

# Chapter 22

## Exempt Entities

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# Requirements For Exempt Status

(slide 1 of 3)

- Serve the “common good”
  - Group served may be broadly defined (general public) or narrowly defined (credit union members)
- Not a for-profit entity

# Requirements For Exempt Status

(slide 2 of 3)

- Net earnings of the entity do not benefit members of the organization
  - Prohibitions differ for various types of exempt entities
    - Code may preclude “benefit of any private shareholder or individual”, for example, or
    - May say earnings must be devoted to specific cause (e.g., religious, charitable, etc.)

# Requirements For Exempt Status

(slide 3 of 3)

- The entity is generally prohibited from attempting to influence legislation or participating in political campaigns
  - This applies both to positive (for a candidate) and negative (against a candidate) influence

# Examples Of Exempt Organizations<sub>(slide 1 of 4)</sub>

- Federal and related agencies
- Religious, charitable, educational, scientific, literary, etc. organizations
- Civic leagues and employee unions
- Labor, agricultural, and horticultural organizations

# Examples Of Exempt Organizations<sub>(slide 2 of 4)</sub>

- Business leagues, chambers of commerce, real estate boards, etc...
- Social and fraternal clubs and societies
- Local teachers' retirement fund associations
- Cemetery companies

# Examples Of Exempt Organizations<sub>(slide 3 of 4)</sub>

- Credit unions
- Mutual insurance companies
- Corporations organized by farmers' cooperatives for financing crop operations
- Armed forces members' posts or organizations
- Group legal service plans

# Examples Of Exempt Organizations<sub>(slide 4 of 4)</sub>

- Religious and apostolic organizations
- Cooperative hospital service organizations
- Cooperative service organizations of educational institutions
- Qualified state tuition programs



# Consequences Of Exempt Status

(slide 1 of 2)

- General
  - Exempt from Federal income tax
  - Exempt from most state and local income, franchise, sales, and property taxes
  - Qualify for reductions in postage rates
  - Gifts to the organization often can be deducted by donor

# Consequences Of Exempt Status

(slide 2 of 2)

- Exceptions
  - May be subject to Federal income tax associated with the following:
    - Engaging in a prohibited transaction
    - Being a feeder organization
    - Being a private foundation
    - Generating unrelated business taxable income

# Engaging In Prohibited Transactions

- May result in:
  - Part or all of organization's income being subject to federal income tax
  - Forfeiture of exempt status
  - Imposition of intermediate sanctions on certain insiders

# Allowable Lobbying Costs

(slide 1 of 6)

- Generally, organizations will lose their exempt status if they attempt to influence legislation or participate in political campaigns
- Limited lobbying can be conducted by many of these §501(c)(3) organizations, if so elected
  - Churches and private foundations cannot conduct lobbying activities under this rule

# Allowable Lobbying Costs

(slide 2 of 6)

- A ceiling applies to the amount of allowable lobbying expenditures under the election
  - Exceeding the ceiling can result in loss of exempt status
  - Also, a tax may be imposed on a portion of lobbying expenditures

# Allowable Lobbying Costs

(slide 3 of 6)

- Lobbying expenditures defined
  - Attempting to affect opinions of the general public or any segment thereof
  - Communicating with any legislator or staff member or with any government official or staff member who may participate in the formulation of legislation

# Allowable Lobbying Costs

(slide 4 of 6)

- The statutory ceiling on lobbying expenditures is computed as follows:

$150\% \times \text{Lobbying Nontaxable Amount}$

- Tax:  $25\% \times \text{excess expenditures over Lobbying Nontaxable Amount}$

# Allowable Lobbying Costs

(slide 5 of 6)

- Grass Roots Expenditure
  - Expenditures to influence legislation through attempting to affect the opinions of the general public or any segment thereof



# Allowable Lobbying Costs

(slide 6 of 6)

- Ceiling:  $150\% \times$  Grass Roots Nontaxable Amount
  - Grass Roots Nontaxable Amount is  $25\%$  of Lobbying Nontaxable Amount
  - Tax:  $25\% \times$  excess expenditures over Grass Roots Nontaxable Amount

# Calculation Of Lobbying Nontaxable Amount (slide 1 of 2)

<u>Exempt Purpose Expenditures</u>	<u>Lobbying Nontaxable Amount Is</u>
Not over \$500,000	20% of exempt purpose expenditures*
Over \$500,000 but not over \$1 million	\$100,000 + 15% of the excess of exempt purpose expenditures over \$ 500,000
Over \$1 million but not over \$1.5 million	\$175,000 + 10% of the excess of exempt purpose expenditures over \$1 million
Over \$1.5 million	\$225,000 + 5% of the excess of exempt purpose expenditures over \$1.5 million

# Calculation Of Lobbying Nontaxable Amount (slide 2 of 2)

- \*Exempt purpose expenditures generally are the amounts paid or incurred for the taxable year to accomplish the following purposes: religious, charitable, scientific, literary, educational, fostering national or international amateur sports competition, or the prevention of cruelty to children or animals.

# Exempt Organizations And Influencing Legislation

<u>Factor</u>	<u>Tax Result</u>
1. Entity subject to rule	§501(c)(3) organization
2. Effect of influencing legislation	Subject to tax on lobbying expenditures under §4912 OR may forfeit exempt status OR not eligible for exempt status (§501(c)(4)).
3. Effect of electing to make ltd. lobbying exp.	Subject to tax under §4911

# Feeder Organizations (slide 1 of 2)

- Carries on a trade or business for the benefit of an exempt organization and remits its profits to the exempt organization
  - Not exempt from federal tax
  - Prevents exemption from tax simply because all profits are payable to an exempt organization

# Feeder Organizations (slide 2 of 2)

- Some income and activities not subject to the feeder organization rules include:
  - Rent income if excluded for purposes of unrelated business income tax
  - Trade or business where substantially all work is performed by volunteers
  - Trade or business of selling goods where substantially all the goods were received as contributions or gifts

# Consequences Of Private Foundation Status (slide 1 of 3)

- In general, a private foundation is classed as such because it serves a more narrowly defined common good
  - It lacks an approved exempt purpose, or
  - Does not receive broad public financial support

# Consequences Of Private Foundation Status (slide 2 of 3)

Private foundations compared to other exempt entities:

	<u>Private Foundation</u>	<u>Not a Private Foundation</u>
Eligible for exempt status?	Yes	Yes
Most beneficial charitable contribution deduction treatment available to donors?	Depends. No, if the private foundation is classified as a private nonoperating foundation.	Yes



# Consequences Of Private Foundation Status (slide 3 of 3)

Private foundations compared to other exempt entities:

	<u>Private Foundation</u>	<u>Not a Private Foundation</u>
Subject to excise taxes levied on prohibited transactions?	Yes	No
Subject to tax on unrelated business income?	Yes	Yes

# Taxes Imposed On Private Foundations (slide 1 of 2)

<u>Type of Tax</u>	<u>Section</u>	<u>Purpose</u>	<u>Initial Tax</u>	<u>Additional Tax</u>
On investment income	4940	Audit fee to defray IRS expenses.	2%*	
On self-dealing	4941	Engaging in transactions with disqualified persons.	5%**	200%**
On failure to distribute income	4942	Failing to distribute adequate amount of income for exempt purposes.	15%	100%

\*May be possible to reduce the tax rate to 1%. Also, an exempt operating foundation is not subject to the tax.

\*\*Imposed on the disqualified person, not the foundation.

# Taxes Imposed On Private Foundations (slide 2 of 2)

<u>Type of Tax</u>	<u>Section</u>	<u>Purpose</u>	<u>Initial Tax</u>	<u>Additional Tax</u>
On excess business holdings	4943	Investments that enable the private foundation to control unrelated businesses	5%	200%
On jeopardizing investments	4944	Speculative investments that put the private foundation's assets at risk	5%	25%
On taxable expenditures	4945	Expenditures that should not be made by private foundations	10%	100%

# Taxes On Foundation Managers

<u>Type of Tax</u>	<u>Section</u>	<u>Purpose</u>	<u>Initial Tax</u>	<u>Additional Tax</u>
On self-dealing	4941	Engaging in transactions with disqualified persons	2.5%*	50%*
On jeopardizing investments	4944	Speculative investments that put the private foundation's assets at risk	5%**	5%*
On taxable expenditures	4945	Expenditures that should not be made by private foundations	2.5%**	50%*

\*Subject to a statutory ceiling of \$10,000

\*\*Subject to a statutory ceiling of \$5,000

# Unrelated Business Income Tax

(slide 1 of 6)

- Purpose
  - To tax the entity on unrelated business income as if it were subject to the corporate income tax
- Applicable tax rates
  - Corporate tax rates
- Exempt organizations to which applicable
  - All organizations exempt under §501(c) except Federal agencies

# Unrelated Business Income Tax

(slide 2 of 6)

- Entities subject to the tax
  - The organization conducts a trade or business
  - The trade or business is not substantially related to the exempt purpose of the organization, and
  - The trade or business is regularly carried on by the organization

# Unrelated Business Income Tax

(slide 3 of 6)

- Trade or business is broadly defined
  - Includes any activity for the production of income through the sale of merchandise or the performance of services
- To be related to the exempt purpose, the activity must be causally related and contribute importantly to the exempt purpose

# Unrelated Business Income Tax

(slide 4 of 6)

- Exceptions to the tax
  - All work is performed by volunteers
  - Substantially all merchandise being sold was received as gifts



# Unrelated Business Income Tax

(slide 5 of 6)

- Exceptions to the tax (cont'd)
  - For §501(c)(3) organizations, the business is conducted primarily for the benefit of the organization's members, students, patients, officers, or employees
  - For most employee unions, the trade or business consists of selling to members work-related clothing and equipment and items normally sold through vending machines, snack bars, or food dispensing facilities

# Unrelated Business Income Tax

(slide 6 of 6)

- \$1,000 provision
  - If the gross income from an unrelated trade or business is less than \$1,000, it is not necessary to file a return associated with the unrelated business income tax

# Corporate Sponsorship Payments

- Not treated as unrelated trade or business if:
  - There is no arrangement or expectation of substantial benefits for the payment other than use of its name, logo or product lines in connection with the activities of the exempt organization (not advertising the payor's products or services)
  - Payment is not contingent on attendance, ratings, etc

# Bingo Games

- A qualified bingo game is not an unrelated trade or business if:
  - Game is legal under state and local law
  - Commercial bingo games are not allowed in the jurisdiction

# Distribution Of Low-Cost Articles

- If organization distributes low-cost items as part of its solicitation for charitable contributions, not treated as unrelated business
- Low-cost articles cost \$8.00 or less (indexed annually)
  - e.g., Pens, stamps, stickers, address labels

# Unrelated Business Income

- Tax is only assessed if:
  - Exempt organization regularly conducts the activity
    - Considers frequency, continuity, and manner in which the activity is pursued
  - The activity produces unrelated business income
    - Income from the unrelated trade or business reduced by deductions directly connected to the activity

# Unrelated Business Taxable Income (slide 1 of 9)

Gross unrelated business income

Less deductions

= Net unrelated business income

± Modifications

Unrelated business taxable income(UBTI)

# Unrelated Business Taxable Income (slide 2 of 9)

- Positive Adjustments
  - Charitable contribution deduction in excess of 10 % of UBTI
  - Unrelated debt-financed income net of unrelated debt-financed deductions
  - Certain interest, annuity, royalty and rent income received from an organization it controls (80% test)



# Unrelated Business Taxable Income (slide 3 of 9)

- Negative Adjustments
  - Income from dividends, interest, and annuities net of directly related deductions
  - Royalty income net of directly related deductions

# Unrelated Business Taxable Income (slide 4 of 9)

- Negative Adjustments (cont'd)
  - Rent income from real property and from certain personal property (if leased with real property) net of directly related deductions
  - Personal property rent must be incidental (10% or less of income under the lease) to be used in computing the negative adjustment
  - None of rent income is a negative adjustment if:
    - > 50% of rent under the lease is from personal property
    - Rent income is calculated using the tenant's profits

# Unrelated Business Taxable Income (slide 5 of 9)

- Negative Adjustments (cont'd)
  - Gains and losses from sale, exchange, or other disposition of property except for inventory
  - Certain research income net of directly related expenses
  - To the extent that charitable contributions exceed those deducted in calculating net UBI, the excess is a negative adjustment
  - A deduction of \$1,000 is allowed

# Unrelated Business Taxable Income (slide 6 of 9)

- Unrelated debt-financed income is a positive adjustment
  - Debt-financed income is gross income from debt-financed property

# Unrelated Business Taxable Income (slide 7 of 9)

- Unrelated debt-financed income is a positive adjustment (cont'd)
  - Debt-financed property is all property held to produce income on which there is acquisition indebtedness except:
    - Property where substantially all (at least 85%) of use is for exempt purpose
    - Property whose gross income is from research for various organizations
    - Property used in an activity that is not an unrelated trade or business

# Unrelated Business Taxable Income (slide 8 of 9)

- Unrelated debt-financed income is a positive adjustment (cont'd)
  - Once debt-financed income and deductions are determined, the portion constituting unrelated debt-financed income and deductions must be determined
  - Unrelated debt-financed income increases UBTI
  - Unrelated debt-financed deductions decrease UBTI

# Unrelated Business Taxable Income (slide 9 of 9)

- Unrelated debt-financed income is a positive adjustment (cont'd)
  - Calculation of unrelated debt-financed income is made for each property using the following formula:

$$\begin{array}{l} \text{Gross income} \\ \text{from property} \end{array} \times \frac{\text{Ave acq. indebtedness}}{\text{Ave adj. basis of property}}$$

# Annual Filing Requirements

(slide 1 of 2)

- Most exempt organizations are required to file an annual information return with the IRS
- Return filed
  - Form 990 (Return of Organization Exempt from Income Tax)
  - Due date is 15th day of fifth month after year-end



# Annual Filing Requirements

(slide 2 of 2)

- Additional returns:
  - Form 990-T (Exempt Organization Business Income Tax Return) if at least \$1,000 gross income from unrelated trade or business
  - Form 4720 (Return of Certain Excise Taxes on Charities and Other Persons) if an exempt organization is subject to any excise taxes imposed on private foundations

**If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:**

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