

# **LEGAL FUNDAMENTALS OF FORMING A CHURCH OR MINISTRY**

**By Dan Beirute, J.D.**



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## **About the Author**

Dan Beirute is a non-profit attorney, serving religious and charitable non-profits across the United States. Dan graduated from Harvard Law School in 1996 and has been practicing non-profit since 1997. As an attorney to non-profits, Dan helps churches and ministries *get legal and stay legal!*

Dan regularly incorporates new churches and ministries and applies to the IRS for their 501(c)(3) federal income tax exemption. For established organizations, he provides a wide variety of legal services including: contracts (writing and reviewing), intellectual property (filing trademarks, copyrights, and advising on ownership and protection of IP), liability management (reducing liability exposure and managing relationships with police, media, and potential plaintiffs), employment law (reviewing handbooks, preparing severance agreements, advising on terminations), and IRS compliance (do's and don'ts for maintenance of 501(c)(3) status).

Dan was born in San Jose', Costa Rica, and is a dual citizen of Costa Rica and the United States. Dan lives in Tulsa, Oklahoma with his wife of 30+ years, four children, and two dogs. He enjoys spending time with family, hiking in the mountains, being routinely disappointed by his chronically under-achieving Dallas Cowboys, and running.

# **Introduction**

Thank you for downloading this eBook on the *Legal Fundamentals of Forming a Church or Ministry*! I hope that this brief guide answers many questions you've had about this often confusing topic.

As the title suggests, my purpose in writing this eBook is to provide a broad overview of the legal steps required to start a religious non-profit organization. I want to lend you the benefit of my 30 years of establishing churches and ministries all across the United States to provide you with a simple to understand explanation of the major issues involved in the legal process. This may help you to form the organization on your own. Or, perhaps this guide will provide you with enough information to know the right questions to ask of others helping you in this process. And if you elect to hire Church & Charity Law to assist you in this process (and I would be honored if you do), this eBook will help you to understand the processes we will be going through as we establish your church or ministry.

If you are starting a ministry and not a church, welcome! Despite the title, this eBook is just as useful in describing the process of forming a ministry as forming a church. Legally, churches and ministries are very similar, although not identical. (See Step 1 of Chapter 1 for a brief explanation of the differences). Throughout this guide, I'll attempt to highlight any areas where the process for establishing a ministry differs from the process for a church.

It should take no more than 30 minutes to an hour to read this booklet. So you're really just a few minutes away from knowing much more about this process! Let's get started...

Dan

## CHAPTER 1:

### What Do “Non-Profit” and “Tax-Exempt” Mean?

If you’re confused by the terms, “non-profit” and “tax-exempt”, you’re not alone. Many people starting churches and ministries use these terms interchangeably without understanding their distinct meaning.

“Non-profit” describes an organization which is organized and operated only for religious, charitable, scientific, or educational purposes. The organization is not operated for the purpose of generating profit (that would be a “for-profit” corporation), such as by conducting business ventures. While non-profits certainly must earn money to operate, and while they are legally permitted to earn “profit”, earning money and making profit is not the reason for their existence. For a church or ministry, the organization exists for the singular purpose of advancing religion.

How does “tax-exempt” differ from “non-profit”? Well, here is where things get a little bit technical: Not all non-profits are tax-exempt. “Tax-exempt” generally describes a non-profit organization which has been recognized by statute or by a governmental agent as exempt from a certain kind of state or federal tax. Usually, reference to a church or ministry being “tax-exempt” refers to the organization’s *federal income tax exemption* under Section 501(c)(3) of the Internal Revenue Code. (The Internal Revenue Code is the set of federal tax laws enforced by the IRS.) For this reason, “tax-exempt status” is also sometimes referred to as “501(c)(3) status”.

There are many different kinds of taxes other than federal income tax. And organizations which are exempt from federal income tax are not necessarily exempt from other types of taxes. Here’s a list of some common kinds of taxes, other than federal income tax, which can apply to churches and ministries:

- ***Federal employment taxes:*** This kind of tax is comprised of social security taxes and Medicare taxes. Religious entities are required to withhold employment taxes from their employees' wages and to pay the withheld amount, along with a portion paid by the church or ministry, to the IRS each pay period. Note, however, ministers are exempt from withholding by law and are treated as "self-employed" for social security purposes. This means that a minister should pay the entire social security tax obligation himself / herself, unless the IRS has approved the minister's timely application for exemption from social security.
  
- ***Taxes assessed by states:***

*State income tax.* This is the state equivalent of the income taxes charged by the federal government. Typically, churches are automatically exempt from state income taxes and ministries are automatically exempt from state income taxes upon receiving recognition of exemption from federal income taxes under Section 501(c)(3). Some states, such as California and Texas require proof of church status or proof of federal income tax exemption before approving state income tax exemption.

*State employment tax.* Like the federal government, many states require employers to withhold some of an employee's wages and to pay the withheld wage to the state's Department of Revenue. Generally, there is no exemption from this requirement, even if federal income tax exemption has been granted.

*Sales tax on purchases.* Most states require payment of sales tax on purchases of consumer goods, such as office supplies or furnishings, as well as food sold at grocery stores and restaurants. Many states offer religious organizations exemption from payment of sales tax on their purchases.

*Sales tax on sales.* Even if a church or ministry obtains exemption from assessment of sales taxes on its own purchases, it may still have to charge sales tax when it sells

items. For example, a church bookstore may have to collect sales tax on its sales and pay the tax to the state's Department of Revenue, and a traveling ministry may be required to do the same when selling books or CDs at a pastors' conference or concert.

*Property tax.* Property taxes are assessed by states on real estate and sometimes other tangible property, such as furnishings and office equipment. Many states offer property tax exemptions for religious organizations, subject to a written application.

*Fuel tax.* All states assess taxes on the sale of gasoline and diesel fuel. The tax is added automatically on sale of the fuel at the gas station. There is no exemption to churches or ministries from this kind of tax.

*Hotel / Entertainment tax.* Many cities and states assess a special tax, much like a sales tax, on stays in hotels. A few states allow non-profits to apply for exemption from hotel taxes.

This isn't a full list. I'm confident that while you read this, a bureaucrat in Washington, D.C. or in your state capitol is thinking of some new kind of tax to implement. In any event, the point is that there are many different kinds of taxes. *When we refer to a "tax-exempt" organization or a "501(c)(3) organization", we are technically referring to an organization which is exempt from federal income taxes—not necessarily other kinds of taxes.*

Now that you understand the difference between non-profit and tax-exempt, let's learn the legal reasons behind forming a non-profit legal entity and, later, how to form a non-profit corporation for a church or ministry and how to obtain its tax-exemption.

## CHAPTER 2:

# Why Establish a Non-Profit Corporation?

For centuries, churches were established without government intervention. They were formed either under procedures set by ancient Catholic or Orthodox tradition or simply by a group of people meeting together under the authority of someone they recognized as a pastor or priest. Today churches and ministries are formed as legal entities recognized under state law. Almost all of these are established as *non-profit corporations*.

Why should you establish a church or ministry as a non-profit corporation? Here's a list of several valuable benefits of forming your church or ministry as a legal entity under state law:

- **Eligibility for 501(c)(3) Status.** Have you ever heard of a for-profit church? Neither have I. The practical reality is, the IRS is not going to approve 501(c)(3) status to a for-profit entity, both because for-profits are formed to earn money instead of advancing charity or religion and because for-profits are owned by someone. Owned entities, such as for-profit corporations and LLCs, are controlled by their owner. By contrast, non-profit corporations are not owned by anyone. While control over a non-profit can be exercised by its board or membership, no one owns or has shares of ownership in a non-profit corporation.
- **Deductibility of Donations.** Donations made directly to individuals are not tax-deductible, but donations to 501(c)(3) non-profit corporations are. For example, a donation made directly to an itinerating minister is not deductible, while a donation to his 501(c)(3) ministry usually is. Similarly, a donation made directly to a Pastor is not deductible, but a donation to a church corporation is.
- **Liability protection.** A very significant benefit of establishing a non-profit corporation is added liability protection for the leaders of the church. If a church or

ministry is not incorporated and someone is injured at a church or ministry event or as a result of the church's activities, that person is able to claim that the leaders of the church are personally liable for the injury. However, if the church or ministry is incorporated, the law tends to point any liability to the corporation instead of its leaders. Without a corporation to stand between church leaders and plaintiffs, potential for personal liability is significantly higher.

- **The ability to transact business.** Another benefit of establishing a non-profit corporation for your church or ministry corporation is that a corporation may can enter into contracts. Without a corporation, a minister may find it necessary to borrow money or enter into contracts for the ministry in his personal capacity. Although banks often require ministers to personally guarantee loans to churches or ministries, a personal obligation will always be required if the church or ministry has not been incorporated.
- **Perpetual existence.** Corporations don't die, get sick, or move away. So, conducting church or ministry operations under the auspices of a corporation allows for the ministry's real estate and finances to be held and used for religious and charitable purposes forever, despite what may happen to the original founders or leaders over time.
- **Income tax exemption.** As mentioned already, non-profit corporations are able to apply to the IRS for 501(c)(3) federal income tax exemption. If a church or ministry corporation is treated as exempt from federal income taxes under Section 501(c)(3), it is not required to pay income taxes on the donations it receives or on the income it earns from engaging religious activities. By contrast, a minister who is paid to provide religious services, such as preaching or counseling, must report and pay income taxes on these payments.

## **CHAPTER 3:**

# **How to Form a Non-Profit Corporation**

Now that you understand why your new church or ministry should be established as a non-profit corporation, let's discuss the steps to establish the corporation legally.

### **Step 1: Determine whether to start a "church" or a "ministry".**

As I point out in the Introduction, the terms "church" and "ministry" have different meanings. In essence, a church is legally defined as a group of people (typically at least 20) who meet together regularly for religious worship. Obviously, churches usually have a congregation of like-minded people, fixed dates and times for worship meetings, and some type of leadership hierarchy. When we refer to a "ministry" in this eBook, we are referring to a religious organization that doesn't meet this definition of a church, such as ministries of itinerating ministers and missionaries.

### **Step 2: Determine your state.**

Non-profit corporations are established under state law. Typically, it's advisable to form the corporation in the state where the corporation will be operating. For churches, that's usually the state that the church will hold its religious services. For ministries, that's usually the state where the ministry's headquarters is located. Overseas missionaries usually form their ministry corporations in the state the missionary considers his or her home base.

There's no particular value in setting up a church or ministry in Delaware or Nevada or some other state if your services or home base aren't located there. The fact is, if you incorporate in a state other than where the corporation will actually function, the corporation will still need to obtain a certificate of qualification in the state where it

operates. Skip the complication, and form the corporation in the state where you intend to operate.

**Step 3: Select a name.**

Usually state law will not allow two corporations in a state to have the exact same name. Before forming a church or ministry corporation, a search should be conducted through the state's Secretary of State or similar agency to determine if the desired name is available. If the name is already taken in the state, the addition of a distinguishing word to the name can often resolve the problem. For example, it's common to add the name of a city to the end of a church name in order to pass state muster.

Particularly if the church or ministry expects to solicit or conduct activities outside of its local area or state, it's a good idea to check the federal trademark database to see if the chosen name has already been trademarked and whether it may be trademarked in the future. Even if the desired name is available at the state level, it is not advisable to use a name that has been trademarked federally by another entity.

**Step 4: Select directors and officers.**

Directors and officers have actual management authority over the affairs of a church or ministry corporation. It's important to understand the meaning of these two terms.

Officers are the individuals who typically have authority over the day-to-day affairs of the corporation. Usually, they are referred to as the President, Vice-President, Secretary, and Treasurer of the corporation, but other names are sometimes used, such as CEO, COO, CFO, etc. It's not uncommon for one person to serve in more than one officer position, such as Secretary and Treasurer of the corporation. This is fine, *except* that the same person should not serve as both President and Secretary, since the Secretary sometimes needs to authenticate the signature of the President on legal documents.

Directors (often referred to as “Trustees”, “Elders”, or “Board members”) usually have general management authority over the corporation. They are usually not involved in day-to-day operations to the same degree as officers of the corporation. Instead they have the right to vote on “big picture” decisions such as: approving the church’s budget, changing the church’s name, electing officers, amending articles of incorporation or bylaws, borrowing money, designating compensation for the pastor, dissolving the corporation, etc.

You’ll note from these definitions that “directors” and “officers” do not mean the same thing. The terms should not be used interchangeably. However, a person may serve in both roles. In other words, an officer may be a member of the Board of Directors, but this is not automatically the case. In order to be both an officer and a director, the person would need to be appointed or elected to serve the corporation in both roles.

**Step 5: File articles of incorporation with the state.**

A non-profit corporation is formed on the records of the state when Articles of Incorporation (sometimes referred to as “Certificate of Incorporation”) are prepared and filed with the applicable state agency, usually the Secretary of State. The requirements for Articles of Incorporation vary from state to state, but in general they must contain:

- **The corporation’s purposes.** See the description of acceptable purposes for a non-profit corporation at the second paragraph of Chapter 1. In particular, the purposes of the corporation should be described in clauses worded according to IRS standards. There is no need to provide a laundry list of desired activities of the organization, since such lists don’t have any legal effect.
- **Name of the corporation.** See Step 3 above.
- **The corporation’s address.** A physical address—not a P.O. Box—is required. This address can be the address of an officer or board member or founder who lives in

the state where the corporation is formed. It does not necessarily have to be the actual physical address of the corporation.

- **Name and address of the resident agent.** The resident agent is the person who is listed with the state as the person who is allowed to receive official correspondence on behalf of the corporation. The resident's agent job is simply to turn over official notices from the state or federal government or any lawsuits served on the corporation, to the board or officers of the corporation.
- **Name and address of the members of the Board.** As discussed at Step 4 above, the "Board" refers to the governing board of the corporation, usually referred to as the "Board of Directors" or "Board of Trustees". Usually, at least three board members should be listed in the Articles of Incorporation. These names and addresses will change over time. Those changes will not require amendment to the original filing, although it is not uncommon for a state to require filing of an "annual report" with the Secretary of State to disclose any changes to the names and addresses of officers and board members.
- **Other IRS-required provisions.** The IRS requires applicants for 501(c)(3) federal income tax exemption to include clauses in their Articles of Incorporation prohibiting private inurement, substantial attempts to influence legislation, and participation by the non-profit in any political campaign. These clauses should be worded in accordance with IRS standards.
- **Provisions for distribute of assets upon dissolution.** This clause should also be written in accordance with IRS specifications. Generally, the clause either names a specific 501(c)(3) organization to receive the assets of the corporation when it dissolves or states that the governing board will determinate an appropriate 501(c)(3) recipient for the assets upon dissolution.

Once the Articles of Incorporation are filed with the state along with the applicable filing fee, and accepted by the state, the corporation is formed.

**Step 6: Obtain an employer identification number.**

Once the corporation is formed (i.e., “incorporated”), a representative of the new corporation should file IRS Form SS-4 to obtain an “employer identification number” for the corporation from the IRS. The employer identification number, commonly referred to as an “EIN” or a “Tax ID number”, is the identification number issued to the corporation by the IRS. It’s much like a social security number for an individual. The EIN does not grant tax exemption or 501(c)(3) status. It’s simply an identifying number used on the corporation’s bank account, application for exempt status, and other federal tax filings.

**Step 7: Prepare Bylaws.**

Bylaws are the central governing document of a church or ministry. Bylaws address the rights of the various parties involved in operating the corporation, including the Board, officers, and members. A detailed discussion of considerations for bylaws is outside the scope of this eBook, but here is a listing of essential issues for bylaws to address:

- The corporation’s Statement of faith
- Requirements for becoming a member
- Voting rights of members, if any
- Procedures for electing and removing members of the Board
- Procedures for electing and removing officers
- Procedures for electing and removing the pastor
- Provisions for succession to the office of pastor in the event of his / her death
- Authority of the corporation to license and ordain ministers
- Authority of officers or board members to execute contracts for the corporation
- Indemnification of Directors and Officers

- Distribution of assets on dissolution
- Procedures for amending the bylaws

**Step 8: Conduct an initial board meeting.**

Now it's time to start operating! As its first official act, the church or ministry corporation should conduct an initial meeting of its Board. At this meeting the Board identified in the corporation's Articles of Incorporation should meet and elect officers (See Step 4 above), agree to open a bank account, adopt bylaws, decide whether to apply for 501(c)(3) status, and make any other initial determinations necessary to begin its religious activities.

**Step 9: Open a bank account.**

Once the corporation is formed, the EIN is obtained from the IRS, and the first meeting of the Board has taken place, it's time to open a bank account for the new corporation. To accomplish this task, the President and Secretary of the corporation should present the bank with a filed copy of the Articles of Incorporation, the letter from the IRS granting the EIN, and a copy of the initial board minutes which list the officers of the corporation and authorizes opening of the account. This account must be a non-profit corporate account opened under the new corporation's EIN. It should not be opened as a personal account and should not be opened under a social security number.

**Step 10: File Charitable Solicitations Filings**

Another kind of filing which some states require is the charitable solicitation filing. Charitable solicitations laws require non-profit organizations to file a special registration application with the state after incorporating but before soliciting or receiving donations from residents of the state. *This process is entirely separate from and in addition to the incorporation process.* The registration and related renewals typically ask for a listing of the organization's officers and directors, description of the organization's operations, and

details concerning its fund raising efforts during the year. *Note, churches are always exempt from charitable solicitations requirements, but many states do not exempt ministries.* Therefore, anyone starting a ministry corporation should verify whether their state requires registration before they begin soliciting donations.

## **CHAPTER 4:**

# **How to Obtain Federal Income Tax-Exemption.**

So the corporation is formed, the board and officers are in place, and a bank account has been opened. Now let's discuss how to get official recognition that the corporation is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code and able to receive tax deductible donations.

### **Churches don't have to apply for 501(c)(3)...**

Most non-profit corporations must file an application with the IRS requesting federal income tax exemption in order to be treated as exempt from federal income tax. Churches are different. Federal law states that churches are exempt from federal income taxes even without applying to the IRS for 501(c)(3) status.

As long as a church meets the IRS definition of a church and follows the normal rules for exemption, the organization is considered exempt from federal income tax and able to receive deductible donations, even if the church never applies for recognition of exemption. As discussed already at Chapter 3, Step 1, a church is generally defined as a group of people (typically at least 20) who meet together regularly for religious worship. In close cases, the IRS may consider a variety of facts and circumstances to determine whether a religious organization qualifies as a church, including whether it has: (a) a recognized creed and form of worship; (b) an ecclesiastical government; (c) a formal code of doctrine and discipline; (d) ordained ministers; (e) an established place of worship; and (f) regular religious services.

**But they should!**

Should a church apply for 501(c)(3) federal income tax exemption even though it's not required to do so? Yes! Even though churches are technically not required to apply for exemption with the IRS, it is still a good idea to do so. Frequently, a church will be asked by its state or local government or by donors to provide evidence that the church is exempt from federal income tax. Churches which have filed for exemption and received IRS approval of their application will receive the coveted IRS "letter of determination" which states that the IRS exempts the church from federal income taxes under Section 501(c)(3) and that the church is authorized to receive tax deductible donations. They will also be included in the IRS's online listing of exempt organizations.

Churches which have never filed for exemption are, of course, not able to provide a letter of determination and are not listed as exempt in the IRS online database. Although these churches are still exempt from federal income tax they have no way to prove it. Without documentation of 501(c)(3) from the IRS, it may be difficult and awkward for the church's leaders to explain to potential donors that donations will be tax deductible or to explain to state or city officials that the church should be granted a property or sales tax exemption based upon the church's federal exemption.

**Ministries must apply!**

Unlike churches, ministries are required to apply to the IRS for federal income tax exemption. This application must be filed by the ministry within 27 months after the date that the ministry incorporates. If the ministry fails to file the application within the required timeframe, the ministry will be reclassified as a taxable entity, subject to federal income taxes on its income, and will not be permitted to receive tax deductible donations. In order to avoid this negative treatment, a ministry must file the IRS Form 1023 or the 1023-EZ within the 27-month period.

### **Form 1023**

Churches and ministries wishing to apply for federal income tax exemption may file the IRS Form 1023 with the Internal Revenue Service. The IRS charges a non-refundable \$600.00 fee to process and review the form. The form is lengthy and requires disclosure of the names and addresses of the organization's officers and trustees, a description of the organization's past and anticipated future activities, sources of financial support, intended fundraising programs, and statements of revenue and expense for the year of application and three previous years of operation, if any. Organizations in existence for less than three years must also provide budgets for the two years following the year of application. Along with the Form 1023, applicants must also provide the IRS with copies of their articles of incorporation and bylaws.

The IRS should respond to the application within six to eight months following the submission of the application. It is not uncommon for the IRS to forward the organization or its attorney a list of additional questions. Once all questions are answered to the IRS's satisfaction, the IRS will issue its approval of exemption in the form of a determination letter.

### **Form 1023-EZ**

Some ministries, but not churches, may use IRS Form 1023-EZ to apply to the IRS for 501(c)(3) status. This is a simplified application form, with a lower filing fee (\$275.00) and processing times generally measured in days or weeks rather than months. A ministry may file under Form 1023-EZ if it projects annual gross receipts of \$50,000.00 or less in each of its next three years and if it has total assets valued at \$250,000.00 or less. The projections of future income and asset valuations are made in good faith. There is no penalty if the ministry ends up bringing in more than \$50,000.00 in a subsequent year or having more than \$250,000.00 in assets.

## **CHAPTER 5:**

### **Conclusion.**

I hope that you've found this eBook helpful and that you now have a stronger grasp of the "fundamentals" of starting a church or ministry.

As I've described above, there are many steps in this process. Some of these steps can be somewhat complicated, with profound practical and legal implications. Because of the brief nature of this eBook resource, this discussion has focused on the "big picture" and has not attempted to address the complexities which you may encounter if you choose to form your church or ministry yourself.

**But I'm here to help. If you choose to proceed by yourself, I'm available to consult with you if you hit a snag. And of course, it would be my pleasure to take care of the entire process for you. With 30 years of experience forming churches and ministries and helping them with their varied legal needs, my desire is to make the legal process as fast and convenient for you as possible.**

**If you are interested in retaining me for this work or discussing my other legal services to churches and ministries, please contact me any time at 918-392-1956 or [dan@uschurchlaw.com](mailto:dan@uschurchlaw.com). I look forward to hearing from you!**

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