

Form 990 Update and Unrelated Business Income

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Topics to be Covered

- Form 990
 - Procedural Matters and Parts of Form 990
 - Public Charity Status and Public Support – Schedule A
 - Transactions with Interested Persons – Schedule L
 - Related Organizations – Schedule R
 - Governance and Management Policies
- Unrelated Business Income
 - 3 Criteria for Taxation and Fragmentation Rule
 - Exceptions and Modifications and Exceptions to Exceptions
 - Advertising and Sponsorship
 - Form 990T
 - Planning Considerations

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Procedural Matters

- What form? 990-N, 990-EZ and 990
- Form 990
 - If gross receipts are at least \$200,000 or
 - If total assets of \$500,000 at end of its tax year
- Form 990-EZ
 - If gross receipts are less than \$200,000 and
 - If total assets of less than \$500,000 at end of its tax year

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Procedural Matters

- Form 990-N, Electronic Notice (e-postcard)
 - If gross receipts are \$50,000 or less
- Certain organizations not required to file
 - Certain religious organizations
 - Certain governmental organizations
 - Governmental unit
 - See further in Instructions to Form 990, B. Organizations Not Required to File Form 990 or 990-EZ

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Procedural Matters

- When Due?
 - 15th day of 5th month after organization's accounting period ends
 - May 15th for calendar year filer
- Use Form 8868, Application for Automatic Extension of Time to request and automatic 6 month extension

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Core Form 990

- Part I on Page 1 is a summary
- Organization Information
 - Exact name (item C)
 - Address (item B)
 - EIN (item D)
- Current Status – Publication 78
- Group exemption (item H)
- Type of Organization (item K)

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Part I and Part II (Page 1)

- Mission and Governance
- Revenue
 - Details
 - Comparative
- Expenses
 - Details
 - Comparative
- Total Assets and Liabilities
- Signature Block

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Part III Statement of Program Service Accomplishments (Page 2)

- Mission
- Three largest program services (was “program service accomplishments”)
- Activity codes – work in progress
- Reporting of changes in narrative in Schedule O

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Part IV Checklist of Required Schedules (Pages 3-4)

- Objectives:
 - Comprehensive triggers to various parts and schedules
 - Reduce incomplete filings
- Selected lines
 - Line 1 all public charities
 - Line 2 triggers Schedule B

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Part IV Checklist of Required Schedules (Pages 3-4)

- Selected lines
 - Lines 3 and 4 political activities and lobbying
 - Lines 15 – grants > \$5,000 outside US to orgs
 - Lines 16 – grants > \$5,000 outside US – grants to individuals
 - Lines 25 to 28 – self-dealing or relationships with directors, officers or key employees
 - Lines 33, 34, 35, 36 and 37 – related entities

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Part V Statement Regarding Other IRS Filings (Page 5)

- Selected lines
 - Lines 1 and 2 – e-filing obligation
 - Line 1c – back-up withholding for vendors and prize winners
 - Line 3 – Unrelated business taxable income; Form 990-T
 - Line 7 – charitable contributions; 8 questions

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Form 990 Overview

- Part VI Governance, Management and Disclosure
- Part VII Compensation
- Part VIII Revenue
- Part IX Statement of Functional Expenses
- Part X and XI Balance Sheet and Reconciliation of Net Assets
- Part XII Financial Statement and Reporting

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Income

- Part VIII Statement of Revenue
- Schedule B, Schedule of Contributors
- Schedule A, Public Charity Status and Public Support

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Part VIII, Line 1: Income

- More detail regarding contributions
- Include contributions collected by charity where donor does not receive fair market value from charity
- Does not include:
 - Donations of goods or services (but are included for GAAP)
 - Use of facilities, e.g. meeting rooms
- Includes cash and non-cash items

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Part VIII, Line 1: Income

Form 990 (2018) Page 9

Part VIII Statement of Revenue
Check if Schedule O contains a response or note to any line in this Part VIII

				(A) Total revenue	(B) Related or exempt function revenue	(C) Unrelated business revenue	(D) Revenue excluded from tax under sections 512-514
Contributions, Gifts, Grants and Other Similar Amounts	1a	Federated campaigns	1a				
	b	Membership dues	1b				
	c	Fundraising events	1c				
	d	Related organizations	1d				
	e	Government grants (contributions)	1e				
	f	All other contributions, gifts, grants, and similar amounts not included above	1f				
	g	Noncash contributions included in lines 1a-1f: \$					
	h	Total. Add lines 1a-1f					
Program Service Revenue				Business Code			
	2a	-----					
	b	-----					
	c	-----					
	d	-----					
	e	-----					
	f	All other program service revenue .					
g	Total. Add lines 2a-2f						
3	Investment income (including dividends, interest)						

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Part VIII, Line 1: Income

- Line 1b – Membership dues
 - If represent contributions from public, not payments for benefits received
 - Example: dues which entitle purchase of subscription to concerts in advance; but at same price as general public
 - Dues may be both contributions (line 1) and payments for services (line 2)
- Contributions are reported on line 1 regardless of whether deductible by donors

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Part VIII, Line 2

- Line 2 – payments for carrying out exempt function of organization
 - Program service revenue
 - Exempt function revenue
 - Example: hospital reports charges for medical services
 - Includes sale of inventory items
 - May include unrelated business items

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Exempt Function vs. Grants

- Governmental payments: test is who is primary beneficiary
 - If purpose is to benefit payor: exempt function (line 2)
 - If purpose is to allow exempt organization to carry on its exempt function to benefit public: grants (line 1e)

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Exempt Function vs. Grants

- Form 990 Instructions, where it is public that benefits:
 - Gov't agency payment to medical clinic for vaccinations to public: line 1e
 - Gov't agency payment to medical clinic for vaccinations to agency employees: line 2
- Relevance of classification: Support test
- Line 2: requires business code for type of income-producing activity

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Part VIII: Passive Income

- Interest and dividends now combined on line 3
 - Unrelated business income exclusion codes have been eliminated
- Royalties – now has its own line 5
 - For use of intellectual property
 - Payments for right to exploit natural resources

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Line 8: Special Events

- Fundraising events include:
 - Dinners/dances
 - Sports events
 - Auctions
- Not include raffles with prizes with nominal value
- Quid pro quo rules to separate deductible from nondeductible portion
- Do not include fundraising expenses; only direct costs of event, e.g. rent, food
- If total on 8a (or 9a) exceeds \$15,000, then complete Schedule G

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Special Events

- Illustration:
 - Total donation: \$100; sold 100 (\$10,000)
 - Dinner value: \$40
 - Costs: Food/drinks \$4,000
 - Advertising/promotion: \$2,500
- Form 990
 - Line 8a: \$4,000
 - Line 8b: \$4,000
 - Line 1 and parenthesis on line 8: \$6,000
 - Part IX line 12 (advertising and promotion): \$2,500

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Special Events

- Form 990
 - Line 8a: \$4,000
 - Line 8b: \$4,000
 - Line 1 and parenthesis on line 8: \$6,000
 - Part IX line 12 (advertising and promotion): \$2,500

Other Revenue	8a Gross income from fundraising events (not including \$ of contributions reported on line 1c). See Part IV, line 18 a b Less: direct expenses b c Net income or (loss) from fundraising events . . ▶	<table border="1" style="width: 100%; height: 40px; border-collapse: collapse;"> <tr> <td style="width: 25%;"></td> <td style="width: 25%;"></td> <td style="width: 25%;"></td> <td style="width: 25%;"></td> </tr> </table>				

Statement of Revenue

- Formerly on Part VII: Analysis of Income Producing Activities
- Three possible categories
 - Relates to exempt function
 - Unrelated business income
 - Statutorily excluded because of IRC Sections 512, 513, or 514

Schedule B

Schedule of Contributors

- Background
 - Donor identification information is sensitive and generally is held confidential
 - For years 1999 and prior, IRS permitted exempt organization to submit information that would not be disclosed to public
 - All public charities must file Schedule B if they receive contributions, gifts grants of \$5,000 or more from any one contributor

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Schedule B

Schedule of Contributors

- Points to consider
 - Only names and addresses are protected
 - Avoid including information that might lead to identification of donor
 - How to comply with public request for copy of Form 990 and withholding of Schedule A, Part IV-A and Schedule B

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Schedule B

Schedule of Contributors

- Points to consider:
 - If qualify, use 2% of contributions to avoid reporting donors whose total gifts are between \$5,000 and the 2%
 - Provide minimal information about noncash contributions on Schedule B, Part II
 - Risk that return will be considered an incomplete return

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Schedule M

Non-Cash Contributions

- Schedule B collects information on the name of contributor, aggregate contributions, type of contribution and description of property (if non-cash)
- Schedule M collects information only on non-cash contributions, on types of contributions and aggregate amount received by EO
- Some redundancy

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Schedule M Non-Cash Contributions

- Who files? If “yes” answer to:
 - >\$25,000 of non-cash contributions (IV: #29)
 - Art, historical treasures, conservation easements (IV: #30)
- Cars – line 6
 - Only donors who are not dealers
 - Excludes cars from donors/car dealers
 - Instead file Form 1098-C

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Schedule M Non-Cash Contributions

- Number of Forms 8283, Noncash Charitable Contributions – line 29
- Agreement(s) to hold onto property 3 years or more – line 30
- Gift acceptance policy for non-standard contributions – line 31
- Third parties or related organizations to solicit, process and sell non-cash contributions – line 32

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Expenses

- Part VII – Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees and Independent Contractors
- Schedule J, Compensation Information
- Part IX – Statement of Functional Expenses

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Part VII Compensation (Pages 7 and 8)

- All officer, Directors, Trustees, Key Employees and Highly Compensated Employees
 - Current and former
 - Reportable from org on W-2 or 1099
 - Reportable from related orgs W-2 or 1099
 - From related organizations estimates

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Part VII Compensation (Pages 7 and 8)

- Highly Compensated Employees (\$100,000 or more): top 5; provide same info
- Key Employee:
 - Glossary definition (page 11 and 12) all 3 tests
 - \$150,000 test
 - Responsibility test
 - Top 20 test

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Schedule J, Compensation Information

- More detailed analysis
- Is info required of org only (Part I: 1,2,7,8) or does it require info from related organizations (3-6)
- Must complete for:
 - Former officers, directors, trustees, key employees and HCE
 - Person on Page 7-8 if comp \geq \$150,000
 - If compensated by related org for services to org

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Part IX Statement of Functional Expenses (Page 10)

- Similar to reporting of functional expenses on existing Form 990
- Selected lines
 - Line 5 compensation for current officers, directors, trustees and key employees
 - Line 6 – compensation to other disqualified persons (4958)
 - Line 7 – other salary

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Part IX Statement of Functional Expenses (Page 10)

- Selected lines
 - Line 8 – pension and other benefit plans
 - Note: Fiscal year reporting (not W-2 and 1099)
 - DO NOT REPORT expenses reported on Part VIII
 - line 6b, rental expenses
 - Line 7b, cost or basis of sold assets
 - Line 8b, special event expenses
 - Line 9b, direct gaming activity
 - Line 10b, cost of goods sold

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Part IX Statement of Functional Expenses (Page 10)

- Selected lines
 - Line 12 – advertising and promotion
 - Line 14 – information technology
 - Line 15 – royalties
 - Line 23 – insurance
 - Line 24 – Miscellaneous can not exceed 5% of total on line 25

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Public Charity Status and Public Support: Schedule A

- Public Charity Status vs. Private Foundation
- Public charities based on funding
 - Donative – 509(a)(1)
 - Exempt function – 509(a)(2)
- Record-keeping for Donations
 - Names (who)
 - When
 - Amount (How much)

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Public Charity Status

- Donative Charities will qualify as public charity if normally
 - Receives at least 1/3 of total support
 - From government units
 - From direct or indirect public contributions
 - Combination of last two sources
- Old Rules: Normally means
 - 4 years prior to current year met on aggregate basis
 - New organizations > 8 months less than 5 years; use actual period
 - Less than 8 months; advance ruling period

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Elimination of Advance Ruling Process

- Temporary Income Tax Regulations – 9/9/08
- Effective immediately
- New organizations automatic classification as public charity for its first 5 years if reasonable expectation of public support
- After 5 years, monitor public support on Schedule A
 - Loss of public charity status if public support test not met for 2 consecutive years
- No Form 8734

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Support Determination

- Report to IRS
 - Changes in sources of support, purposes character or method of operation
 - Amendment to organizational documents or bylaws
- Reliance on advance ruling letters
- Small organizations filing Form 990-N

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Support Determination

- Revised Schedule A
 - Exclusive focus on public charity status
 - Unrelated topics transferred to other parts of Form 990
- Donative public charities complete Part II
- Exempt function public charities complete Part III

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Donative vs. Exempt Function Charities

- Donative charities – 509(a)(1)
- Support fraction:
 - Numerator
 - Denominator
- EO CPE Text – sources of support
- Exclusion from public support (numerator)
 - Donations exceeding 2% of total support
 - Unusual grants
 - Exempt function revenue
 - Earmarked revenue for ultimate donee (Example 3)

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Source of Support - IRC sections 509(a)(1) vs. 509(a)(2)

IRC Sections 509(a)(1) & 170(b)(1)(A)(vi)		Source of Support	IRC Section 509(a)(2)	
Numerator	Denominator		Numerator	Denominator
Include ¹	Include	Gifts, bequests and contributions from: Individual, trust, corporation	Include ²	Include
Include	Include	Governmental unit	Include	Include
Include ⁵	Include	170(b)(1)(A)(vi) organization	Include ³	Include
Include	Include	Ordinary Grants	Include	Include
Exclude	Exclude	Unusual Grants (approved)	Exclude	Exclude
Exclude	Exclude	Membership Fees: to obtain merchandise, admissions, etc.	Include ^{2, 6, 4}	Include
Include	Include	to provide support	Include	Include
Exclude	Include	Dividends and Interest	Exclude	Exclude
Exclude	Exclude	Rents: related activity	Include ^{2, 6, 4}	Include
Exclude	Include	other	Include	Include
Exclude	Exclude	Gross receipts from related activity: Admissions, sale of merchandise, services rendered, fundraising not UBI (e.g., charitable gaming), facilities furnished, etc.	Include ^{2, 6, 4}	Include
Exclude	Include	Net income from unrelated activity	Exclude	Include
Include	Include	Value of services received from Governmental units without charge	Include	Include
Include	Include	Governmental units under contracts or grants: for services rendered for benefit of the Government	Include ^{2, 6, 4}	Include
Exclude	Exclude	for carrying out related activity	Include ^{2, 6, 4}	Include
Include	Include	for direct benefit of public	Include	Include
Include	Include	Taxes levied for benefit of organization	Include	Include
Exclude	Exclude	Capital gains	Exclude	Exclude
Exclude	Exclude	Contributions of non-deductible services	Exclude	Exclude
Exclude	Exclude	Amounts borrowed	Exclude	Exclude

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Continued on next page

Donative vs. Exempt Function Charities

- Donative charities – 509(a)(1)
- Example of Public Support Computation
– EO text

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An Example of a Public Support Computation

M, an organization described in IRC 170(c)(2), shows that it derived funds from the following sources during taxable years 1970 through 1973:

- (a) Interest and dividends--\$80,000
- (b) Net income from unrelated business activities--\$20,000
- (c) Gifts and contributions from the general public--\$200,000
- (d) Capital gains--\$5,000
- (e) Admission fees (amounts from the exercise of its exempt function under IRC 501(a))--\$5,000

In this situation, M's total support (denominator of the public support fraction) is \$300,000, the sum of items (a), (b), and (c); items (d) and (e) are excluded because capital gains and income related to exempt functions are not included in the definition of support for purposes of IRC 170(b)(1)(A)(vi). M organization's public support (numerator of the public support fraction) is \$200,000, since of the total support received only item (c), gifts and contributions, qualifies as public support. M's public support fraction is public support \$200,000 over total support \$300,000 or 66 2/3 percent public support.

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DONATIVE PUBLIC CHARITY EXAMPLE

Schedule A Form 990 or 990-EQ 2008

Part II Support Schedule for Organizations Described in Sections 170(b)(1)(A)(iv) and 170(b)(1)(A)(v)
(Complete only if you checked the box on line 5, 7, or 8 of Part I.)

Section A. Public Support

Calendar year (or fiscal year beginning in) ▶	(a) 2004	(b) 2005	(c) 2006	(d) 2007	(e) 2008	(f) Total
1 Gifts, grants, contributions, and membership fees received. (Do not include any "unusual grants.")	200,000					200,000
2 Tax revenues levied for the organization's benefit and either paid to or expended on its behalf						
3 The value of services or facilities furnished by a governmental unit to the organization without charge						
4 Total. Add lines 1-3	200,000					200,000
5 The portion of total contributions by each person (other than a governmental unit or publicly supported organization) included on line 1 that exceeds 2% of the amount shown on line 11, column (f)						
6 Public support. Subtract line 5 from line 4						200,000

Section B. Total Support

Calendar year (or fiscal year beginning in) ▶	(a) 2004	(b) 2005	(c) 2006	(d) 2007	(e) 2008	(f) Total
7 Amounts from line 4	200,000					200,000
8 Gross income from interest, dividends, payments received on securities loans, rents, royalties and income from similar sources	80,000					80,000
9 Net income from unrelated business activities, whether or not the business is regularly carried on	20,000					20,000
10 Other income. Do not include gain or loss from the sale of capital assets (Explain in Part IV)						
11 Total support. Add lines 7 through 10						300,000
12 Gross receipts from related activities, etc. (see instructions)						12,000
13 First five years, if the Form 990 is for the organization's first, second, third, fourth, or fifth tax year as a section 501(c)(3) organization, check this box and stop here ▶ <input type="checkbox"/>						
14 Public support percentage for 2008 (line 6, column (f)) divided by line 11, column (f)					14	66.67 %
15 Public support percentage from 2007 Schedule A, Part IV-A, line 29f					15	%

Donative vs. Exempt Function Charities

- Capital gain exclusion
- Lines 8 and 9:
 - Exclusion of interest, dividends
 - Exclusion of UBI

Donative vs. Exempt Function Charities

- Exempt function charities – 509(a)(2)
- Significant differences in support fractions
 - First: more than 1/3 from exempt function
 - This was excluded in 509(a)(1)
 - Second: limitations test: no more than 1/3 of total support from
 - Gross investment income
 - Net unrelated business income
 - Third: all receipts from “disqualified persons” excluded from numerator
 - Fourth: public support is limited to \$5,000 or 1% per person

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Donative vs. Exempt Function Charities

- Exempt function charities – 509(a)(2)
- Example of Support Computation (from EO text)

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Examples of Support Computation

The following example from Reg. 1.509(a)-3(b)(2) illustrate an application of the 33 1/3 percent support test. For purposes of the example:

The term "general public" is defined as persons other than disqualified persons and other than persons from whom the foundation receives gross receipts of the greater of \$5,000 or 1 percent of its support in any taxable year, and the term "gross receipts" is limited to receipts from activities which are not unrelated trade or business (within the meaning of section 513).

Example (2). For the taxable year 1970, Y, an organization described in section 501(c)(3), received support of \$600,000 from the following sources:

Bureau O (gross receipts for services rendered)...	\$10,000
Bureau P (gross receipts for services rendered).....	10,000
General public (gross receipts for services rendered)	150,000
General public (contributions).....	40,000
Gross investment income.....	150,000
Contributions from substantial contributors.....	<u>240,000</u>
Total support.....	\$600,000

Continued on next page

Examples of Support Computation, continued

Since the \$10,000 received from each bureau amounts to more than the greater of \$6,000 or 1 percent of Y's support for 1970 (1 percent of \$600,000 = \$6,000), each amount is includible in the numerator of the one-third support fraction only to the extent of \$6,000. Thus, for the taxable year 1970, Y received support from sources required to meet the one-third support test of section 509(a)(2)(A) computed as follows:

Bureau O.....	\$6,000
Bureau P.....	6,000
General public (gross receipts).....	150,000
General Public (contributions).....	<u>40,000</u>
Total.....	\$202,000

- Therefore, in computing the support test set forth in IRC 509(a)(2)(A), \$202,000 is includible in the aggregate numerator and \$600,000 is includible in the aggregate denominator of the support fraction.

EXEMPT FUNCTION PUBLIC CHARITY EXAMPLE Page 3

Schedule A Form 990 or 990-EZ 2008

Part III Support Schedule for Organizations Described in Section 509(a)(2)
(Complete only if you checked the box on line 9 of Part I.)

Section A. Public Support

Calendar year (or fiscal year beginning in)	(a) 2004	(b) 2006	(c) 2008	(d) 2007	(e) 2008	(f) Total
1 Gifts, grants, contributions, and membership fees received. (Do not include any "unusual grants.")				40,000	240,000	280,000
2 Gross receipts from admissions, merchandise sold or services performed, or facilities furnished in any activity that is related to the organization's exempt purpose		10,000	10,000	160,000	0	170,000
3 Gross receipts from activities that are not an unrelated trade or business under section 513						
4 Tax revenues levied for the organization's benefit and either paid to or expended on its behalf						
5 The value of services or facilities furnished by a governmental unit to the organization without charge		10,000	10,000	180,000	240,000	460,000
6 Total. Add lines 1-5		10,000	10,000	180,000	240,000	460,000
7a Amounts included on lines 1, 2, and 3 received from disqualified persons					240,000	240,000
7b Amounts included on lines 2 and 3 received from other than disqualified persons that exceed the greater of 1% of the total of lines 4, 10c, 11, and 12 for the year or \$5,000		4,000	4,000			8,000
8 Public support (subtract line 7b from line 6)		4,000	4,000		240,000	248,000
Section B. Total Support						252,000
Calendar year (or fiscal year beginning in)	(a) 2004	(b) 2006	(c) 2008	(d) 2007	(e) 2008	(f) Total
9 Amounts from line 6		10,000	10,000	180,000	240,000	460,000
10a Gross income from interest, dividends, payments received on securities loans, rents, royalties and income from similar sources					160,000	160,000
b Unrelated business taxable income (less section 511 taxes) from businesses acquired after June 30, 1975						
c Add lines 10a and 10b					160,000	160,000
11 Net income from unrelated business activities not included in line 10c, whether or not the business is regularly carried on						
12 Other income. Do not include gain or loss from the sale of capital assets (Report in Part IV.)						
13 Total support. (Add lines 9, 10c, 11, and 12.)						620,000
14 First five years. (If this Form 990 is for the organization's first, second, third, fourth, or fifth tax year as a section 501(c)(3) organization, check this box and stop here.) <input type="checkbox"/>						
Section C. Computation of Public Support Percentage						
15 Public support percentage for 2008 (line 8, column (f) divided by line 13, column (f))				15		33.67 %
16 Public support percentage for 2007 (Schedule A, Part III-A, line 27a)				18		%
Section D. Computation of Investment Income Percentage						
17 Investment income percentage for 2008 (line 10c, column (f) divided by line 13, column (f))				17		25.00 %

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Donative vs. Exempt Function Charities

- Completed Schedule A
 - Bureau O (2004); Bureau P (2003)
 - General Public (2002)
 - Substantial contributors (2001)
- Details
 - Line 7a - substantial contributors
 - Line 7b - other than substantial contributors
 - Line 15 - 33.67%
 - Line 17 - 25%

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Donative vs. Exempt Function Charities

- Donative charities
 - More flexibility in demonstrating public charity status
 - Numerical test: more than 1/3 (33-1/3%)
 - Facts and circumstances: if greater than 10% but less than 1/3 (33-1/3%)
- Exempt function charities
 - No facts and circumstances test

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Facts and Circumstances Test

- Sources
 - Form 990 Instructions
 - Chart from EO Text (Figure 3)
- Attraction of public support requirement
- Five public support factors
 - Percentage of financial support
 - Sources of support
 - Representative governing body

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Facts and Circumstances Test

- Composition of governing body
 - (Item c of Figure 3)
 - Public officials acting in their public capacity
 - Persons selected by public officials “itpc”
 - Those with specialized knowledge/expertise in field in which organization operates

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Facts and Circumstances Test

- Community leaders, such as
 - Clergy
 - Educators
 - Civic leaders
 - Others representing broad cross-section of views and interests of community

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Selected Form 990 Schedules

- Schedule L, Transactions with Interested Persons
 - If answered yes on Form 990, Part IV, lines 25a, 26, 27, 28a, 28b, or 28c or Form 990-EZ, line 38a or 40b
- Schedule R, Related Organizations and Unrelated Partnerships
 - If answered yes on Form 990, Part IV, lines 33, 34 35B, 36 or 37

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Excess Benefit Transactions Information Required

- Name of disqualified person
- Relationship between DP and EO
 - E.g. officer, family member of director
- Description of transaction
- Whether the transaction has been corrected

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I: Excess Benefit Transactions

Questions 2 and 3

Part I Excess Benefit Transactions (section 501(c)(3) and section 501(c)(4) organizations only).
Complete if the organization answered "Yes" on Form 990, Part IV, line 25a or 25b, or Form 990-EZ, Part V, line 40b.

1	(a) Name of disqualified person	(b) Relationship between disqualified person and organization	(c) Description of transaction	(d) Corrected?	
				Yes	No
(1)					
(2)					
(3)					
(4)					
(5)					
(6)					

2 Enter the amount of tax incurred by the organization managers or disqualified persons during the year under section 4958. ▶ \$ _____

3 Enter the amount of tax, if any, on line 2, above, reimbursed by the organization ▶ \$ _____

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Schedule L: Part II

Loans

- Loans required to be reported
 - Loans
 - Salary advances
 - Other advances received
- To or from
 - current or former officers, directors, trustee, key employee, hke or disqualified person
 - Outstanding as of EO's year end

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Schedule L: Part II Loans

- Loans required to be reported:
 - Loan between EO and third party
 - Transferred → outstanding debt between EO and interested person
 - Loan between interested person and third party
 - Transferred → outstanding debt between EO and interested person

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Schedule L: Part II Loans

- Information to be reported:

Part II

Loans to and/or From Interested Persons.

Complete if the organization answered "Yes" on Form 990-EZ, Part V, line 38a or Form 990, Part IV, line 26; or if the organization reported an amount on Form 990, Part X, line 5, 6, or 22.

(a) Name of interested person	(b) Relationship with organization	(c) Purpose of loan	(d) Loan to or from the organization?		(e) Original principal amount	(f) Balance due	(g) In default?		(h) Approved by board or committee?		(i) Written agreement?	
			To	From			Yes	No	Yes	No	Yes	No
(1)												
(2)												

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Schedule L: Part III Grants

- Interested persons
- Substantial contributors
- Related persons
- What grants need to be reported
 - Grants or other assistance
 - Any interested person
 - Anytime during EO’s tax year

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Schedule L: Part III Grants

- Information to be reported

Part III Grants or Assistance Benefiting Interested Persons. Complete if the organization answered "Yes" on Form 990, Part IV, line 27.				
(a) Name of interested person	(b) Relationship between interested person and the organization	(c) Amount of assistance	(d) Type of assistance	(e) Purpose of assistance
(1)				
(2)				
(3)				
(4)				

- Reporting by schools
- Reasonable effort

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IV: Business Transactions with Interested Persons

- If aggregate payments exceeds \$100,000
- If all payments from single transaction > \$10,000 or 1% of EO total revenue
- If compensation to family member of current or former officer, director, trustee or key employee > \$10,000
- If JV with IP, EO invested \$10,000 or more

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IV: Business Transactions

- Initiated in current or prior year
- Include joint ventures where profits or capital interest > 10%
- Contracts, lease, license, performance of services, insurance
- Transactions between EO with management company – 35% owned/controlled by c/f officer, director, trustee, key employee

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IV: Entities as Interested Persons

- Entity if c/f EO officer, director, trustee, key employee or any family member serving as
 - Officer
 - Director
 - Trustee
 - Partner w direct/indirect ownership > 5%
 - Shareholder w direct/indirect ownership > 5% if entity is professional corporation

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IV: Example 1

- Officer's child, T, employed by EO
- Receives \$15,000 (< 1% of EO's revenue)

- Required to report T compensation
 - Family member compensation > \$10,000
 - Even if T's compensation is not reported on Part VII (compensation of officers, directors, key employees)

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IV: Example 2

- X, director's daughter, is first year associate at law firm
- EO pays law firm \$150,000
- No reporting required
 - X no ownership of law firm
 - X is not officer, director or trustee of law firm

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IV: Example 3

- Y, director's daughter, is partner of law firm and has ownership of 5.25% of p/s profits
- EO pays law firm \$150,000
- Reporting required
 - Y's ownership of law firm > 5%
 - Amount paid > \$100,000

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IV: Example 4

- First, Y is partner of law firm and has ownership of 5.25% of p/s profits
- Then Y's dad becomes director of EO
- EO pays law firm \$150,000
- Reporting required
 - Y's ownership of law firm > 5%
 - Amount paid > \$100,000

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IV: Example 5

- Y's dad was director of EO and resigns
- Then, Y is partner of law firm and has ownership of 5.25% of p/s profits
- EO pays law firm \$150,000
- Reporting required
 - Y's ownership of law firm > 5%
 - Amount paid > \$100,000

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IV: Example 6

- Y, director's daughter, is partner of law firm and has ownership of 5.25% of p/s profits
- EO pays law firm \$75,000 total
 - 15 separate transaction each < \$10,000
- No reporting required
 - Y's ownership of law firm > 5%
 - But amounts paid < \$10,000 single transaction and < \$100,000 in aggregate

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IV: Example 7

- Y, director's daughter, is partner of law firm and has ownership of 5.25% of p/s profits
- EO pays law firm \$105,000 total
- Reporting required
 - Y's ownership of law firm > 5%
 - Amounts paid > \$100,000 in aggregate
 - All transactions need be reported in aggregate or listed separately

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Schedule R – Related Organizations and Unrelated Partnerships

- Part I: disregarded entities
- Part II: related tax-exempt entities
- Part III: related orgs taxed as partnerships
- Part IV: related orgs taxed as c or s corps
- Part V: unrelated orgs taxed as partnerships

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Schedule R

- Related organizations
 - Parent/subsidiary
 - Brother/sister
 - Glossary
 - Schedule R instruction
 - Supporting/supported
 - 509(a)(3)

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Schedule R

- Definition of Control – if without owners
 - Parent/subsidiary: power to remove/replace majority of directors
 - Brother/sister: management or board overlap
- Definition of Control – if with owners
 - > 50% of stock – voting power of corp
 - > 50% of profits or capital interests of p/s
 - > 50% beneficial interest in trust

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Schedule R

- Information requested in Parts I – III

Part I Identification of Disregarded Entities (Complete if the organization answered "Yes" to Form 990, Part IV, line 33.)												
(a) Name, address, and EIN (if applicable) of disregarded entity	(b) Primary activity	(c) Legal domicile (state or foreign country)	(d) Total income	(e) End-of-year assets	(f) Direct controlling entity							
(f)												
Part II Identification of Related Tax-Exempt Organizations (Complete if the organization answered "Yes" to Form 990, Part IV, line 34 because it had one or more related tax-exempt organizations during the tax year.)												
(a) Name, address, and EIN of related organization	(b) Primary activity	(c) Legal domicile (state or foreign country)	(d) Exempt Code section	(e) Public charity status (if section 501(c)(3))	(f) Direct controlling entity	(g) Section 512(b)(13) controlled entity?						
						Yes	No					
(f)												
Part III Identification of Related Organizations Taxable as a Partnership (Complete if the organization answered "Yes" to Form 990, Part IV, line 34 because it had one or more related organizations treated as a partnership during the tax year.)												
(a) Name, address, and EIN of related organization	(b) Primary activity	(c) Legal domicile (state or foreign country)	(d) Direct controlling entity	(e) Predominant income (related, unrelated, excluded from tax under sections 512-514)	(f) Share of total income	(g) Share of end-of-year assets	(h) Disproportionate allocations?		(i) Code V—UBI amount in box 20 of Schedule K-1 (Form 1065)	(j) General or managing partner?		(k) Percentage ownership
							Yes	No		Yes	No	
(f)												80

Schedule R

- Information requested in Parts IV

Part IV Identification of Related Organizations Taxable as a Corporation or Trust (Complete if the organization answered "Yes" to Form 990, Part IV, line 34 because it had one or more related organizations treated as a corporation or trust during the tax year.)

(a) Name, address, and EIN of related organization	(b) Primary activity	(c) Legal domicile (state or foreign country)	(d) Direct controlling entity	(e) Type of entity (C corp, S corp, or trust)	(f) Share of total income	(g) Share of end-of-year assets	(h) Percentage ownership	(i) Section 512(b)(13) controlled entity?	
								Yes	No
(1)									

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Schedule R

- Information reported in Part V

Part V Transactions With Related Organizations (Complete if the organization answered "Yes" to Form 990, Part IV, line 34, 35b, or 36.)

Note. Complete line 1 if any entity is listed in Parts II, III, or IV of this schedule.

1 During the tax year, did the organization engage in any of the following transactions with one or more related organizations listed in Parts II-IV?

a Receipt of (i) interest (ii) annuities (iii) royalties or (iv) rent from a controlled entity

b Gift, grant, or capital contribution to related organization(s)

c Gift, grant, or capital contribution from related organization(s)

d Loans or loan guarantees to or for related organization(s)

e Loans or loan guarantees by related organization(s)

f Dividends from related organization(s)

g Sale of assets to related organization(s)

h Purchase of assets from related organization(s)

i Exchange of assets with related organization(s)

j Lease of facilities, equipment, or other assets to related organization(s)

k Lease of facilities, equipment, or other assets from related organization(s)

l Performance of services or membership or fundraising solicitations for related organization(s)

m Performance of services or membership or fundraising solicitations by related organization(s)

n Sharing of facilities, equipment, mailing lists, or other assets with related organization(s)

o Sharing of paid employees with related organization(s)

p Reimbursement paid to related organization(s) for expenses

q Reimbursement paid by related organization(s) for expenses

r Other transfer of cash or property to related organization(s) **82**

s Other transfer of cash or property from related organization(s)

Schedule R – Part VI

- Unrelated organizations taxable as partnership may result in:
 - Unrelated business taxable income
 - Private benefit
 - Inurement
 - Exempt status issues, where EO does not control venture

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Schedule R – Part VI

- Information reported

Part VI **Unrelated Organizations Taxable as a Partnership** (Complete if the organization answered "Yes" to Form 990, Part IV, line 37.)

Provide the following information for each entity taxed as a partnership through which the organization conducted more than five percent of its activities (measured by total assets or gross revenue) that was not a related organization. See instructions regarding exclusion for certain investment partnerships.

(a) Name, address, and EIN of entity	(b) Primary activity	(c) Legal domicile (state or foreign country)	(d) Predominant income (related, unrelated, excluded from tax under section 512-514)	(e) Are all partners section 501(c)(3) organizations?		(f) Share of total income	(g) Share of end-of-year assets	(h) Disproportionate allocations?		(i) Code V-UBI amount in box 20 of Schedule K-1 (Form 1065)	(j) General or managing partner?		(k) Percentage ownership
				Yes	No			Yes	No		Yes	No	
(1)													

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Governance

- Principles
- Governance
- Federal tax guidance
- Policies

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Principles

- “Well-governed charity is more likely to obey tax laws, safeguard charitable assets and serve charitable interest than one with poor or lax governance.”
- Clearly articulated purposes describing mission
- Knowledgeable and committed mgmt
- Sound management practices

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Principles

- No statutory authority
- Draft of Good Governance Practices for 501(c)(3) Organizations 2/8/07
- Life cycle of a public charity
 - Governance and related topics (replaced draft)

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Principles

- Mission
- Organizational documents
- Governing Body
- Governance and Management Policies
- Financial Statements and Form 990 Reporting
- Transparency and Accountability

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Mission Statement

- Disclosed Part III, line 1 on Form 990
- Not defined in glossary
- Elements
 - Why charity exists
 - What are its goals
 - What are its activities and where do they done
 - Who does charity serve
- Different from purposes in Articles
- Up-to-date?

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Federal Tax Guidance

- Exemption application guidance
 - Resumes / backgrounds of directors
- Donative public charities - 509(a)(1)
 - Support test; facts and circumstances
- “Representative governing body factor”
 - If represents broad interests of the public rather than personal or private interests of limited number of donors

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Federal Tax Guidance

- Composition of governing body
 - Public officials acting in their public capacity
 - Persons selected by public officials “itpc”
 - Those with specialized knowledge/expertise in field in which organization operates
 - Community leaders, such as
 - Clergy
 - Educators
 - Civic leaders
 - Others representing broad cross-section of views and interests of community

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Governing Body Part VI, Form 990, Section A

- Question 1a – number of voting members at end of year
 - Question 1b – number independent members
- Question 2 – officer, director or key employee have any family or business relationship with another off, director or k e
- Question 3 – Any delegation of control over management to a management company

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Governance and Management Policies

- 1. Policy for consistent operation of chapters, branches & affiliates – line B10b
- 2. Conflict of interest – line B12a
- 3. Whistleblower policy – line B13
- 4. Document Retention and Destruction Policy – line B 14
- 5. Compensation policy – lines B15 a, b
 - CEO, Executive Director, top management
 - Other key employees

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Governance and Management Policies

- 6. Policy for reimbursement of business, travel and entertainment line 1b Schedule J
- 7. Policy on participation in Joint Ventures – line B16b
- 8. Financial information review policy – line B11
- 9. Policy on disclosure – line C18

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the organization's mailing address? If "Yes," provide the names and addresses in Schedule O 9

Section B. Policies (This Section B requests information about policies not required by the Internal Revenue Code.)

	Yes	No
10a Does the organization have local chapters, branches, or affiliates?		
b If "Yes," does the organization have written policies and procedures governing the activities of such chapters, affiliates, and branches to ensure their operations are consistent with those of the organization?		
11a Has the organization provided a copy of this Form 990 to all members of its governing body before filing the form?		
b Describe in Schedule O the process, if any, used by the organization to review this Form 990.		
12a Does the organization have a written conflict of interest policy? If "No," go to line 13		
b Are officers, directors or trustees, and key employees required to disclose annually interests that could give rise to conflicts?		
c Does the organization regularly and consistently monitor and enforce compliance with the policy? If "Yes," describe in Schedule O how this is done		
13 Does the organization have a written whistleblower policy?		
14 Does the organization have a written document retention and destruction policy?		
15 Did the process for determining compensation of the following persons include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision?		
a The organization's CEO, Executive Director, or top management official		
b Other officers or key employees of the organization		
If "Yes" to line 15a or 15b, describe the process in Schedule O. (See instructions.)		
16a Did the organization invest in, contribute assets to, or participate in a joint venture or similar arrangement with a taxable entity during the year?		
b If "Yes," has the organization adopted a written policy or procedure requiring the organization to evaluate its participation in joint venture arrangements under applicable federal tax law, and taken steps to safeguard the organization's exempt status with respect to such arrangements?		

Section C. Disclosure

17 List the states with which a copy of this Form 990 is required to be filed ▶

18 Section 6104 requires an organization to make its Forms 1023 (or 1024 if applicable), 990, and 990-T (601(c)(3)s only) available for public inspection. Indicate how you make these available. Check all that apply.
 Own website Another's website Upon request

19 Describe in Schedule O whether (and if so, how), the organization makes its governing documents, conflict of interest policy, and financial statements available to the public.

20 State the name, physical address, and telephone number of the person who possesses the books and records of the organization: ▶

Form 990 (2010)

SCHEDULE J
(Form 990)

Compensation Information
For certain Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees

OMB No. 1545-0047
2010
Open to Public Inspection

▶ Complete if the organization answered "Yes" to Form 990, Part IV, line 23.
▶ Attach to Form 990. ▶ See separate instructions.

Department of the Treasury Internal Revenue Service

Name of the organization _____ Employer identification number _____

Part I Questions Regarding Compensation

	Yes	No
1a Check the appropriate box(es) if the organization provided any of the following to or for a person listed in Form 990, Part VII, Section A, line 1a. Complete Part III to provide any relevant information regarding these items. <input type="checkbox"/> First-class or charter travel <input type="checkbox"/> Housing allowance or residence for personal use <input type="checkbox"/> Travel for companions <input type="checkbox"/> Payments for business use of personal residence <input type="checkbox"/> Tax indemnification and gross-up payments <input type="checkbox"/> Health or social club dues or initiation fees <input type="checkbox"/> Discretionary spending account <input type="checkbox"/> Personal services (e.g., maid, chauffeur, chef)		
b If any of the boxes on line 1a are checked, did the organization follow a written policy regarding payment or reimbursement or provision of all of the expenses described above? If "No," complete Part III to explain		
2 Did the organization require substantiation prior to reimbursing or allowing expenses incurred by all officers, directors, trustees, and the CEO/Executive Director, regarding the items checked in line 1a?		
3 Indicate which, if any, of the following the organization uses to establish the compensation of the organization's CEO/Executive Director. Check all that apply. <input type="checkbox"/> Compensation committee <input type="checkbox"/> Written employment contract <input type="checkbox"/> Independent compensation consultant <input type="checkbox"/> Compensation survey or study <input type="checkbox"/> Form 990 of other organizations <input type="checkbox"/> Approval by the board or compensation committee		
4 During the year, did any person listed in Form 990, Part VII, Section A, line 1a, with respect to the filing organization or a related organization: a Receive a severance payment or change-of-control payment from the organization or a related organization?		
b Participate in, or receive payment from, a supplemental nonqualified retirement plan?		
c Participate in, or receive payment from, an equity-based compensation arrangement?		
If "Yes" to any of lines 4a-c, list the persons and provide the applicable amounts for each item in Part III.		

Conflict of Interest Policy

- Duty of Loyalty
 - Owed by directors to charity
 - Requires director to act in the interest of charity
 - Not in personal interest of director or other person or organization
- Sample policy
 - Form 1023, Appendix A

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Conflict of Interest Policy

- Elements of Good Policy
 - Requires directors and staff to act solely in the interests of the charity without regard for personal interests
 - Includes written procedures for determining whether relationship, financial interest or business affiliation results in conflict of interest
 - Prescribes course of action in case conflict is identified

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Policy for Consistent Operation of Chapters, Branches & Affiliates

- Have local chapters, branches or affiliates?
Question 10a
- Have written policies and procedures governing the activities of chapters, branches or affiliates to ensure operations are consistent with organization? Question 10b

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Chapters, Branches & Affiliates Misbehaving

- Unrelated activities
 - UBIT?
 - Potential for loss of exemption?
- Bank accounts
 - Reported to organization
 - Same EIN or new EIN?
 - Tax reporting correct?

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Whistleblower Policy

- Handles employees complaints or unethical conduct
- Anonymous and/or confidential
 - To allay fears of retaliation or demotion

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Whistleblower Policy

- Considerations in formulating policy:
- Who is protected by policy
- What protection is provided
- How broad should policy be
- What is the reporting mechanism
- Who resolves complaints

102

Code of Ethics

- Describes behavior want to encourage and behavior want to discourage
- Communicate a strong culture of legal compliance and ethical conduct
- Implementation and enforcement critical
- “EO shall comply with all applicable local, state and federal laws and regulations”
- Sets a minimum standard

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Document Retention and Destruction Policy

- Policy for systematic review, retention and destruction of documents
- Rationales:
 - Promotes efficiency and frees up storage space
 - Protection in litigation
- Cease destruction upon notification of investigation by law enforcement

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Document Retention and Destruction Policy

- What documents covered?
 - Employment records
 - Accounting and tax records
 - Legal records
 - Electronic records
- Coordinate with archiving and back-up procedures

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Compensation Policy

- Prohibition on Excess Benefits
 - Private inurement – IRC 501(c)(3)
 - Absolute prohibition
 - Improper private benefit
 - Exception: Qualitatively and quantitatively incidental
 - Reasonable compensation: compensation must be reasonable for the services rendered

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Unrelated Business Income

- See the following:
Unrelated Business Income for Tax-Exempt Organizations Presentation Outline

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Unrelated Business Income for Tax-Exempt Organizations Presentation Outline

I. Overview of Unrelated Business Taxable Income (“UBTI”)

A. **Historical Framework.**

Before 1950, many tax-exempt organizations had begun to engage in commercial profit-making activities which competed with for-profit businesses, primarily relying on cases which looked to the destination of the income rather than its source. Legislation enacted in 1950, which was further expanded in 1969, imposed a tax on a tax-exempt organization’s unrelated business taxable income. The statutory framework for UBTI is located in Sections 511-515 of the Internal Revenue Code.¹

B. **Qualification for Tax-Exemption.**

To qualify for exemption from federal income tax, a nonprofit organization must be organized and operated exclusively for exempt purposes.² Despite this requirement, a tax-exempt organization is permitted to carry on some level of activity that is not related to its exempt purpose.³ If, however, the unrelated business activities become the primary purpose of the organization, its exemption will be revoked.⁴

¹ All Section references, unless otherwise noted, are to the Internal Revenue Code of 1986, as amended, or the Regulations thereunder.

² Section 501(c)(3). Treas. Reg. § 1.501(c)(3)-1.

³ Treas. Reg. § 1.501(c)(3)-1(e)(1).

⁴ Treas. Reg. §§ 1.501(c)(3)-1(c)(1), (e)(1). *See, e.g.* Rev. Rul. 73-127, 1973-1 C.B. 221; *United Missionary Aviation, Inc. v. Commissioner*, 60 TCM 1152 (1990).

C. Organizations Subject to the Tax.

The tax on unrelated business income applies to most organizations exempt from tax under IRC Section 501(a). These organizations include charitable, religious, scientific and other organizations described in IRC Section 501(c) as well as employees' trusts forming part of pension, profit-sharing and stock bonus plans described in IRC Section 401(a). Public colleges and universities and their wholly-owned subsidiaries are subject to tax on unrelated business income.

II. Three Criteria For Taxation.

Subject to certain modifications and exceptions, gross income from an activity carried on by a tax exempt organization is subject to the unrelated business income tax if the following three criteria are present:

A. Trade or Business.

1. Definition.

The activity is a "trade or business," which is defined as any activity carried on for the production of income from the sale of goods or the performance of services.⁵ The term "trade or business" is not limited to integrated aggregates of assets, activities and goodwill which comprise businesses for other provisions of the Internal Revenue Code.

2. Fragmentation Rule.

A trade or business from which a particular amount of income is derived does not lose its identity merely because it is carried on within a larger aggregate of other activities, which may or may not be related to the organization's exempt purpose.⁶ This rule is commonly referred to as the "fragmentation rule." For example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose its identity as a trade or business merely because the pharmacy also

⁵ Section 513(c).

⁶ Section 513(c); Treas. Reg. Sec. 1.513-1(b).

furnishes the supplies to the hospital and patients of the hospital in accordance with its exempt purposes.

B. Regularly Carried On.

1. Definition.

The activity is “regularly carried on” by the tax exempt organization. Specific business activities of a tax exempt organization will ordinarily be deemed to be “regularly carried on” if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.⁷

2. Time Variations.

Where income producing activities are of a kind normally conducted by for-profit commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a shorter period of time, such as a few weeks, would not constitute the regular carrying on of a trade or business. However, where the income producing activities are normally undertaken by for-profits only on a seasonal basis, the conduct of such activities by a non-profit during a significant portion of the season generally would constitute the regular conduct of a trade or business.

C. Not Substantially Related.

1. Causal Relationship Definition.

The conduct of the activity is “not substantially related” (other than through the production of funds) to the performance of the organization’s exempt function.⁸ A trade or business which is “related” is one which is causally related to the achievement of the organization’s exempt purpose and the causal relationship is a substantial one that “contributes importantly” to the tax exempt purpose.⁹

⁷ Treas. Reg. § 1.513-1(c)(1).

⁸ Section 513(a).

⁹ Treas. Reg. § 1.513-1(d)(2)

2. Larger than necessary.

Where income is realized from activities which are conducted on a larger scale than is necessary for the performance of the exempt function, the income attributable to the excess constitutes gross income from the conduct of a trade or business. See, Internal Revenue Manual 7.27.5.4. If the organization generates too much of such income, it might jeopardize exempt status.

III. Modifications: Investment Income.

Section 512(b) excludes from the calculation of UBTI specific items commonly viewed as derived from passive investments.

A. **Dividends.**

Dividends and all deductions directly connected with dividend income are excluded from calculation of UBTI.¹⁰

1. There are some exceptions:
 - a. dividends that are debt-financed
 - b. dividends from insurance activity income of controlled foreign corporations.

B. **Interest.**

Interest and all deductions directly connected with interest income are excluded from calculation of UBTI.¹¹

1. There also may be exceptions if:
 - a. interest income that is debt-financed
 - b. interest that is paid by a controlled for-profit corporation

C. **Annuities.**

Annuities and all deductions directly connected with the annuities are

¹⁰ Section 512(b)(1).

¹¹ Section 512(b)(1).

excluded from calculation of UBTI.¹²

1. Exceptions:
 - a. Payments received by an exempt organization on securities in its investment portfolio which are loaned to brokers are not treated as unrelated business income.¹³

D. Royalties.

Royalty payments are excluded from UBTI, along with all deductions directly connected with such payments.¹⁴ To be a royalty, the payment must relate to the use of a valuable right. This is discussed further below.

E. Rent.

Rents and all deductions directly connected with rents are excluded from UBTI¹⁵ for:

1. all rents from real property,¹⁶ and
2. rents from personal property leased in connection with real property, if the rents attributable to the real property are an incidental amount of the total rents.¹⁷ received or accrued under the lease. Rents attributable to personal property leased with real property are not regarded as an incidental amount if the personal property rents exceed 10% of the total rents from all property leased, determined at the time the personal property is first placed

¹² Section 512(b)(1).

¹³ Section 512(b)(1).

¹⁴ Section 512(b)(2).

¹⁵ Section 512(b)(3).

¹⁶ Section 512(b)(3)(A)(i).

¹⁷ Section 512(b)(3)(A)(ii).

in service.¹⁸

3. Three Exceptions to Rental Exclusion.
 - a. The rental exclusion does not apply if more than 50% of the total rent received or accrued under the lease is attributable to personal property.¹⁹
 - b. The rental exclusion does not apply if the determination of the rent depends in whole or in part on the income or profits of the lessee, other than an amount based on a fixed percentage of receipts or sales.²⁰
 - c. Payments for the use or occupancy of space where services are also rendered to the occupant should be examined closely. Rent should be excluded where the exempt owner is providing services usually or customarily rendered in connection with rental of space, such as normal cleaning of public entrances, exits, stairways, furnishing of heat and light (utilities) and collection of trash. However, if the exempt owner exceed this, and provides services to the tenant for the convenience of the tenants (such as providing a maid service) the payments are not considered rent from real property.²¹
4. Example: Services provided with lease
 - a. Exempt university leases its football stadium to a professional football team for several months for a fixed

¹⁸ Treas. Reg. § 1.512(b)-1(c)(2)(ii).

¹⁹ Section 512(b)(3)(B)(i).

²⁰ Section 512(b)(3)(B)(ii).

²¹ Treas. Reg. § 1.512(b)-1(c)(5).

fee.

- b. University furnishes heat, light, water, and is responsible for all ground maintenance.
- c. University also provides dressing room, linen, and stadium security services for the professional team.
- d. IRS Position: leasing is an unrelated business: substantial services furnished for the convenience of the lessee go beyond those usually provided with the rental for occupancy only.
- e. Page 4 of Pub. 598

F. Controlled Corporations.

1. Inapplicability of exclusions.

Under Section 512(b)(13), the exclusions of interest, annuities, royalties and rents provided by Section 512(b)(1), (2) and (3) do not apply where those amounts are derived from controlled organizations. Section 512(b)(13) provides that if any organization (“controlling organization”) receives or accrues, directly or indirectly, any interest, annuity, royalty or rent, from a controlled entity, the controlling organization must include the payment as an item of gross income derived from UBTI to the extent that the payment reduces the “net unrelated income” of the controlled entity.

2. “Net unrelated income” definition.

“Net unrelated income” means, in the case of a for-profit subsidiary, the portion of the entity's taxable income which would be UBTI if the entity would be tax-exempt and had the same purposes as the controlling organization; in the case of a tax-exempt subsidiary, the amount of UBTI of the tax-exempt subsidiary.

3. Definition of “control.”

The term “control” means in the case of a corporation, ownership by vote or value of more than 50 percent of the stock in such corporation; in the case of a partnership, ownership of more than 50 percent of the profits interests or capital interests

in such partnership; or in any other case, ownership of more than 50 percent of the beneficial interests in the entity. The constructive ownership rules of Section 318 (relating to constructive ownership of stock) apply for purposes of ownership of stock in a corporation. Similar principles apply for purposes of determining ownership of interests in any other entity.

G. Partnerships and Joint Ventures.

A tax exempt organization that is a partner in a partnership that regularly engages in a trade or business that would be an unrelated trade or business if carried on directly by the tax exempt organization is required to include in UBTI its share of income (whether or not distributed) and attributable deductions.²² Thus a tax exempt partner is required to classify each trade or business activity of a partnership as either related or unrelated to the organization's exempt purposes. Amounts derived by a tax exempt organization from "debt-financed property" are subject to tax under Section 511.²³

H. Affinity Credit Cards (Royalty versus Personal Services)

1. IRS Position.

Income from the licensing of name, logo, copyrights, trademarks, etc., is royalty income and thus exempt under Section 512(b)(2). However, except for the right to oversee quality control, there can be no performance of services by the tax exempt organization. The IRS view has been that in using the term "royalties" in Section 512(b)(2), Congress had in mind only "investment income" and intended "royalties" to describe only passive income of that character.

2. "Sierra Club I"²⁴

The Tax Court ignored the active/passive argument of the IRS in ruling for Sierra Club on rental or sale of its mailing list and refused to exclude from the

²² Section 512(c).

²³ Section 514.

²⁴ *Sierra Club v. Commissioner*, 65 TCM 2582 (1993).

term “royalty” payments for the use of intangible property derived from active conduct of a trade or business. The Court rejected the IRS position that Section 513(h)(1)(B) created a *per se* UBTI result where the exchange or rental of a mailing list was not between certain tax exempt organizations.

3. “Sierra Club II”²⁵

Payments received by the Sierra Club from an affinity card arrangement with American Bankcard Services (“Bank”) were tax exempt royalties income. Sierra Club agreed to assist in the solicitation and encouragement of member to own and use the card. Cards were solicited on Sierra Club letterhead and the club reserved the right to approve all promotional material. The Tax Court held that the income from the credit cards were royalties from the use of intangible assets (name, logo, use of mailing list).

4. “Sierra Club III”²⁶

The Ninth Circuit held that a royalty is by definition “passive” and, thus, cannot include compensation for services rendered by the owner of the intangible property. The Ninth Circuit reversed the Tax Court’s grant of summary judgment in Sierra Club II, and remanded the case to the Tax Court for determination of whether Sierra Club’s contract with the Bank called for services (and would thus result in UBTI) or use of the name, logo and mailing list (and thus would be a royalty).

5. “Sierra Club IV”²⁷

The Tax Court ruled against the IRS’s determination that the amount received by Sierra Club were consideration for services and held that the amounts were royalties. Sierra Club did not control marketing for the credit card program and thus was not compensated for providing marketing services. Further, the club did not treat the

²⁵ *Sierra Club v. Commissioner*, 103 T.C. 307 (1994).

²⁶ *Sierra Club v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996).

²⁷ *Sierra Club v. Commissioner*, 77 TCM 1999 (1999).

credit card as a member service, the receipts were not attributable to the club's advertising or use of its mail permit. The club's contractual obligation to cooperate was not an agreement to endorse or promote the credit card program beyond the endorsement that necessarily results from intangible licensing.

The IRS argued that the club provided a service pursuant to the credit card program when the club guaranteed a refund of the second year membership fee (if imposed by the Bank). The club was not required to use its own funds to refund the annual fee if charged by the Bank. The court reasoned that since the club was receiving royalty income in consideration of assuming the risk of damage to its intangible assets, when that risk matured into a foreseeable loss, the club spend its own money to avoid that loss. These reimbursements were held not to be inconsistent with its receipt of royalty income.

6. Oregon cases.

The Tax Court had previously held that the Oregon State University and Oregon University affinity card income constitute royalty income and was not UBTI.²⁸ The cases were consolidated on appeal. The Ninth Circuit affirmed the Tax Court decisions.²⁹ The alumni associations raised money for their schools by allowing a bank to offer credit cards using their names. The associations agreed to provide accurate mailing lists and to provide materials the bank could reproduce and distribute to alumni. The court reasoned that the alumni associations spent approximately 50 hours of mostly secretarial and clerical work during the two years at issue pursuant to the contracts with the banks. The Ninth Circuit affirmed the Tax Court's conclusion that the bank paid the alumni associations for the use of their property rights, not for their services.

7. Revised IRS View.

²⁸ *Oregon State University Alumni Association, Inc. v. Commissioner*, 71 TCM 1935 (1996); *Alumni Association of the University of Oregon v. Commissioner*, 71 TCM 2093 (1996).

²⁹ *Oregon State University Alumni Association, Inc. v. Commissioner*, No. 96-70565 (Oct. 4, 1999).

(Then) IRS Exempt Organization Division Director Marcus Owens reacted to the Ninth Circuit’s decision in the Oregon cases by remarking that he does not expect continued litigation by the IRS on affinity cards and mailing list rentals. One alternative which may be considered by the IRS is “reasonable allocation,” in which tax exempt organizations would allocate income from their affinity arrangements between payments for property rights and payments for services. He was quoted, “It is an approach that we have used internally in some cases, and I think if done in a reasonable fashion it might be a good methodology for dealing with these questions.”³⁰

IV. Exceptions for Particular Activities.

A. ***Volunteer Labor.***

Income from any trade or business in which substantially all of the work is carried out by volunteers is not UBTI.³¹ For example, an orphanage operating a retail store where substantially all the work in carrying on the business is performed by unpaid volunteers would not be carrying on an unrelated trade or business.

B. ***Thrift Shops.***

Section 513(a)(3) excludes from the definition of an unrelated trade or business businesses that involves the sale of merchandise, substantially all of which has been received by the organizations as gifts or contributions. For example, the operation of a thrift shop by a 501(c)(3) organization, which sells donated clothes and books to the general public, would not be considered an unrelated trade or business.³²

C. ***Primarily For Convenience of Members, Students, etc.***

A trade or business carried on for the benefit of an organization’s

³⁰ Stokeld, *IRS Litigation of Affinity Cases to Stop, Owens Says*, Tax Notes, page 433 (Oct. 25, 1999).

³¹ Section 513(a)(1).

³² Rev. Rul. 71-581, 1971-2, C.B. 236.

members, students, patients, officers or employees is excepted.³³ For example, the operation of a cafeteria and coffee shop by a hospital, for the convenience of its employees and medical staff is not an unrelated trade or business.³⁴

D. Research.

One of the exempt purposes under Section 501(c)(3) is “scientific.” Income from research that is substantially related to an organization's scientific purposes does not constitute UBTI. The term “research” has a variety of meanings and is not synonymous with “scientific.” The nature of particular research depends on the purpose it serves. For research to be scientific, it must be carried out in furtherance of a scientific purpose. The term “scientific” includes the carrying on of scientific research in the public interest. Whether research is classified as scientific may depend on whether the research is fundamental or basic, in contrast to research which is applied or practical.³⁵ Scientific research does not include activities ordinarily carried out incident to commercial operations, such as the testing or inspection of materials or products or the designing or construction of equipment or buildings.

Even if the organization's research activities do not meet the requirements for scientific research, amounts derived from such research might still be excluded from UBTI if certain provisions of Section 512(b)(7), (8) or (9) are applicable. Section 512(b)(7) excludes from UBTI all income derived from research performed for the United States, or any of its agencies or instrumentalities, or any State or political subdivision thereof.

Section 512(b)(8) excludes from UBTI all income derived from research performed “for any person” by a college, university or hospital. Income from research conducted by a college, university or hospital will not be subject to the tax on UBTI

³³ Section 513(a)(2).

³⁴ Rev. Rul. 69-269, 1969-1 C.B. 160.

³⁵ Treas. Reg. § 1.501(c)(3)-1(d)(5).

without regard to whether the research activities further the exempt purpose of the organization.

Section 512(b)(9) excludes from UBTI all income derived from research performed “for any person” by an organization operated primarily for the purpose of carrying on fundamental research. Such research may be performed for any person, but the results of such research must be freely available to the general public. Whether an organization is operated primarily for the purpose of carrying on fundamental, as opposed to applied, research is a question of fact, determined based on all of the facts and circumstances.

E. ***S Corporations Income and Sales.***

Exempt charitable organizations are allowed to be shareholders in small business corporations, also known as S corporations. Despite the pass-through treatment that normally is afforded to S corporation shareholders; income, loss and deduction from S corporations flow through to exempt organization as unrelated business taxable income, irrespective of the source or nature of the income.³⁶ On disposition of S corporation stock, any gain received is also automatically treated as unrelated business income.³⁷

F. ***Other excluded trade or business activities.***

1. Employee association sales. See pages 7 and 8 of Publication 598, Tax on Unrelated Business Income of Exempt Organizations (“Pub 598”).
2. Gambling Activities, Including Bingo Games. See page 8 of Pub 598.
3. Distribution of Low Cost Articles incidental to soliciting charitable contributions. See page 8 of Pub 598.
4. Exchange or Rental of Member Lists. See page 8 of Pub 598.

³⁶ Section 512(e)(1)(B)(i).

³⁷ Section 512(e)(1)(B)(ii)

5. Convention or trade show activity conducted at a convention, annual meeting or trade show. See page 8 of Pub 598.
6. Pole rentals by a mutual or cooperative telephone or electric company. See page 8 of Pub 598.

V. Debt Financed Rules.

A. **Formula.**

Section 514 expands UBTI to include “unrelated debt-finance income” from investment property. Income from investment property is subject to liability if there is “acquisition indebtedness” regarding such property. The investment income included in UBTI is proportionate to the debt on the property. The formula for deriving “unrelated debt-financed income” is:

$$\begin{array}{rcccl} \text{Average acquisition} & & \text{Gross income from debt-finance} & & \text{Unrelated debt} \\ \text{Indebtedness} & \times & \text{property} & = & \text{Financed income} \end{array}$$

Under this formula, the percentage of income treated as income from an unrelated trade or business decreases as the indebtedness on the debt-financed property decreases.

The term “average acquisition indebtedness” means the amount of outstanding principal indebtedness during that portion of the taxable year the property is held by the organization. It is computed by determining the principal on the first day of each calendar month, adding them together, then dividing the sum by the total number of months during the year the organization held the property.

B. **Acquisition Indebtedness.**³⁸

For any debt-financed property, acquisition indebtedness is the unpaid amount of debt incurred by the organization:

1. When acquiring or improving the property.
2. Before acquiring or improving the property if the debt would not have been incurred except for the acquisition or improvement of

³⁸ Section 514(c)(1).

the property, and

3. After acquiring or improving the property if:
 - a. The debt would not have been incurred except for the acquisition or improvement, and
 - b. Incurring the debt was reasonably foreseeable when the property was acquired or improved.
4. Certain debts and obligations are not acquisition indebtedness:
 - a. Debts incurred in performing an exempt purpose
 - b. Annuity obligations
 - c. Securities loans
 - d. Real property debts of qualified organizations (qualified retirement plans, educational organizations and affiliated support organizations or title holding companies)
 - e. Certain federal financing

C. Exceptions to Debt-Financed Property.

Certain property is excepted from treatment as debt-financed property:

1. If substantially all (85% or more) of the use of any property is substantially related to the organization's exempt purposes, the property is not treated as debt-financed property. Related use does not include a use related solely to the organization's need for income or the use of its profits.
2. To the extent that income from any property is treated as unrelated business taxable income, the property is not treated as debt-financed property.
3. Property that produces gross income derived from research activities is not treated as debt-financed property.
4. Debt-financed property does not include property used in a trade or business that is excluded from the definition of "unrelated trade or

business” because of the volunteer exception, the convenience exception or the donated merchandise exception.

5. Property owned by an exempt organization and used by a related organization when the property is used to further its exempt purpose.

VI. Corporate Sponsorship.

A. **Distinction from Advertising**

Section 513(i) draws a distinction between activities that constitute advertising, the income from which may be subjected to tax as UBTI, and activities that constitute sponsorship, the income from which is not taxed to the recipient exempt organization. The solicitation and receipt of "qualified sponsorship payments" ("QSP") by an exempt organization does not constitute an unrelated trade or business.

B. **QSPs**

1. Definition

A QSP is defined as any payment made by a person engaged in a trade or business where there is no "arrangement" or "expectation" that the person will receive any "substantial return benefit" for the payment.³⁹

2. Use or Acknowledgment

The use or acknowledgment of the payor's name, logo or product lines is not a "substantial return benefit." The use or acknowledgment may not include any qualitative or comparative language or price information.⁴⁰ It must not include other indications of savings or value, an endorsement, or an inducement to purchase, sell or use the products or services.⁴¹ Logos or slogans that are an established part of the sponsor's

³⁹ Section 513(i)(2)(A).

⁴⁰ Section 513(i)(2)(A).

⁴¹ Section 513(i).

identity are not considered qualitative or comparative descriptions.⁴²

3. Disregarded Benefits

Benefits are disregarded, and therefore not considered to be a “substantial return benefit,” provided that the market value of all the benefits provided to the payor or persons designated by the payor is not more than 2 percent of the amount of the payment made to the organization during the organization’s tax year.⁴³ If the aggregate fair market value of the benefits provided to the payor exceeds 2 percent of the amount of the sponsorship payment, then the entire fair market value of the benefits is a substantial return benefit, unless it is an excluded use or acknowledgement.⁴⁴

4. Permitted Acknowledgments

Use or acknowledgment may include a list of the payor's locations, telephone numbers or Internet address. The mere display of the payor's product by the payor or by the tax-exempt organization to the general public at the sponsored activity is not considered an inducement to purchase, sell or use the payor's products.⁴⁵

5. Contingent Payments

A QSP does not include a payment that is contingent upon factors indicating the degree of public exposure to one or more events, such as the level of attendance or broadcast ratings.⁴⁶ The regulations further provide that the fact that a payment is contingent on the sponsored activities actually occurring will not prevent the payment from being a QSP.⁴⁷

⁴² Reg. § 1.513-4(c)(2)(iv).

⁴³ Reg. § 1.513-4(c)(2)(i).

⁴⁴ Reg. §§ 1.513-4(c)(2)(ii).

⁴⁵ Reg. § 1.513-4(c)(2)(iv)

⁴⁶ Section 513(i)(2)(B)(i).

⁴⁷ Reg. § 1.513-4(e)(2).

6. Periodicals

The QSP safe-harbor does not apply where the use or acknowledgment appears in regularly scheduled and printed material published by the exempt organization that is not related to and distributed in connection with a specific event conducted by the exempt organization (such as a program).⁴⁸

7. Relatedness to Exempt Purpose

It is irrelevant whether the sponsorship activity is related or unrelated to the exempt organization's exempt purpose.⁴⁹ This is important for fund-raising events that bear no direct relationship to the organization's exempt purpose, other than raising needed funds. It is also not relevant whether the sponsored event is temporary or permanent: it may be an activity of continuing or indefinite duration or a series of events.

C. **Exceptions to QSP Rules**

There are exceptions to the general QSP rules for contingent payments (discussed above), payments for acknowledgments in periodicals, and payments made in connection with conventions and trade shows.

D. **Tainting Rules**

Section 513(i) does not have the "tainting rule," whereby any message that constitutes advertising "taints" all related messages, even if they might otherwise qualify as mere acknowledgments. Instead, to the extent that any portion of the payment would be a QSP if made separately, it is treated as a separate payment. The statute does not specify the method of allocation. The regulations include an allocation method that places the burden on the exempt organization to establish the fair market value of any substantial return benefit.⁵⁰ Effectively, this applies a residual method of allocation to the

⁴⁸ Section 513(i)(2)(B)(ii)(I).

⁴⁹ Reg. § 1.513-4(c)(2).

⁵⁰ Reg. § 1.513-4(d)(1).

QSP portion of a payment.

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Questions and Comments

- Questions?
- Comments?

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