lease would provide greater protection for the owner (Lessor) than a space-sharing agreement.

In many cases of this type the exempt owner’s motivation is unclear in regard to issues of profit. Often the owner does not intend to rent the property for maximum profit, but wishes to generate some modest income to support its exempt objectives. Careful consideration should be given to determine whether the property taxes and possible federal UBIT that may result outweigh the benefit of additional income.
An ambiguous space-sharing agreement may be interpreted as an essentially profit-motivated lease and may jeopardize the tax-exempt status of the entire property. By contrast, it is reasonable to expect the owner will continue to benefit from tax exemption on the property under a well-drafted space-sharing agreement.

The Illinois courts have reviewed several situations involving the lease of otherwise exempt property. In one case, a church leased its parking lot to the local village government. Even though both organizations were tax-exempt in their own right, the court held that the underlying motivation of the lease was to profit the church. In another case, a Catholic convent leased space to a school. The court carefully reviewed the terms of the agreement and held the property was not leased with a view to profit.

This case and several others demonstrate that diverse use of qualified exempt property need not affect its tax status if the owner is not seeking to profit from the transaction. A carefully drafted space-sharing agreement that clearly describes the exempt purposes of each party and avoids profit for the owner organization is essential to help preserve the tax-exempt status of the property.

Exempt Property Shared with a Private Entity

Frequently portions of religious facilities are simply leased as commercial property to individuals or businesses. In these situations, the owner needs to plan carefully to preserve the partial tax-exempt status of the property.

In the Chicago "Loop" area there are several houses of worship located in otherwise commercial office buildings. In these cases, the religious institution operates a small part of the facility for qualified exempt purposes. The remainder of the property is subject to real estate taxes. Tenant agreements in these buildings look like any other commercial leases, and the tenants pay the taxes.

Another common situation occurs when a religious institution owns a storefront with residential apartments upstairs. Perhaps the pastor lives in one apartment and the others are leased to private individuals. If this situation is properly documented, the worship facility on the first floor and the pastor's apartment will qualify for tax-exempt status, while the remaining part of the building will be subject to taxes.

It is important in these agreements to show the exempt property is used exclusively for a qualified purpose, because any space used in common with commercial tenants will be fully taxable. Space-sharing agreements subject to real estate taxes may also be subject to federal income taxes unless the property is covered by one of the UBIT exceptions.

Assessor's Office and Annual Certificate Requirements

Since the Illinois property tax exemption is granted to specific owners for special exempt uses, the statute provides that the owner must notify the County Assessor's office if any changes occur in the ownership or use of the property.

Failure to comply with this law may result in the total property being retroactively taxed, notwithstanding a partial tax-exempt use. Therefore, it is important to notify the appropriate county office when space-sharing agreements have been negotiated.

When there is a question whether the Assessor will affirm an anticipated tax-exempt shared use, a determination should be obtained prior to the execution of the agreement. Otherwise, the agreement can be made contingent upon the tax-exempt status of the agreement being approved, with the tenant paying for any assessed taxes.

To maintain a property's tax-exempt status in Illinois, the owner of the tax-exempt real estate is required to file an affidavit of use each year, prior to January 31, with the County Assessor's Office. This affidavit is a notarized certificate stating the property is still being used for exempt purposes and declaring any changes in the entity using the property or the way in which the property is being used. Failure to file an accurate certificate may result in the termination of tax-exempt status.

Sales and Use Tax Considerations

When negotiating a space-sharing agreement it is important to consider whether either party will be selling goods or services subject to Illinois sales and use taxes. These tax laws are complex, and many nonprofit organizations fail to recognize that their sales activities are subject to taxation.

The property of retail organizations can be confiscated by the Illinois Department of Revenue if they are negligent in collecting and remitting sales and use taxes. The consequences of negligent retail operations are especially important to nonprofit organizations.

Any organization that shares space with a retail operation should monitor compliance with the sales tax laws. The space-sharing agreement should provide for compliance standards.
OTHER STATE & LOCAL REGULATORY LAWS

In addition to issues of corporate authority and taxes, space-sharing agreements are usually affected by local land-use controls. Many communities in Illinois are beginning to impose special user fees on houses of worship.

For example, religious institutions are often subject to a fee for use of water and sewage facilities. Religious institutions in Chicago can apply for a water credit which usually eliminates this fee.28

However, permitting another organization to share a worship facility may disqualify the religious institution for the water credit. A space-sharing agreement should allocate this expense to the guest.

Local Zoning Regulation

Nearly every community in Illinois has zoning ordinances designed to restrict the use of real estate. With most community land-use plans, houses of worship are permitted in some areas and prohibited in others.

Likewise, clothing resale shops are restricted as to location. For example, in most communities the operation of a charitable resale shop out of a church facility requires a special zoning permit.

Since zoning ordinances vary significantly from community to community any house of worship planning to share its facility should check its proposal with the local zoning board. A space-sharing agreement incompatible with the local zoning laws can be a serious problem for all parties involved.

Local Building and Fire Codes

Most communities have building and fire codes as a complement to their zoning ordinances. These codes regulate what activities can occur in certain buildings according to the nature of the structure.

For example, the storage of printing ink and cleaning solvents in most worship facilities would probably violate the local fire code. Most schools or day care facilities for children are closely regulated by the fire marshall through licensing procedures and are required to have fire sprinkler systems. It is essential for anyone planning a space-sharing agreement to consult with the local building department and the fire marshall.

CONTRACT CONSIDERATIONS

Assuming that (1) all interested parties have proper corporate authority to act, (2) there are no insurmountable income tax or real estate tax obstacles, and (3) the subject facility is suitable for a space-sharing agreement, the negotiations should focus on contractual issues. The law affecting contracts for use of real estate is very complex. Space-sharing arrangements often continue for many years, and participating parties usually come to depend upon availability of the space or revenue generated by the agreement. The term "space-sharing agreement" has been used to describe what might otherwise be called a commercial lease. The term is not used casually.

First, when people negotiate a space-sharing agreement, as opposed to a commercial lease, they have a different mindset. Second, when the County Assessor or the agent at the Illinois Department of Revenue examines a space-sharing agreement, their orientation to the document will be different than when they review a preprinted commercial lease purchased at a stationary shop, even if the basic terms of the two documents were similar. The projected image of a space-sharing agreement reinforces the fact the agreement was negotiated without a view to profit.

When preparing a space-sharing agreement, the following contract provisions must be carefully drafted:

1. Corporate Name and Representative of Each Party to the Agreement

The first paragraph of a legal agreement should accurately identify the full corporate names of each party and their authorized agents. The federal identification number of each party should also be included.

2. The Nature of Each Party

If the tax-exempt status of property is to be preserved, it is important to express in the agreement the religious, charitable or educational purpose of each party. State whether each party is recognized by the IRS or the Illinois Department of Revenue as being tax-exempt.

When appropriate, explain how the tax-exempt purpose of the owner is being served or complemented by the tax-exempt purpose of the tenants. Having these explanatory statements at the beginning of the space-sharing agreement will make the transaction easier to process with the County Assessor's office.

3. Description of Space to be Shared and Limitations on its Usage

This component of the agreement is very important if there is any concern that any part of the facility will be subject to real estate taxes. Most important in this regard is the pre-
cise description of the space that will be exclusively used by the tenant.

A well drafted agreement describes the square footage of the total building as well as the space being used by the tenant. Joint use of common areas may present a problem if the tenant's uses of the property are not qualified under the more restrictive Illinois tax statutes.

Tax-exempt status is always based upon the exclusive use of property for qualified purposes. Shared use of common areas in a building (or even a parking lot) with a non-exempt organization will cause the entire common area to be subject to property taxes. When sharing space with a non-exempt organization, it is reasonable to provide for a separate entrance and to avoid common use of exempt property.

4. Financial Contribution for Space Usage

If a space-sharing agreement is not negotiated with a view to profit then it should make that fact very clear. Avoid statements in the agreement that refer to "rent". The tenant may be described as being the guest. Monthly payments are contributions intended to help the "host organization" maintain the facility; payments are reimbursements for mortgage interest, heat, electricity, janitorial services, supplies, building upkeep, or even a reserve fund to repair the roof. The guest should not contribute the principal payments on the mortgage but may be expected to pay a full share of building expenses.

The term "rent" implies a commercial lease which suggests profit. By contrast, "financial contribution" implies shared expenses. The statutory condition that a tax-exempt property cannot be "leased or used with a view to profit" is not only an element of the financial bottom line, but also a test to the mindset of the parties to an agreement. Care should be used when calculating and describing the tenant's contribution.

Termination Procedures

Space-sharing agreements need special provisions that allow the various parties to negotiate disputes in a peaceful manner. The parties to these agreements may have different motives for using the space, and these differences need to be respected by all so that accommodations can be made without terminating the agreement.

A good space-sharing agreement provides for regular meetings between the parties in order to identify trouble areas before they become legal problems. In the event a serious legal problem arises, the agreement should provide for a mediated solution. Seldom do space-sharing agreements involve property disputes that must be resolved in court. Finally, this section should identify certain conditions that will cause the agreement to terminate if other resolution procedures fail.

Legal Liability and Indemnification

Parties to any legal agreement bring with them a special set of potential legal liabilities resulting from their activities. Sharing real estate inherently brings the various participants into a close connection wherein legal problems can spread to the other parties. Accurate evaluation of the other party's potential problems is important when negotiating a space-sharing agreement.

When drafting a space-sharing agreement there should be a provision that specifically identifies all potential liabilities and requires the responsible party to undertake procedural measures calculated to reduce the risk.

For example, a child care center should be required to screen its employees for potential child abusers. If the program shares space in a house of worship, the administrator should give the religious institution's leaders written assurance that the staff are all qualified and potential child abusers are reasonably screened out.

The religious institution's leaders should require the program to institute a protocol for this screening process. If the protocol is properly enforced and a parent sues the program for alleged child injuries, the religious institution is then relatively secure from liability. The same concerns arise in programs that serve food to the public, provide overnight shelter, or care for the elderly.

In addition to requiring each party to minimize potential areas of liability, the agreement should provide that each party will "hold-harmless and indemnify" the other parties from liability. This means that if one organization is sued for causing any injury, that organization will protect and defend the other parties to the space-sharing agreement if a lawsuit includes them.

The indemnity provision establishes that the principal party in the suit will pay all costs associated with the legal defense as well as any judg-
ments rendered in the case. This indemnification, of course, presupposes the other parties are innocent in the cause of the alleged injury.

Insurance

Covenants to indemnify other contract parties are only good if the indemnities have the financial resources to back up the promise. Few social service programs engaged in high-liability activities actually have sufficient resources to protect themselves or others.

It is therefore critical that the indem- nitor back up its covenants with appropriate insurance coverage. At a minimum, the parties to a space-sharing agreement should have general public liability insurance. Insurance policies should be carefully reviewed to make certain they insure against specific potential liabilities.

Condition, Care and Maintenance

All parties to a space-sharing agreement should be concerned about the physical condition of the premises. Organizations that service the public want the premises kept in a neat, clean condition that promotes a good corporate image.

Property owners that permit occupancy by a day-care center want to ensure that the children will not destroy the facility. Therefore, the agreement should identify specifically who is responsible to maintain what part of the building. A party having exclusive control of certain space should be responsible for maintaining that area.

Charitable organizations with limited financial resources that share space with other organizations, may contribute maintenance work as part of their financial contribution. Such maintenance arrangements have great potential for conflict unless they are carefully described in the agreement.

Environmental Issues

Increasingly, environmental issues are affecting management of real estate. Buried oil tanks and prior improper disposal of chemical wastes cause nightmares for many unsuspecting religious and charitable organizations.

A space-sharing agreement should prohibit use of hazardous substances without proper supervision and, if necessary, governmental registration. Houses of worship seem to inherit most environmental problems from businesses engaged in printing, dry cleaning, painting, and automobile maintenance.

The space-sharing agreement should identify potential environmental hazards and provide parties with a way to contain the problem or terminate the agreement.

SUMMARY

Space-sharing agreements are affected by many contract, corporation and tax laws, and other regulations that require careful attention. Nevertheless, the benefits associated with increased usage of houses of worship usually outweigh the problems related to space-sharing agreements. There are many ways to successfully share space with other organizations without jeopardizing the tax-exempt status of the organization or the property.

This publication has provided only a brief review of the most important issues involved in such agreements, but hopefully it can serve as a checklist for people planning and preparing a successful space-sharing agreement. (A planning checklist for Space-sharing agreements is located in Appendix #3.)
END NOTES


2. IRS Exempt Organizations Handbook, p. 7(10)69-26. To be treated as a "church," a religious organization must demonstrate that it has: (1) A distinct legal existence; (2) A recognized creed and form of worship; (3) A definite and ecclesiastical government; (4) A formal code of doctrine and discipline; (5) A distinct religious history; (6) A membership not associated with any other church or denomination; (7) A complete organization of ordained ministers, ministering to their congregations; (8) Ordained ministers selected after completing a prescribed source of study; (9) A literature of its own; (10) An established place of worship; (11) A regular congregation; (12) Regular and frequent religious services; (13) Sunday schools for the religious education of the young; or (14) Schools for the education of its ministers.

   Of course, few churches will satisfy all fourteen criteria but the IRS does expect to find most of these criteria. The IRS handbook goes on to instruct that the fourteen criteria are not exclusive but merely give direction to an effective investigation. The IRS agent is permitted to consider "any other fact and circumstances" which may bear upon the organization's claim for church status.

3. 805 ILCS 105/101-117. This Act is a compendium of laws directly affecting the operation of such organizations. Copies of the Act may be obtained without charge from the Corporate Department of the Secretary of State's Office.

4. 805 ILCS 110/0.01 et. séq.

5. Internal Revenue Code, Section 501(c)(3) establishes church exemption and Section 508 provides that they need not register with the IRS.

6. See Wells v. Tax Commissioner of New York, 397 U.S. 664; also, an excellent commentary is found in Miller and Flowers, Toward Benevolent Neutrality: Church, State, and the Supreme Court, Baylor University Press, 1977 at page 401. There are many ways in which the government can legally regulate the activities of the church so long as it remains unentangled with actual religious practices.

7. IRC Section 512(a)(1).

8. IRC Section 513.


12. IRC Section 513(a)(1).

13. IRC Section 513(a)(2).

14. IRC Section 513(a)(3).

15. IRC Section 512(b) par.(1),(2),(3) and (5).

16. IRC Section 512(b)(4).

17. IRC Section 514(b)(1)(A).

18. Revenue Regulation 1.514(b)-1(b)(1)(ii).


21. 35 ILCS 5/205 et. seq.

26. 35 ILCS 205/19 et. seq.
27. 35 ILCS 105/1; 120/2
28. Chicago City Ordinance Ch. 185, Sec. 1 and 47.
Resource List


Buzzard, Lynn & Sherra Robertson. *IRS Political Activity Restrictions on Churches & Charitable Ministries*. Diamond Bar, California: Christian Management Association, 1990. To obtain a copy, write the Christian Management Association, P.O. Box 4638, Diamond Bar, California 91765 or call 1-800-727-4262.


Schmidt, Richard F. *Legal Aspects of Church Management*. Diamond Bar, California: Christian Management Association, 1984. To obtain a copy, write the Christian Management Association, P.O. Box 4638, Diamond Bar, California 91765 or call 1-800-727-4262.
APPENDIX #1
BASIC RULES AFFECTING TAX EXEMPTION

Organizations covered by Internal Revenue Code 501(c)(3) include: "...corporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes... no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distribution of statements), any political campaign on behalf of any candidate for public office." 1

This Code provision includes the following five tests, that each tax-exempt organization, including religious institutions, must satisfy on an ongoing basis:

Test 1: Organized Exclusively for Religious Purpose

Religious institutions are tax-exempt only if they are organized exclusively for religious purposes. The IRS has denied exemption to many organizations claiming to be religious institutions because they had other significant purposes that affected their religious purpose.

For example, one church was operating a restaurant; another church was substantially involved in social and political activities; while another church seemed to primarily benefit a single family. In each case, the IRS said the church was not organized primarily for religious purposes.

If a religious institution becomes involved with space-sharing activities, they must remain secondary to the religious purpose. To satisfy the IRS's "exclusively religious" test, the organization must have: (1) a written organizational document or charter that describes its religious purposes; and (2) some language in its documents that prohibits certain transactions (prohibited activities are discussed below).

An organization expressly organized not only for religious purposes, but also to own and operate real estate for the benefit of other organizations, would not be a qualified religious institution. However, this final caveat would not apply to a religious institution that had a few incidental space-sharing agreements.

Test 2: Operated Exclusively for Tax-Exempt Purpose

A religious institution must also be able to show it is operated exclusively for religious purposes. The "operational test" looks to the actual activities, regardless of the organizational purposes. The IRS considers all the facts and circumstances, but especially the organization's sources of revenue and the nature of its expenses.

It is assumed that religious institutions receive most revenue from gifts and offerings. If there is significant income from other sources, it may be considered unrelated business income. For example, a missionary aviation society lost its tax-exempt status because more than 50% of its income was from the sale of airplane parts in the mission field. In another case, a religious organization operating a health food store and restaurant was determined not to be exempt because most of its funds came from the sale of food. These two organizations became overly involved with unrelated business activities.

There is no firm rule as to how much unrelated business activity is too much. The IRS and the courts are required to examine all of the facts and circumstances in each case. One Federal Tax Court opined that an organization is safe with less than 10% commercial activity while another court expressed that an organization with more than one-third of its income from unrelated activities would not be tax-exempt. The facts in these cases turn on many factors such as, how closely the business activity was related to the exempt activity and how much administrative effort the organization expended to generate taxable income. The IRS also assumes that a religious organization's expenses should be for clergy and related services or to maintain a house of worship. Expenditures for other purposes may jeopardize the organization's tax-exempt status.
Test 3: Prohibition on Private Inurement

No part of the net earnings of an exempt organization can inure to the benefit of any private shareholder or individual. “Inurement” occurs when someone who is a leader, or otherwise exercises control over an exempt organization, takes or uses money or other assets for personal use without due consideration in return.

Salaries and wages are paid in return for services, so they are not considered inurement. If a religious institution’s minister or any insider operates a personal business out of its facility without paying fair market rental there is an inurement problem.

There is no minimum amount of private inurement permitted. The presence of any inurement may be grounds for the IRS to revoke an organization’s tax-exempt status. Religious institutions planning a space-sharing agreement need to be extremely cautious yet flexible in dealing with potential tenants who are also leaders of the organization.

Test 4: Legislative Activity Must Be Insubstantial

No substantial part of the activities of the organization may be the carrying out of propaganda or otherwise attempting to influence legislation. Legislative activity generally relates to efforts to encourage or discourage the passage of government ordinances or statutes.

Test 5: Political Activity is Prohibited

Religious institutions may “...not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.” Like the problem with inurement, the IRS does not recognize any minimum safe amount of political activity.

Anyone who reads the daily newspaper knows that churches all over the country have been actively involved in the presidential campaigns as well as in local politics. In recognition of this situation, the IRS recently issued a public statement IR 92-57 warning tax-exempt organizations against endorsing political candidates, making donations to political campaigns, or allowing any candidate to use the organization’s resources in a way that promotes a candidate, or is in any way detrimental to another candidate. Religious institutions need to exercise extreme care when renting to a political candidate or to any related political support groups.

Federal Reporting Requirements for Tax-Exempt Organizations

The IRC requires most tax-exempt organizations to file an annual return, IRS Form 990, to report income, expenses and structural changes that may affect the organization’s continued performance of its exempt purposes.9 The Form 990 is used by the IRS to identify prohibited activities.

Churches and similar religious institutions are not required to file the Form 990.10 However, this exemption should not be confused with the IRS requirements for IRS Form 990T for reporting “unrelated business income tax.” (See main text for a more complete discussion of the topic.)

Any tax-exempt organization required to file Form 990 which is involved in a space-sharing agreement will need to describe the transaction in that report. The Form 990 must be filed no later than the fifteenth day of the fifth month after the organization’s fiscal year ends, or a penalty of $10.00 per day for late filing may be imposed.

END NOTES

1. IRC Section 501(c)(3)
2. Riker v. Commissioner, 244 F.2d 220 (1957)


9. IRC Section 6033.

10. IRC Section 6033(a)(2)(A)(i) provides a mandatory exception for reporting by "churches, their integrated auxiliaries, and conventions or associations of churches," and Subparagraph (iii) includes exception for "exclusively religious activities of any religious order."
APPENDIX #2
ILLINOIS STATUTES PERTAINING TO EXCEPTIONS
FOR RELIGIOUS, CHARITABLE
AND EDUCATIONAL PROPERTIES

Real Estate Used for Religious Purposes

Illinois statutes provide tax exemption for the following religious properties:

"...all property used exclusively for religious purposes, or used exclusively for school and religious purposes, or for orphanages and not leased or otherwise used with a view to profit, including all such property owned by churches or religious institutions or denominations and used in conjunction therewith as parsonages or other housing facilities provided for ministers (including bishops, district superintendents and similar church officials whose ministerial duties are not limited to a single congregation), their spouses, children and domestic workers, performing the duties of their vocation as ministers at such churches or religious institutions or for such religious denominations, and including the convents and monasteries where persons engaged in religious activities reside."

"A parsonage, convent or monastery shall be considered for purposes of this Section to be exclusively used for religious purposes when the church, religious institute, or denomination requires that the above listed persons who perform religious related activities shall, as a condition of their employment or association, reside in such parsonage, convent or monastery."\(^1\)

Real Estate Used for Charitable Purposes

The statute provides exemption specifically for the following charitable properties:

"...all property of institutions of public charity, all property of beneficent and charitable organizations,... all property of old people's homes and facilities for the developmentally disabled, and all property of not-for-profit organizations providing services or facilities related to the goals of educational, social and physical development, and all property of not-for-profit health maintenance organizations certified by the Director of the Illinois Department of Insurance under the provisions of the Health Maintenance Organization Act 1 when such property is actually and exclusively used for such charitable or beneficent purposes, and not leased or otherwise used with a view to profit; and all free public libraries...[such organizations] shall qualify for the exemption stated herein, if, upon making application for such exemption, the applicant provides affirmative evidence that such home or facility or not-for-profit organization is an exempt organization pursuant to paragraph (3) of Section 501(c) of the Internal Revenue Code, or its successor, and the bylaws of the home or facility or not-for-profit organization provide for a waiver or reduction of any entrance fee, assignment of assets or fee for services, based upon the individuals ability to pay. Property of such health maintenance organizations shall be exempt from taxation despite the provision of services to members at prepaid rates approved by the Illinois Department of Insurance provided that membership of such organizations is sufficiently large or of indefinite classes so that the community is benefitted by its operation. The foregoing shall be construed as declaratory of the existing law and not as a new enactment...No hospital or health maintenance organization, however, which has been adjudicated by a court of competent jurisdiction to have denied admission to any person because of race, color, creed, sex or national origin shall be exempt from taxation."\(^2\)
Real Estate Used for Educational Purposes

The Illinois statute, in part, provides exemption for the following educational properties:

"...all lands donated by the United States for school purposes, not sold or leased; all property of schools, including the real estate of schools, which is leased to a municipality to be used for municipal purposes on a not-for-profit basis and including the real estate on which the schools are located and any other real property used by such schools exclusively for school purposes, not leased by such schools or otherwise used with a view to profit, including, but not limited to student residence halls, dormitories and other housing facilities for students and their spouses and children, and staff housing facilities...and not leased or otherwise used with a view to profit." 3

END NOTES
1. 35 ILCS 205/19.2
2. 35 ILCS 205/19.7
3. 35 ILCS 205/19.1
APPENDIX #3
SPACE-SHARING AGREEMENT PLANNING CHECKLIST

A religious institution planning to share its facility with another organization should consider the following questions prior to the preparation of the written space-sharing agreement. If any of these questions cannot be answered experienced counsel should be obtained.

1. _____ What are the philosophical priorities of each participant?
2. _____ What potential social/political conflicts may arise from the differences?
3. _____ How can the potential problems be avoided or reduced by careful communication and agreements to do certain things?
4. _____ Will the sharing of space with this organization adversely affect either party’s public image or reputation?
5. _____ Is the space-sharing agreement intended to enhance the participants’ religious or charitable capacity, or simply to provide income for the property owner?
6. _____ Will the income be used to defray the costs of operating the building, or does the owner expect to profit?
7. _____ How much does it cost to operate the facility annually? per square foot?
8. _____ How will the costs be shared by the participants?
9. _____ Will the sharing of space be long term or short term?
10. _____ What space will be used in common, and what space will be used exclusively by one party or the other?
11. _____ Who will maintain the common areas?
12. _____ What standards will be used in maintaining the property?
13. _____ Is there a common basis for conflict resolution between the organizations or their members?
14. _____ Who will be responsible to pay for damages if there is a legal injury caused by one of the participants?
15. _____ What insurance will be necessary to back-up the responsibility?
16. _____ What is the legal status of each organization, e.g. not-for-profit corporation, religious corporation or unincorporated association?
17. _____ What legal authority does each participant need in order to enter into a legally binding agreement? (Some groups require corporate resolutions to authorize negotiation and execution of a space-sharing agreement.)
18. _____ Will the income received by the owner cause any state or federal tax liabilities?
19. _____ Will the space-sharing agreement affect either party’s federal income tax-exempt status?
19. Will the space-sharing agreement affect either party’s federal income tax-exempt status?

20. Will the space-sharing agreement affect any real estate tax exemptions?

21. How can any adverse tax consequences be minimized?

22. Who should pay the additional taxes incurred?

23. Who will ensure proper payment of any state sales tax on retail sales out of the facility that may be subject to state sales taxes?

24. What steps should be taken to ensure the building is properly zoned and the program properly licensed for the intended use?

25. Is the building structure appropriate for the intended use, or will renovation be required to bring the building into compliance with the local building and fire codes?

26. Have adequate provisions been made for termination of the agreement?

27. Has the annual certificate been filed with the County Assessor’s Office for Illinois Property Tax Exemption?

28. Has the County Assessor’s Office been notified that a space-sharing agreement has been negotiated?
Acknowledgments

Space-sharing Arrangements in Houses of Worship: Federal and Illinois Tax and Legal Implications was written by Michael P. Mosher, a licensed attorney with law offices in Chicago. His practice concentrates in representing tax-exempt organizations in corporate and tax matters. He may be contacted via the Law Offices of Michael P. Mosher & Associates, 19 South LaSalle Street, Suite 1203, Chicago, IL 60603-1201, Phone: (312) 220-0019, Fax: (312) 220-0700. This publication was co-edited by Lois M. Ottaway, a free-lance writer with extensive experience with religious organizations and Charles Kiefer, Technical Services Associate, Inspired Partnerships. Additional contributors include Inspired Partnerships staff members Neal A. Vogel, Director of Technical Services and Linda Young, Assistant Director, and Addison Street Baptist Church, Berry Memorial United Methodist Church, First Presbyterian Church Day Care (Chicago), Hyde Park Union Church and Nursery School, United Church of Rogers Park, Rogers Park Children’s Learning Center, and Willow Creek Community Church. We also gratefully acknowledge the assistance of John K. Notz, Jr., an Inspired Partnerships director and officer, Illinois Bar Foundation Fellow and an Illinois Bar member.

Inspired Partnerships, a nonprofit charitable organization located in Chicago, Illinois, supports and encourages the creative stewardship of houses of worship, so they can continue to serve their communities. Inspired Partnerships recognizes the substantial challenges and responsibilities of religious property administration and maintenance and is committed to improving the management skills of clergy and laity.

Inspired Partnerships’ goal is to help congregations maintain and use their buildings for community service. Your contribution helps Inspired Partnerships to continue its vital mission of assisting congregations with their building needs. Seed money for Inspired Partnerships was provided by the Lilly Endowment, Inc. This publication was also supported by a generous grant from the Illinois Bar Foundation. Additional support for the continuing development of Inspired Partnerships programs and services is welcomed.

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