

CHAPTER 22
EXEMPT ENTITIES
SOLUTIONS TO PROBLEM MATERIALS

<u>Question/ Problem</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
1	Exempt organizations: church	Unchanged	1
2	Exempt organizations: purpose	Unchanged	2
3	Exempt organizations: types	Unchanged	3
4	Exempt organizations: types	Unchanged	4
5	Exempt organizations: subject to tax	Unchanged	5
6	Exempt organizations: other benefits	Unchanged	6
7	Exempt organizations: prohibited transactions	Unchanged	7
8	Issue ID	Unchanged	8
9	Intermediate sanctions	Modified	9
10	Feeder organization	New	
11	Feeder organization	Unchanged	11
12	Private foundation: definition and disadvantages	Unchanged	12
13	Private foundation: definition	Unchanged	13
14	Private foundation: external and internal support tests	Unchanged	14
15	Private foundation: taxes imposed	New	
16	Private foundation: tax on investment income	New	
17	Issue ID	Unchanged	17
18	Unrelated business income tax	New	
19	Issue ID	Unchanged	19
20	Unrelated trade or business	Unchanged	20
21	Unrelated trade or business versus feeder organization	New	
22	Unrelated trade or business	Unchanged	22
23	Unrelated trade or business: regularly carried on test	New	
24	Issue ID	Unchanged	24
25	Debt-financed property: definitions	Unchanged	25

<u>Question/ Problem</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
26	Obtaining exempt status	Unchanged	26
27	Annual filing requirements and obtaining exempt status	Unchanged	27
28	Disclosure requirements	Unchanged	28
29	Exempt organization: lobbying expenditures	New	
30	Feeder organization	Unchanged	30
31	Classification as a private foundation	Unchanged	31
32	Private foundation: tax on net investment income	Unchanged	32
33	Private foundation: tax on failure to distribute income	Unchanged	33
34	Private foundation: tax on jeopardizing investments	Unchanged	34
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36	Unrelated business income	Unchanged	36
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39	Unrelated business income tax: sponsorship payments	Unchanged	39
40	Unrelated business taxable income: effect of charitable contributions	Unchanged	40
41	Unrelated business taxable income: rent income	New	
42	Unrelated business taxable income: sale of assets	Unchanged	42
43	Debt-financed property and acquisition indebtedness	Unchanged	43
44	Reporting requirements	Modified	44
45	Charitable contribution deduction to donor	Unchanged	45

CHECK FIGURES

29.a.	Could forfeit exempt status; penalty of \$60,000.	35.b.	\$2,500.
29.b.	Tax on excess lobbying expenditures of \$50,000.	36.a.	\$750,000.
30.a.	Yes; \$136,000.	36.b.	\$750,000.
30.b.	No.	37.a.	\$7,000,000.
30.c.	No change in answer.	38.a.	\$109,610.
31.a.	Yes.	38.b.	\$68,610.
31.b.	No.	38.c.	\$0.
31.c.	Not a private foundation.	38.d.	\$0.
32.a.	\$96,000.	38.e.	\$0.
32.b.	\$1,920.	39.a.	No effect on UBIT.
32.c.	Defray audit costs.	39.b.	\$22,250 tax liability.
33.a.	2003 \$24,000; 2004 \$0.	40.a.	\$360,000.
33.b.	\$0.	40.b.	\$361,000.
34.a.	Yes.	41.	\$130,000.
34.b.	Rectify \$25,000; Otis \$5,000.	42.	\$0.
34.c.	Rectify \$125,000; Otis \$10,000.	43.	\$630,000; \$420,000.
34.d.	Yes.	44.a.	Yes; Form 990.
35.a.	\$10,000.	44.b.	March 15, 2004.
		45.a.	\$90,000.
		45.b.	\$55,000.

DISCUSSION QUESTIONS

1. A C Corporation is subject to double taxation. However, a church is classified as an exempt organization. Therefore, a church generally is not subject to Federal income taxation. A church may be subject to the unrelated business income tax. pp. 22-2, 22-6, and 22-15
2. Section 501 permits certain organizations to be either partially or completely exempt from Federal income taxation. The social considerations objective provides the justification for this treatment by Congress. Congress recognizes the benefit of having certain activities which promote the general welfare being performed by private organizations, rather than having the function directly performed by the Federal government. pp. 22-2 and 22-3
3. All of these organizations qualify for exempt status, except for Disneyland (d), Green Bay Packers (i), and Cleveland Indians (j). Exhibit 22-1
4.
 - a. Kingsmill Country Club: § 501(c)(7).
 - b. Shady Lawn Cemetery: § 501(c)(13).
 - c. Amber Credit Union: § 501(c)(14).
 - d. Veterans of Foreign Wars: § 501(c)(19).
 - e. Boy Scouts of America: § 501(c)(3).
 - f. United Fund: § 501(c)(3).
 - g. Federal Deposit Insurance Corporation: § 501(c)(1).
 - h. Bruton Parish Episcopal Church: § 501(c)(3).
 - i. PTA: § 501(c)(5).
 - j. National Press Club: § 501(c)(7).

Exhibit 22-1

5. An exempt organization generally is exempt from Federal income tax. However, there are four exceptions to this exempt treatment.
 - The exempt organization engages in a prohibited transaction.
 - The exempt organization is a feeder organization.
 - The exempt organization is classified as a private foundation.
 - The exempt organization has unrelated business taxable income.

Evidently, one of the exempt organizations for which Adrenna is the treasurer is not subject to tax under the general provision, whereas the other exempt organization is subject to at least one of the four exceptions.

Concept Summary 22-2

6. Other benefits for which an exempt organization may be eligible, in addition to exemption from Federal income tax, include the following.
 - The organization may be exempt from state income tax, state franchise tax, sales tax, and property tax.
 - The organization may receive discounts on postal rates.
 - Donors of property to the exempt organization may qualify for charitable contribution deductions on their Federal and state income tax returns.

p. 22-6

7. Engaging in § 503 prohibited transactions by an exempt organization can result in three negative tax consequences. First, part or all of the organization's income may be subject to Federal income tax. Second, the organization may forfeit its exempt status. Finally, intermediate sanctions may be imposed on certain exempt organization insiders. p. 22-6
8. The issue facing Helping People, Inc., is the effect of hiring the law firm in Washington to lobby for it. Such lobbying could result in the loss of tax-exempt status and/or the imposition of penalty taxes. However, if Helping People is eligible to elect to make lobbying expenditures on a limited amount under § 501(h) (and this appears to be the case), then it could do so without any negative consequences as long as it stays within the statutory parameters. pp. 22-6 to 22-8 and Footnote 14
9. The statement is false. There is no direct relationship between intermediate sanctions and unrelated business gross income or unrelated business net income. Intermediate sanctions on public charities take the form of excise taxes imposed on disqualified persons (any individuals who are in a position to exercise substantial influence over the affairs of the organization) who engage in *excess benefit transactions* and on exempt organization managers who participate in such transactions knowing that it is improper. Such excess benefit transactions include transactions in which a disqualified person engages in a non-fair market value transaction with the exempt organization or receives unreasonable compensation. pp. 22-8 and 22-9
10. No. Dolphin Corporation is a feeder organization. A feeder organization is subject to Federal income taxation as if it were a regular C corporation. p. 22-9
11. The following types of activities are not subject to the tax on feeder organizations.
 - An activity that generates rent income that would be excluded from the definition of the term *rent* for purposes of the unrelated business income tax.
 - Activities that normally would constitute a trade or business, but for which substantially all of the work is performed by volunteers.

- Activities that normally would constitute the trade or business of selling merchandise, but for which substantially all of the merchandise has been received as contributions or gifts.

p. 22-9

12. A private foundation is an organization which may satisfy the requirements for exempt status. As a result of being a private foundation, excise taxes may be levied on the private foundation, even though it qualifies as an exempt organization. In addition, donors who make contributions to a private foundation may not be treated as favorably with respect to the charitable contribution deduction as they would if the exempt organization was not a private foundation. The general purpose of the excise taxes is to motivate the private foundation to refrain from certain actions. The reduced charitable contribution deduction results because the organization envisions a more narrow definition of the common good. pp. 22-10 and 22-11
13. Of the listed exempt organizations, churches (a. and b.) and hospitals (c.) are § 501(c)(3) organizations that are statutorily excluded from classification as a private foundation. Organizations that otherwise would be classified as private foundations are excluded from the classification because they receive broad public support (e. and f.). Thus, it appears that only the NFL (d.) and the Burr's Foundation (g.) would be classified as private foundations. pp. 22-10 to 22-13
14. Broadly supported § 501(c)(3) organizations are outside the definition of a private foundation. To satisfy the broadly supported provision, the § 501(c)(3) organization must meet both an external support test and an internal support test.

The external support test requires that more than one-third of the organization's support each taxable year must normally come from the general public (excluding disqualified persons), governmental units, or organizations described in category 1 of the listing of § 501(c)(3) organizations which are not private foundations. Such support must be in the following forms.

- Gifts, grants, contributions, and membership fees.
- Gross receipts from admissions, sales of merchandise, performance of services, or the furnishing of facilities in an activity that is not an unrelated trade or business for purposes of the unrelated business income tax. However, such gross receipts from any person or governmental agency in excess of the greater of \$5,000 or 1% of the organization's support for the taxable year are not counted.

The internal support test limits the amount of support normally received from the following sources to one-third of the organization's support for the taxable year.

- Gross investment income (gross income from interest, dividends, rents, and royalties).
- Unrelated business taxable income minus the related tax.

pp. 22-11 to 22-13

15. Several types of taxes may be imposed on the private foundation. A so-called “audit fee” is levied on the net investment income of a private foundation unless the private foundation is an exempt operating foundation. Second, if the private foundation engages in the following prohibited transactions, it will be subject to an excise tax.
- Tax on self-dealing.
 - Tax on failure to distribute income.
 - Tax on excess business holdings.
 - Tax on investments which jeopardize charitable purposes.
 - Tax on taxable expenditures.

The audit fee is to defray the costs incurred by the Federal government for audits of private foundations. The excise taxes on prohibited transactions are designed to motivate the private foundation to refrain from certain actions.

pp. 22-13, 22-14, and Concept Summary 22-3

16. The purpose of the tax on the net investment income of a private foundation is to help defray IRS audit expenses. The rate is 2%. If certain distribution requirements are satisfied, it is possible to reduce the rate to 1%. In addition, this tax is not imposed on private foundations which are classified as exempt operating foundations. p. 22-13 and Concept Summary 22-3
17. Accepting the additional support from the disqualified person could result in Welcome, Inc., being classified as a private foundation and being subject to the related tax detriments (e.g., excise taxes). Welcome needs to determine if private foundation status would result and, if so, if there would be any negative tax consequences for it. pp. 22-10 to 22-13 and Concept Summary 22-3
18. An exempt organization generally is exempt from Federal income tax. However, such organizations are subject to taxation on unrelated business income using the corporate tax rates. Thus, the tax liability is \$136,000 (\$400,000 unrelated business taxable income X 34%). pp. 22-14 to 22-17 and Concept Summary 22-4
19. The task force needs to be aware of the unrelated business income tax. Although the church is tax-exempt and the sale of cards and books in the church tower is tax-exempt, the gift shop in the parish house may be subject to the UBIT. One way to keep the activity exempt is to have the gift shop staffed by volunteers rather than paid employees. pp. 22-14 to 22-17
20. Since the pharmacy serves only the hospital patients (i.e., it contributes to the conduct of the hospital’s exempt purpose), the pharmacy is not an unrelated trade or business. pp. 22-15 and 22-16
21. Since the computer chain is an unrelated business, it is subject to Federal income tax. If the hospital operates it as a subsidiary which remits its profits to the hospital, it will be a “feeder organization,” subject to the corporate income tax. Likewise, if the computer chain is operated as a division of the hospital, it is subject to the unrelated business

income tax, and its unrelated business taxable income will be taxed at the corporate income tax rates.

Operating the computer chain as a subsidiary of the hospital would not jeopardize the tax-exempt status of the hospital, whereas operating it as a division could do so.

pp. 22-9 and 22-14 to 22-17

22. The unrelated business income tax (UBIT) could apply to the organizations in a., b., c., d., and e. All of these are organizations that are exempt from Federal income tax under § 501(c). The key is whether the organization operates an unrelated trade or business.

The UBIT does not apply to Federal agencies. Thus, the Federal Land Bank in f. is not subject to the UBIT.

p. 22-15

23. A trade or a business classified as an unrelated trade or business is subject to Federal income taxation (i.e., the unrelated business income tax). The purpose of the tax is to neutralize the advantageous tax treatment of the exempt organization that competes with non-exempt organizations. To be considered as competing, the trade or business must be regularly carried on. Factors to be considered in making this determination include the frequency of the activity, the continuity of the activity, and the manner in which the activity is pursued. pp. 22-16, 22-19, and 22-20

24. The bingo games should not affect the organization's exempt status. However, the net income from the bingo games could be taxable as unrelated business income. To provide advice on this issue, you need to know whether the bingo game is legal under both state and local law, and whether commercial bingo games (conducted for a profit motive) ordinarily are not permitted in the jurisdiction. If the answer to both of these questions is yes, then the bingo game is a qualified bingo game and therefore is not an unrelated trade or business. However, if the answer to either of these questions is no, then the related net income is taxable. p. 22-17

25. a. Debt-financed income is the gross income generated from debt-financed property.
- b. Debt-financed property is all property of the exempt organization that is held to produce income and on which there is acquisition indebtedness except:
- property for which substantially all the use is for the achievement of the exempt purpose of the exempt organization.
 - property whose gross income is otherwise treated as unrelated business income.
 - property whose gross income is from certain research and is not otherwise treated as unrelated business income.
 - property used in an activity that is not an unrelated trade or business.
- c. Acquisition indebtedness generally is debt sustained by the exempt organization associated with the acquisition of property. More precisely, it consists of the unpaid amounts of the following for debt-financed property.
- Debt incurred in acquiring or improving the property.

- Debt incurred prior to the acquisition or improvement of the property, but which would not have been incurred absent such acquisition or improvement.
 - Debt incurred subsequent to the acquisition or improvement of the property, but which would not have been incurred absent such acquisition or improvement.
- d. Average acquisition indebtedness for a debt-financed property is the average amount of the outstanding debt for the taxable year (ignoring interest) during the portion of the year the property is held by the exempt organization. The amount is calculated by summing the outstanding debt on the first day of each calendar month the property is held by the exempt organization and dividing this summation by the number of months the property is held by the organization.
- e. Average adjusted basis is the summation of the adjusted basis of debt-financed property on the first day and last day during the taxable year the property is held by the exempt organization divided by two.

pp. 22-21 to 22-24

26. Since garden clubs qualify for exempt status under § 501(c)(4) rather than under §§ 501(c)(3), (c)(9), or (c)(20), the garden club is not required by statute to obtain IRS approval for exempt status. However, it is a good idea for Tom's garden club to do so anyway. Only by so doing can the garden club be assured that it satisfies all of the requirements for exempt status. The application will be filed on Form 1024. p. 22-24
27. Abby needs to be aware of the following with respect to the Federal income tax reporting responsibilities of a church.
- A church is *not required* to obtain IRS approval for its exempt status. However, most exempt organizations, even though not required to do so, do apply for exempt status. The appropriate form for applying for exempt status is Form 1023 [Application for Recognition of Exemption under § 501(c)(3)].
 - A church is *not required* to file an annual information return.
 - A church could be subject to the unrelated business income tax. The appropriate annual form for exempt organizations that are subject to the UBIT is Form 990-T (Exempt Organization Business Income Tax Return). The due date is the fifteenth day of the fifth month after the end of the tax year.

pp. 22-24 to 22-27

28. Shane's exempt organization, which is not a private foundation, has broader disclosure requirements than Brittany's exempt organization, which is a private foundation. Copies of the following must be made available to the general public.
- Form 990 (Return of Organization Exempt from Income Tax).
 - Form 1023 [Application for Recognition of Exemption under § 501(c)(3)].

For the Form 990, copies must be made available for the three most recent returns.

If an individual requests a copy in person, Shane’s exempt entity must provide a copy immediately. If the request is received in writing or by e-mail or fax, the copy must be provided within 30 days. The copy must be provided without charge, except for a reasonable fee for reproduction and mailing costs.

Shane’s exempt organization will not have to fill individual requests if the forms have been made widely available. Probably the easiest way to satisfy the widely available requirement is to make the information available on the Internet.

Brittany’s exempt organization, a private foundation, must make a completed Form 990-PF available for public inspection.

p. 22-27

PROBLEMS

- 29. a. Absent the § 501(h) election to participate in lobbying activities on a limited basis, Research is in violation of the qualification and maintenance requirement which prohibits § 501(c)(3) organizations from attempting to influence legislation (i.e., lobbying activities) or participating in political campaigns. Therefore, the lobbying expenditures can result in Research forfeiting its exempt status. In addition, Research is subject to a tax on the lobbying expenditures of \$60,000 (\$1.2 million X 5%). If the organization’s management knew that the lobbying expenditures were likely to result in Research no longer being described in § 501(c)(3), and if such activities were willful and not due to reasonable cause, a tax of \$60,000 will also be levied on the organization’s management.
- b. The § 501(h) election permits the medical research organization to participate in lobbying activities on a limited basis. To determine the extent of participation permitted, it is necessary to calculate the lobbying nontaxable amount, which is the lesser of the following.
 - \$1,000,000
 - \$1,150,000 [$\$225,000 + 5\%(\$20 \text{ million} - \$1.5 \text{ million})$]

The ceiling on permitted lobbying expenditures is then calculated.

Lobbying nontaxable amount	\$1,000,000
X Statutory rate	<u>X 150%</u>
= Ceiling on permitted lobbying expenditures	<u>\$1,500,000</u>

Since Research’s lobbying expenditures of \$1,200,000 are below the ceiling of \$1,500,000, all of the lobbying expenditures are permitted lobbying expenditures. However, since the lobbying expenditures exceed the lobbying nontaxable amount, Research has excess lobbying expenditures of \$200,000 (\$1,200,000 – \$1,000,000). The tax liability on the excess lobbying expenditures is \$50,000 (\$200,000 X 25%).

- c. A 50% increase in lobbying expenditures results in total lobbying expenditures of \$1,800,000 (\$1,200,000 + \$600,000). With the § 501(h) election, the ceiling on permitted lobbying expenditures is \$1,500,000. Therefore, \$300,000 (\$1,800,000 – \$1,500,000) are not permitted lobbying expenditures. Research is subject to a tax on the lobbying expenditures of \$90,000 (\$1.8 million X 5%), since the expenditures are disqualifying lobbying expenditures. If the organization's management knew that the lobbying expenses were likely to result in Research no longer being described in § 501(c)(3), and if such activities were willful and not due to reasonable cause, a tax of \$90,000 also will be levied on the organization's management.

Research should not make such nonpermitted lobbying expenditures, since this could result in the loss of exempt status. In addition, since the lobbying expenditures exceed the lobbying nontaxable amount, Research has excess lobbying expenditures of \$800,000 (\$1,800,000 – \$1,000,000). The tax liability on the excess lobbying expenditures is \$200,000 (\$800,000 X 25%).

Research should definitely not increase its lobbying expenditures to \$1,800,000. At most, the expenditures should be increased by \$300,000 to \$1,500,000.

pp. 22-6 to 22-9 and Figure 22-1

30. a. Quail is a feeder organization. Even though it remits its earnings to an exempt organization, Quail is subject to the Federal income tax on corporations. The income tax on corporate taxable income of \$400,000 is \$136,000 (\$400,000 X 34% corporate tax rate).
- b. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Cincinnati, OH 45040

September 18, 2003

Mr. Arthur Morgan, Treasurer
Roadrunner, Inc.
500 Rouse Tower
Rochester, NY 14627

Dear Mr. Morgan:

I am responding to your inquiry regarding whether the potential liquidation of Quail, Inc., a 100% owned taxable subsidiary, into Roadrunner would enable the earnings of Quail to be tax-exempt.

Presently, the earnings of Quail are subject to the Federal corporate income tax. Based on your projection of annual earnings of approximately \$400,000, Quail's corporate tax liability would be \$136,000 (\$400,000 X 34%).

The liquidation of Quail into Roadrunner would bring about the legal dissolution of Quail and would terminate it being taxed as a separate entity. However, the sporting goods business would be classified as an unrelated trade or business and thus be subject to the unrelated business income tax. Even though Roadrunner is

tax-exempt, the projected earnings of the sporting goods business conducted by it still would be subject to taxation. The corporate tax liability on the \$400,000 would remain the same, \$136,000 ($\$400,000 \times 34\%$).

Since your only objective for liquidating Quail is to reduce the income tax liability, I recommend that you continue to operate Quail as a subsidiary. If you would like to discuss this further, please contact me.

Sincerely,

Karen Roby, CPA
Partner

- c. The answer would not change. How Roadrunner acquired the Quail stock (e.g., purchase rather than inheritance) is not relevant to Quail's classification as a feeder organization.

pp. 22-9 and 22-14 to 22-17

31. a. For an organization to qualify as receiving broad public support, both the external support test and the internal support test must be satisfied.

The total support received by Cardinal is \$241,000. For purposes of the external support (more than one-third support) test, the following amounts are included.

Governmental unit A for services rendered (limited to)	\$ 5,000
General public for services rendered	80,000
Contributions from other than disqualified persons	<u>95,000</u>
Qualifying support	<u>\$180,000</u>

Therefore, the external support test is satisfied ($\$180,000 \div \$241,000 = 75\%$).

For purposes of the internal support (not more than one-third support) test, only the gross investment income of \$40,000 is within the limited categories. Thus, this test also is satisfied ($\$40,000 \div \$241,000 = 17\%$).

Cardinal satisfies both tests for receiving broad public support.

- b. Since Cardinal satisfies both of the required tests for being an organization that is broadly supported by the public, it is not a private foundation.

- c. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

February 25, 2003

Mr. Arnold Horn, Treasurer
Cardinal, Inc.
250 Bristol Road
Charlottesville, VA 22903

Dear Mr. Horn:

As you requested, I have determined whether Cardinal, Inc., is a private foundation for the prior year. Cardinal is not a private foundation.

For Cardinal not to be classified as a private foundation, it must satisfy both an external support (i.e., broadly supported) test and an internal support test. The total support received by Cardinal is \$241,000. To satisfy the external support test, more than one-third of Cardinal's support must normally come from certain external sources. For Cardinal, this includes the following.

Governmental unit A for services rendered	\$ 5,000
General public for services rendered	80,000
Contributions from other than disqualified persons	<u>95,000</u>
	<u>\$180,000</u>

Thus, the external support test is satisfied ($\$180,000 \div \$241,000 = 75\%$).

To satisfy the internal support test, not more than one-third of Cardinal's support must normally come from certain internal sources. For Cardinal, this includes the following.

Gross investment income	\$40,000
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Thus, the internal support test is satisfied ($\$40,000 \div \$241,000 = 17\%$).

If I can be of further assistance, please let me know.

Sincerely,

Wilton Maxwell, CPA
Partner

pp. 22-10 to 22-12 and Example 2

32. a. Net investment income is calculated as follows.

Gross investment income		
Interest income	\$24,000	
Rental income	60,000	
Dividend income	20,000	
Royalty income	<u>10,000</u>	\$114,000
Allowable deductions		<u>(18,000)</u>
Net investment income		<u>\$ 96,000</u>

Neither the unrelated business income nor the unrelated business expenses are relevant in calculating net investment income.

- | | |
|------------------------------|-----------------|
| b. Net investment income | \$96,000 |
| Statutory rate | <u>X 2%</u> |
| Tax on net investment income | <u>\$ 1,920</u> |

- c. The principal purpose of the tax is to defray the costs incurred by the Federal government for IRS audits of private foundations.

Concept Summary 22-3

33. a. The initial tax will apply for the 2002 undistributed taxable income to the extent that it is not distributed by the end of 2003. Thus, for 2003, the initial tax is \$24,000 ($\$160,000 \times 15\%$) and the initial tax for 2004 is \$0 ($\$0 \times 15\%$).
- b. All of the inadequate distribution has been distributed by the assessment date. Therefore, there is no additional tax.

pp. 22-12 to 22-14, Example 3, and Concept Summary 22-3

34. a. Based on the data provided, it appears that Rectify is making speculative investments that put the private foundation's assets at risk. If this is the case, the tax on jeopardizing investments applies.
- b. The initial tax imposed on Rectify is \$25,000 ($\$500,000 \times 5\%$) and the initial tax imposed on Otis is \$5,000. The calculated initial tax for Otis is \$25,000 ($\$500,000 \times 5\%$), but the statutory ceiling is \$5,000.
- c. The additional tax for Rectify would be \$125,000 ($\$500,000 \times 25\%$). The calculated additional tax for Otis is \$25,000 ($\$500,000 \times 5\%$), but the statutory ceiling is \$10,000.
- d. Both Rectify and Otis are better off financially if the prohibited transaction (i.e., jeopardizing investment) is corrected within the correction period. With the correction, Rectify can avoid an additional tax of \$125,000 and Otis can avoid an additional tax of \$10,000.

Concept Summary 22-3

35. a. The initial tax on the private foundation is \$10,000 ($\$100,000 \times 10\%$).
- b. The initial tax on the foundation manager is \$2,500 ($\$100,000 \times 2.5\%$).

Concept Summary 22-3

36. a. The net unrelated business income of the museum consists of the gift shop profit of \$750,000. The gross unrelated business income consists of the sales revenue from the gift shop and is offset by related deductions. The fact that the \$750,000 is used to support museum operations does not modify this result.
- b. The amount of the net unrelated business income still is \$750,000.

c. The Open Museum
250 Oak Avenue
Peoria, IL 61625

February 4, 2003

Mr. Wayne Davis
45 Pine Avenue
Peoria, IL 61625

Dear Mr. Davis:

I am responding to your inquiry regarding the tax-exempt status of the Open Museum. The Open Museum generally is exempt from Federal income taxation under § 501(c)(3) of the *Internal Revenue Code of 1986*. We applied for Form 1023 - Application for Recognition of Exemption Under Section 501(c)(3) and were granted exempt status in 1980.

Our gift shop is considered an unrelated trade or business even though all of its profits are used in carrying out the mission of the museum. Therefore, the profits of the gift shop are taxed at the corporate income tax rates. For last year, this amounted to a tax liability of \$255,000 (\$750,000 X 34%). According to our CPA, Janet Carey, if the gift shop were staffed completely by volunteers, its profits would also be exempt. As we discussed at the board meeting, that is not feasible, based on the scale of the gift shop operations.

Except for the gift shop, all of our income is tax-exempt. This includes our admission fees of \$1.25 million and \$500,000 of endowment income.

If I can be of further assistance, please let me know.

Sincerely,

Ted Waller, Treasurer

pp. 22-14 to 22-17 and Concept Summary 22-4

37. a. The corporate tax rates are used to calculate the unrelated business income tax. Thus, Salmon's unrelated business income tax is \$7,000,000 (\$20,000,000 X 35%).
- b. Unrelated Business Income Tax For New Members of the Board of Salmon, Inc.
- I. Introduction.
- A. Reason for the UBIT: nonexempt organizations (regular taxable business entities) would be at a substantial disadvantage when trying to compete with an exempt organization.
- B. Tax effect.

1. Treats the unrelated business income as if it were subject to the corporate income tax.
 2. Apply the corporate tax rates to unrelated business taxable income to calculate the unrelated business income tax (UBIT).
- C. Applicable.
1. To all organizations that are exempt from Federal income tax under § 501(c), except Federal agencies.
 2. Includes religious, charitable, educational, literary, etc. organizations plus most other exempt organizations.
 3. Does not apply if unrelated business income is not greater than \$1,000.
- II. Unrelated trade or business.
- A. To be classified as such, must satisfy the following.
1. Organization conducts a trade or business.
 2. Trade or business is not substantially related to the exempt purpose of the organization.
 3. Trade or business is regularly carried on by the organization.
- B. Exceptions from such classification.
1. Substantially all the work is done by volunteers.
 2. Trade or business consists of selling merchandise and substantially all the merchandise has been received as gifts or contributions.
 3. Special rule for § 501(c)(3) organizations and for state colleges and universities.
 4. Special rule for most employee unions.
- C. Definition of trade or business.
1. Any activity conducted for the production of income through the sale of merchandise or the performance of services.
 2. Activity may be part of a larger set of activities conducted by the organization, some of which may be related to the exempt purpose.

- D. Not substantially related to the exempt purpose.
1. To be related to the accomplishment of the exempt purpose, the conduct of the business activities must be causally related and contribute importantly to the exempt purpose.
 2. Whether a causal relationship exists and the degree of its importance are determined by examining the facts and circumstances.
- E. Regularly carried on by the organization.
1. Intent is to assure that only activities that are actually competing with taxable organizations are subject to the UBIT.
 2. Factors to be considered.
 - a. Frequency of the activity.
 - b. Continuity of the activity.
 - c. Manner in which the activity is pursued.

III. UBIT Tax Model.

$$\begin{array}{r}
 \text{Gross unrelated business income} \\
 - \text{Deductions} \\
 \hline
 = \text{Net unrelated business income} \\
 \pm \text{Modifications} \\
 \hline
 = \text{Unrelated business taxable income}
 \end{array}$$

pp. 22-14 to 22-21, Concept Summary 22-4, and Figure 22-2

38. a. AIDS, Inc., is a charitable organization that is exempt from Federal income taxes under § 501(c)(3). However, it is subject to Federal income tax on its unrelated business income. The retail medical supply store is an unrelated trade or business. The Federal tax liability is calculated using the corporate tax rates on UBTI, assumed to be the net income of the organization minus the \$1,000 deduction.

$$\begin{array}{r}
 15\% \times \$ 50,000 = \$ 7,500 \\
 25\% \times \$ 25,000 = \quad 6,250 \\
 34\% \times \$ 25,000 = \quad 8,500 \\
 39\% \times \$224,000 = \quad 87,360 \\
 \hline
 \underline{\underline{\$109,610}}
 \end{array}$$

- b. The Episcopal Church is a religious organization that is exempt from Federal income tax under § 501(c)(3). However, it is subject to Federal income tax on its unrelated business income. The gift shop competes with commercial entities. It is staffed by employees rather than volunteers. The gift shop is classified as an

unrelated trade or business. The employee salaries of \$80,000 and the \$1,000 statutory amount are deducted from the net income of \$300,000 to produce taxable income of \$219,000. The Federal tax liability is \$68,660.

$$\begin{array}{rcl}
 15\% \times \$ 50,000 & = & \$ 7,500 \\
 25\% \times \$ 25,000 & = & 6,250 \\
 34\% \times \$ 25,000 & = & 8,500 \\
 39\% \times \$119,000 & = & \underline{46,410} \\
 & & \underline{\$68,660}
 \end{array}$$

- c. Education University is an educational organization that is exempt from Federal income tax under § 501(c)(3). However, it is subject to Federal income tax on its unrelated business income. The vending machine activity, which could be provided by a nonexempt business, appears to be an unrelated trade or business. However, the Code provides that if the trade or business is conducted primarily for the convenience of the organization's students, faculty, and staff, the activity is not an unrelated trade or business. Thus, the \$75,000 is exempt from Federal income tax.
- d. The thrift shop appears to compete with for-profit businesses. However, since all of the inventory is received through contributions, the thrift shop is not classified as an unrelated trade or business. Thus, the \$100,000 profit generated by the thrift shop is exempt.
- e. Since the unrelated business gross income is not at least \$1,000, Small is not subject to the unrelated business income tax.

pp. 22-14 to 22-17, 22-21, Concept Summary 22-4, and Figure 22-2

39. a. The \$100,000 contribution made by Animal Feed to Save the Squirrels is a *qualified* corporate sponsorship payment. Such payments are not unrelated business income. Thus, Save the Squirrels' unrelated business income tax is \$0.
- b. The \$100,000 contribution made by Animal Feed is not a *qualified* corporate sponsorship payment because Save the Squirrels advertises Animal Feed products in its monthly newsletter. Thus, Save the Squirrels has unrelated business income of \$100,000. Assuming there are no related expenses or adjustments, the unrelated business taxable income is \$100,000. The tax liability is \$22,250 [(\$50,000 X 15%) + (\$25,000 X 25%) + (\$25,000 X 34%)].

pp. 22-14 to 22-18 and Examples 10 and 11

40. a. In calculating unrelated business taxable income, both the charitable contributions associated with the unrelated trade or business and the other charitable contributions are eligible for deduction. However, the charitable contribution deduction is limited to 10% of unrelated business taxable income (excluding the deduction for charitable contributions). Of the \$45,000 of charitable contributions, only \$40,000 (\$400,000 X 10%) can be deducted in calculating unrelated business taxable income. Therefore, unrelated business taxable income is \$360,000 (\$400,000 – \$40,000).

- b. The change in the composition of charitable contributions does not affect the method for calculating unrelated business taxable income. Therefore, unrelated business taxable income is \$361,000 (\$400,000 – \$39,000). Both the charitable contributions associated with the unrelated trade or business (\$38,000) and the other charitable contributions (\$1,000) are eligible for deduction.

pp. 22-19 and 22-20

41. Tranquility must include the \$130,000 (\$300,000 rent income – \$170,000 rent expenses) in its unrelated business taxable income. The ownership of the building and the related cost recovery deduction of Blouses have no effect on Tranquility. pp. 22-20 and 22-21
42. Gains or losses from the sale, exchange, or other disposition of property, except for inventory, are not included in unrelated business taxable income. Education, Inc., has a net loss of \$20,000 from the property transactions.

Loss on sale of land and building	(\$50,000)
Gain on sale of land and building	5,000
Gain on sale of land	45,000
Loss on sale of computers	<u>(20,000)</u>
Net loss	<u>(\$20,000)</u>

Since none of these transactions related to inventory, the effect on unrelated business taxable income is \$0. p. 22-20 and Example 20

43. Part of the one-story building is debt-financed property, since only 30% is used in carrying out Fix's exempt purpose. The 70% (7,000 square feet) that is leased to Belts is classified as debt-financed property. Therefore, \$630,000 (70% X \$900,000) of the adjusted basis is allocated to the debt-financed property, and \$420,000 (70% X \$600,000) of the mortgage is treated as acquisition indebtedness. pp. 22-21, 22-22, and Example 24
44. a. Seagull is required to file an annual return on Form 990 (Return of Organization Exempt from Income Tax). Seagull's gross receipts of \$600,000 exceed the \$25,000 amount below which a return is not required. Note that the \$25,000 test relates to gross receipts rather than net income.
- b. The due date for Form 990 is the fifteenth day of the fifth month after the end of the tax year. Therefore, the due date for Seagull's return for the tax year ended October 31, 2003 is March 15, 2004.

pp. 22-24, 22-26, and Example 30

45. a. If Historic Burg is a private operating foundation, the value of the charitable contribution is \$100,000. If Sally had sold the chest, she would have had a long-term capital gain of \$45,000 (\$100,000 – \$55,000). However, for donees who are *not* private nonoperating foundations, a \$45,000 negative adjustment is required only if the property donated is tangible personal property and the use by the donee is unrelated to its exempt purpose. While the chest is tangible personal property, Historic Burg can be expected to display the chest in its museum.

The amount of Sally's charitable contribution deduction is \$90,000. The \$100,000 value amount exceeds the ceiling on her contribution deduction of \$90,000 ($\$300,000 \times 30\%$). The \$10,000 excess amount qualifies for five-year carryover.

- b. If Historic Burg is a private nonoperating foundation, the value of Sally's contribution is \$55,000 (\$100,000 fair market value – \$45,000 negative adjustment). For appreciated long-term capital gain property contributed to donees who are private nonoperating foundations, the amount of the negative adjustment is the long-term capital gain that would have resulted if the property had been sold. The amount of Sally's charitable contribution deduction is \$55,000 before the percentage limit is applied.

p. 22-28 and Example 32