Sample Church
Balance Sheet
December 31, 2015

Assets

Cash	$	8,000
Accounts Receivable		2,000
Prepaid Expenses		2,000
Short-term Investments		10,000
Property and Equipment, net		400,000
Long-term Investments		50,000
Total Assets	$	472,000

Liabilities and Net Assets

Liabilities:		
Accounts Payable	$	5,000
Other Accrued Liabilities		4,500
Notes Payable		65,000
Total liabilities		74,500
Net Assets:		
Unrestricted		342,500
Restricted		55,000
Total Net Assets		397,500
Total Liabilities and Net Assets	$	472,000

Sample Church
Statement of Activities
December 31, 2015

	Actual	Budget	Variance
Income			
Contributions			
Pledges	$ 70,000	$ 80,000	$ (10,000)
Offering Plate	2,500	4,000	(1,500)
Special Offerings	4,000	3,200	800
Earned Income			
Building Rental	11,000	12,000	(1,000)
Church Bazaar	1,000	1,800	(800)
Investment Income			
Interest	150	100	50
Endowment	4,500	3,000	1,500
Miscellaneous	200	800	(600)
Total Income	93,350	104,900	(11,550)
Expenses			
Personnel			
Salaries & Benefits	61,000	65,000	(4,000)
Payroll Taxes	3,500	5,100	(1,600)
Programs			
Christian Education	1,500	1,900	(400)
Children & Youth	2,100	2,000	100
Mission			
OCWM	7,000	8,000	(1,000)
Special Offerings (4)	4,000	3,200	800
Building & Grounds			
Mortgage Interest	3,000	3,400	(400)
Utilities	10,000	6,000	4,000
Janitorial	5,000	4,000	1,000
Repairs	1,300	1,200	100
Property Insurance	3,500	3,000	500
Administrative Expenses			
Office	900	1,200	(300)
Phone & Internet	800	900	(100)
Total Expenses	103,600	104,900	(1,300)
Net Income (Loss)	$ (10,250)	$ -	$ (10,250)

The Pension Boards
United Church of Christ, Inc.

2016

Federal Reporting Requirements for Churches

Prepared by Church Law & Tax Report
Published by The Pension Boards–United Church of Christ, Inc.

Federal Reporting Requirements for Churches

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This publication is intended to provide a timely, accurate, and authoritative discussion of tax reporting compliance, and the impact of recent changes in the tax laws. It is not intended as a substitute for legal, accounting, or other professional advice. If legal, tax, or other expert assistance is required, the services of a competent professional should be sought. Although we believe this book provides accurate information, there may be changes resulting from IRS or judicial interpretations of the Tax Code, new tax regulations, or technical corrections that occurred after the printing of this edition that are not reflected in the text.

The most important federal reporting obligation for most churches is the withholding and reporting of employee income taxes and Social Security taxes. These payroll reporting requirements apply, in whole or in part, to almost every church. Yet many churches do not fully comply with them for various reasons, including the following:

- The church treasurer is elected by the congregation and does not remain in office long enough to understand the application of the payroll tax reporting rules to churches.
- Church leaders assume that churches are exempt from the payroll tax reporting requirements. This is a false assumption. The courts have rejected the argument that the application of the payroll tax reporting rules to churches violates the constitutional guaranty of religious freedom.
- There are a number of special payroll tax reporting rules that apply to churches, and these often are not clearly understood by church staff members. These special rules include the following:
  - *Ministers are self-employed for Social Security with respect to their ministerial services.* While most ministers are employees for federal income tax reporting purposes, they are self-employed for Social Security with respect to services they perform in the exercise of ministry. This means that they pay the self-employment tax (SECA) rather than the employee's share of Social Security and Medicare taxes – even if they report their federal income taxes as a church employee. It is incorrect for churches to treat ministers as employees for Social Security and to withhold the employee's share of Social Security and Medicare taxes from their wages.
  - *A minister's wages are exempt from income tax withholding.* Wages paid to a minister as compensation for ministerial services are exempt from income tax withholding whether the minister reports income taxes as an employee or as self-employed. Ministers use the estimated tax procedure to pay their federal taxes, unless they have entered into a voluntary withholding agreement with their employing church.
  - Some churches are exempt from the employer's share of Social Security and Medicare taxes because they filed a timely exemption application. For most churches, this exemption had to be filed before October 31, 1984. The exemption does not excuse the church from income tax withholding, filing Form 941, or issuing W-2 forms to church employees. The non-minister employees of a church that filed such an exemption application are treated as self-employed for Social Security, and must pay the self-employment tax (SECA) if they are paid $108.28 or more during the year.

Warning: Federal law specifies that any corporate officer, director, or employee who is responsible for withholding taxes and paying them over to the government may be liable for a penalty in the amount of 100 percent of such taxes if they are either not withheld or not paid over to the government. This penalty is of special relevance to church leaders, given the high rate of non-compliance by churches with the payroll reporting procedures.

HOUSING ALLOWANCE (parsonage allowance)
The most important tax benefit available to ministers who own or rent their home is the housing allowance exclusion. Unfortunately, many churches fail to designate a portion of their minister's compensation as a housing allowance, and thereby deprive the minister of an important tax benefit.

A housing allowance is simply a portion of a minister's compensation that is so designated in advance by the minister's employing church. For example, in December of 2015 a church agrees to pay its pastor total compensation of $45,000 for 2016, and designates $15,000 of this amount as a housing allowance. (The remaining $30,000 is salary.) This costs the church nothing. It is simply a matter of designating part of a minister's salary as a housing allowance.

The Tax Code specifies that the housing allowance of a minister who owns or rents a home is non-taxable in computing federal income taxes to the extent that it is (1) declared in advance, (2) used for housing expenses, and (3) does not exceed the fair rental value of the minister's home (furnished, plus utilities).

- ✓ ***Key Point.*** Under no circumstances can a church designate a housing allowance retroactively.

- ✓ ***Key Point.*** Although repayments of principal and interest on a home mortgage loan qualify as a housing expense to which a housing allowance can be applied, costs associated with refinancing a principal residence or a home equity loan qualify only if the proceeds are used for housing expenses.

Ministers who live in a church-owned parsonage that is provided rent-free as compensation for ministerial services do not include the annual fair rental value of the parsonage as income in computing their federal income taxes. The annual fair rental value is not deducted from the minister's income. Rather, it is not reported as additional income on Form 1040 (as it generally would be by non-clergy workers). Ministers who live in a church-provided parsonage do not pay federal income taxes on the amount of their compensation that their employing church designates in advance as a parsonage allowance, to the extent that the allowance represents compensation for ministerial services and is used to pay parsonage-related expenses such as utilities, repairs, and furnishings.

Note that the housing allowance and fair rental value of a parsonage are non-taxable only when computing federal income taxes. Ministers must include their housing allowance and rental value of a parsonage as taxable income when computing their self-employment taxes (except for retired ministers). In addition, any housing provided to a minister that is excludable from taxable income pursuant to IRC §119, under the convenience of the employer statute, also must be included in a minister's taxable income when computing self-employment income.

- ✓ ***Key Point.*** Be sure that the designation of a housing allowance for the following year is on the agenda of the church for one of its final business meetings of the current year. The designation should be an official action, and it should be duly recorded in the minutes of the meeting. The IRS also recognizes designations in employment contracts and budget line items – assuming that the church duly adopted the designation and it is reflected in a written document.

ACCOUNTABLE REIMBURSEMENTS
The best way for ministers to handle their ministry-related business expenses is to have their employing church adopt an *accountable* expense reimbursement arrangement. An accountable arrangement is one that meets the following four requirements: (1) only business expenses are reimbursed; (2) no reimbursement without an adequate accounting of expenses within a reasonable period of time (not more than 60 days after an expense in incurred); (3) any excess reimbursement or allowance must be returned to the employer within a reasonable period of time (not more than 120 days after an excess reimbursement is paid); (4) an employer's reimbursements must come out of the employer's funds and not by reducing the employee's salary. Under an accountable plan, an employee reports to the church rather than to the IRS. The reimbursements are not reported as taxable income to the employee, and the employee does not claim any deductions. This is the best way for churches to handle reimbursements of business expenses.

- ✓ ***Key Point.*** Reimbursements of business expenses under an accountable arrangement are not reported as taxable income on an employee's Form W-2 or Form 1040, and there are no deductions to claim. In effect, the employee is reporting to the church rather than to the IRS. This often translates into significant tax savings for the employee.

An *accountable* reimbursement arrangement should be established by the church board or congregation in an appropriate resolution. In adopting a resolution, pay special attention to the following rules:

- Condition the reimbursement of any expense on adequate substantiation. This will include written evidence for all expenses and receipts for expenses of $75 or more. For most expenses, the evidence must substantiate the amount, date, place, and business nature of each expense. The key point is this: A church must require the same degree of substantiation

as would be required for a deduction on the minister's income tax return.

- Expenses must be substantiated, and excess reimbursements returned to the church, within a reasonable time. Expenses will be deemed substantiated within a reasonable time if they are substantiated within 60 days. Excess reimbursements will be deemed to be returned to the employer within a reasonable time if they are returned within 120 days.
- Churches occasionally reimburse ministers for non-business expenses. Such reimbursements, though they require an accounting, ordinarily must be included in the minister's wages for income tax reporting purposes, and they are not deductible by the minister. Such personal, living, or family expenses are not deductible, and the entire amount of a church's reimbursement must be reported as taxable income on the minister's Form W-2 and Form 1040.

FLEXIBLE SPENDING ACCOUNTS

A health flexible spending arrangement (FSA), such as the Flexible Benefit Plan for UCC Ministries, allows employees to be reimbursed for medical expenses. FSAs are usually funded through voluntary salary reduction agreements with one's employer. No payroll taxes are deducted from employee contributions. The employer also may contribute.

✓ ***Key Point.*** Unlike health spending arrangements which must be reported on Form 1040, FSA contributions are not reported on the employee's Form 1040.

FSAs have several benefits, including the following: (1) employer contributions can be non-taxable; (2) no payroll taxes are deducted from employee contributions; (3) withdrawals may be tax-free if used to pay qualified medical expenses; (4) employees can withdraw funds from an FSA to pay qualified medical expenses even if they have not placed the funds in the account.

Generally, distributions from a health FSA must be paid to reimburse the employee for qualified medical expenses. Qualified medical expenses are those incurred by an employee, or the employee's spouse and certain dependents (including a child under age 27 at the end of the year).

Employees must be able to receive the total amount they have elected to contribute for the year at any time during the year, regardless of the amount they have actually contributed.

FSAs are "use-it-or-lose-it" plans. This means that amounts in the account at the end of the plan year cannot be carried over to the next year. However, the plan can provide for a grace period of up to 2½ months after the end of the plan year. If there is a grace period, any qualified medical expenses incurred in that period can be paid from any amounts left in the account at the end of the previous year. An employer is not permitted to refund any part of the balance to the employee.

✓ ***Key Point.*** An employer, at its option, may amend its cafeteria plan document to provide for the carryover to the immediately following plan year of up to $500 of any amount remaining unused as of the end of the plan year in a health FSA. The carryover of up to $500 may be used to pay or reimburse medical expenses under the health FSA incurred during the entire plan year to which it is carried over. For this purpose, the amount remaining unused as of the end of the plan year is the amount unused after medical expenses have been reimbursed at the end of the plan's run-out period for the plan year. In addition to the unused amounts of up to $500 that a plan may permit an individual to carry over to the next year, the plan may permit the individual to also elect up to the maximum allowed salary reduction amount ($2,550 for 2016). Thus, the carryover of up to $500 does not count against or otherwise affect the $2,550 salary reduction limit applicable to each plan year. Although the maximum unused amount allowed to be carried over in any plan year is $500, the plan may specify a lower amount as the permissible maximum (and the plan sponsor has the option of not permitting any carryover at all). A plan adopting this carryover provision is not permitted to also provide a grace period with respect to health FSAs. **The Flexible Benefit Plan for UCC Ministries has a $500 carryover provision and no grace period.**

The maximum amount available for reimbursement of incurred medical expenses of an employee and the employee's dependents under a health FSA cannot exceed $2,550 for 2015, or $2,550 for 2016.

Note that the Affordable Care Act prohibits employers from using an FSA to pay for, or reimburse, the cost of individually-owned health insurance policies with pre-tax dollars.

✓ ***Key Point.*** The Flexible Benefit Plan for UCC Ministries has a $500 carryover provision and no grace period.

✓ ***Key Point.*** Non-prescription medicines (other than insulin) do not qualify as an expense for FSA purposes.

✓ ***Key Point.*** For more information on enrolling employees in the Flexible Benefit Plan for UCC Ministries, contact the Pension Boards toll-free at **1.800.642.6543, Option 6**.

SECTION 403(b) PLANS

A 403(b) plan, also known as a tax-sheltered annuity or retirement income account, is a retirement plan for certain employees of churches and other tax-exempt organizations. These plans have the following tax benefits: (1) Employees do not pay income tax on allowable contributions until they begin making withdrawals from the plan, usually after they retire. Note, however, that lay employees must pay Social Security and Medicare tax on their contributions to a 403(b) plan, including those made under a salary reduction agreement. (2) Earnings and gains on amounts in an employee's 403(b) account are not taxed until they are withdrawn. (3) Employees may be eligible to claim the retirement savings contributions credit ("saver's credit") for elective deferrals contributed to a 403(b) account.

There are limits on the amount of contributions that can be made to a 403(b) account each year. If contributions made to a 403(b) account are more than these contribution limits, penalties may apply. Generally, annual contributions to a 403(b) plan cannot exceed either the limit on annual additions or the limit on elective deferrals. See IRS Publication 571 for details.

✓ ***Key Point.*** The Annuity Plan for the United Church of Christ is an effective way of establishing a retirement plan for church employees. Contact the Pension Boards' Member Services Department toll-free at **1.800.642.6543, Option 6** for more information.

Step 1. Obtain an employer identification number (EIN) from the federal government if this has not been done.

This number must be recited on some of the returns listed below and is used to reconcile a church's deposits of withheld taxes with the W-2 forms it issues to employees. The EIN is a nine-digit number that looks like this: 00-0246810. If your church does not have an EIN, you may apply for one online. Go to the IRS website at **www.irs.gov** for information. You may also apply for an EIN by calling **1.800.829.4933**, or you can fax or mail Form SS-4 to the IRS. You should have only one EIN.

✓ ***Key Point.*** An employer identification number is not a tax exemption number and has no relation to your nonprofit corporation status. It merely identifies you as an employer subject to tax withholding and reporting and ensures that your church receives proper credit for payments of withheld taxes. You can obtain an EIN by submitting a Form SS-4 to the IRS.

Step 2. Determine whether each church worker is an employee or self-employed.

In some cases, it is difficult to determine whether a particular worker is an employee or is self-employed. If in doubt, churches should treat a worker as an employee, since substantial penalties can be assessed against a church for treating a worker as self-employed whom the IRS later reclassifies as an employee. In general, a self-employed worker is one who is not subject to the control of an employer with respect to how a job is to be done. Further, a self-employed person typically is engaged in a specific trade or business and offers his or her services to the general public.

The IRS and the courts have applied various tests to assist in classifying a worker as an employee or self-employed. Factors that tend to indicate employee status include the following:

- The worker is required to follow an employer's instructions regarding when, where, and how to work.
- The worker receives on-the-job training from an experienced employee.
- The worker is expected to perform the services personally, and not use a substitute.
- The employer rather than the worker hires and pays any assistants.
- The worker has a continuing working relationship with the employer.
- The employer establishes set hours of work.
- The worker is guaranteed a regular wage amount for an hourly, weekly, or other period of time.
- The worker is expected to work full time.
- The work is done on the employer's premises.
- The worker must submit regular oral or written reports to the employer.
- The worker's business expenses are reimbursed by the employer.
- The employer furnishes the worker's tools, supplies, and equipment.
- The worker does not work for other employers.
- The worker does not advertise his or her services to the general public.

Not all of these factors must be present for a worker to be an employee. But if most of them apply, the worker is an employee. Once again: If in doubt, treat the worker as an employee.

✓ ***Key Point.*** For 2016 churches must withhold 28 percent of the compensation paid to a self-employed person who fails to provide his or her Social Security number to the church. This is referred to as backup withholding and is designed to promote the reporting of taxable income.

✓ ***Key Point.*** Some fringe benefits are non-taxable only when received by employees.

Step 3. Obtain the Social Security number for each worker.

After determining whether a worker is an employee or self-employed, you must obtain the worker's Social Security number. A worker who does not have a Social Security number can obtain one by filing Form SS-5. This is a Social Security Administration form, not an IRS form. If a self-employed worker performs services for your church (and earns at least $600 for the year), but fails to provide you with his or her Social Security number, then the church is required by law to withhold a specified percentage of compensation as backup withholding. The backup withholding rate is 28 percent for 2016.

A self-employed person can stop backup withholding by providing the church with a correct Social Security number. The church will need the correct number to complete the worker's Form 1099-MISC (discussed later).

Churches can be penalized if the Social Security number they report on a Form 1099-MISC is incorrect, unless they

have exercised due diligence. A church will be deemed to have exercised due diligence if it has self-employed persons provide their Social Security numbers using Form W-9. It is a good idea for churches to present self-employed workers (e.g., guest speakers, contract laborers) with a Form W-9, and to backup withhold unless the worker returns the form.

The church should retain each Form W-9 to demonstrate its due diligence.

All taxes withheld through backup withholding must be reported to the IRS on Form 945. The Form 945 for 2015 must be filed with the IRS by February 1, 2016. However, if you made deposits on time in full payment of the taxes for the year, you may file the return by February 10, 2016.

Step 4. Have each employee complete a Form W-4. These forms are used by employees to claim withholding allowances. A church will need to know how many withholding allowances each non-minister employee claims to withhold the correct amount of federal income tax. Ministers need not file a Form W-4 unless they enter into a voluntary withholding arrangement with the church. A withholding allowance lowers the amount of tax that will be withheld from an employee's wages. Allowances generally are available for the employee, the employee's spouse, each of the employee's dependents, and in some cases for itemized deductions.

Ask all new employees to give you a signed Form W-4 when they start work. If an employee does not complete such a form, then the church must treat the employee as a single person without any withholding allowances or exemptions. Employers must put into effect any Form W-4 that replaces an existing certificate no later than the start of the first payroll period ending on or after the 30th day after the day on which you received the replacement Form W-4. Of course, you can put a Form W-4 into effect sooner, if you wish. Employers are not responsible for verifying the withholding allowances that employees claim.

- ✓ ***Tip.*** The withholding calculator found on the IRS website (**www.irs.gov**) can help employees determine the proper amount of federal income tax withholding.

Step 5. Compute each employee's taxable wages. The amount of taxes that a church should withhold from an employee's wages depends on the amount of the employee's wages and the information contained on his or her Form W-4. A church must determine the wages of each employee that are subject to withholding. Wages subject to federal withholding include pay given to an employee for service performed. The pay may be in cash or in other forms. Measure pay that is not in money (such as property) by its fair market value. Wages often include a number of items in addition to salary. (There is a comprehensive list of examples in Step 10.)

Step 6. Determine the amount of income tax to withhold from each employee's wages. The amount of federal income tax the employer should withhold from an employee's wages may be computed in a number of ways. The most common methods are the wage bracket method and the percentage method.

Wage bracket method. Under the wage bracket method, the employer simply locates an employee's taxable wages for the applicable payroll period (that is, weekly, biweekly, monthly) on the wage bracket withholding tables in IRS Publication 15 ("Circular E"), and determines the tax to be withheld by using the column headed by the number of withholding allowances claimed by the employee. You can obtain a copy of IRS Publication 15 at any IRS office by calling the IRS forms number (**800.829.3676**), or by downloading a copy from the IRS website (**www.irs.gov**).

Percentage method. Under the percentage method, the employer multiplies the value of one withholding allowance (derived from a table contained in Publication 15) by the number of allowances an employee claims on Form W-4, subtracts the total from the employee's wages, and determines the amount to be withheld from another table. This method works for any number of withholding allowances an employee claims and any amount of wages.

Recommendation. Be sure to obtain a new IRS Publication 15 in January of 2016. It will contain updated tables for computing the amount of income taxes to withhold from employees' 2016 wages and other helpful information.

Both of these methods are explained in detail in Publication 15. Each year, a church should obtain a copy of Publication 15 to ensure that the correct amount of taxes is being withheld. Wages paid to a minister as compensation for ministerial services are exempt from income tax withholding. However, ministers who report their income taxes as employees can enter into a voluntary withholding arrangement with their church. Under such an arrangement, the church withholds federal income taxes from the minister's wages as if the minister's wages are not exempt from withholding. Some ministers find voluntary withholding attractive, since it avoids the additional work and discipline associated with the estimated tax procedure.

A minister initiates voluntary withholding by providing the church with a completed IRS Form W-4 (Employee's Withholding Allowance Certificate). The filing of this form is deemed to be a request for voluntary withholding.

Voluntary withholding arrangements may be terminated at any time by either the church or minister, or by mutual consent.

The Tax Code specifies that ministers are self-employed for Social Security with respect to services performed in the exercise of ministry. Therefore, a church whose minister elects voluntary withholding is only obligated to withhold the minister's federal income taxes. The minister is still required to use the estimated tax procedure to report and prepay the self-employment tax (the Social Security tax on self-employed persons). However, ministers electing voluntary withholding can indicate on line 6 of Form W-4 that they want an additional amount of income taxes to be withheld from each pay period that will be sufficient to pay the estimated self-employment tax liability by the end of the year. This additional withholding of income taxes becomes a credit that can be applied against a minister's self-employment taxes on Form 1040. It is reported by the church as additional income taxes withheld on its quarterly Form 941.

Since any tax paid by voluntary withholding is deemed to be timely paid, a minister who pays self-employment taxes using this procedure will not be liable for any underpayment penalty (assuming that a sufficient amount of taxes are withheld).

Step 7. Withhold Social Security and Medicare taxes from non-minister employees' wages.
Employees and employers each pay Social Security and Medicare taxes (FICA) equal to 7.65 percent of an employee's wages. The 7.65 percent tax rate comprises two components: (1) a Medicare hospital insurance tax of 1.45 percent, and (2) an "old age, survivor and disability" (Social Security) tax of 6.2 percent. There is no maximum amount of wages subject to the Medicare tax. For 2016, the maximum wages subject to the Social Security tax (the 6.2 percent amount) is $118,500. Beginning in 2013, the Affordable Care Act increased the employee portion of the Medicare (HI) tax by an additional tax of 0.9 percent on wages received in excess of a threshold amount. However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, and $200,000 for single persons. The $250,000 and $125,000 amounts are not adjusted for inflation and remain the same for 2016.

The Social Security tax rates for 2015 and 2016 are shown in the following table:

Year	Tax on Employee	Tax on Employer	Combined Tax
2015	7.65%	7.65%	15.3%
2016	7.65%	7.65%	15.3%

✓ ***Key Point.*** Federal law allowed churches that had non-minister employees as of July 1984 to exempt themselves from the employer's share of Social Security and Medicare taxes by filing a Form 8274 with the IRS by October 30, 1984. Many churches did so. The exemption was available only to those churches that were opposed for religious reasons to the payment of Social Security taxes. The effect of such an exemption is to treat all non-minister church employees as self-employed for Social Security purposes. Such employees must pay the self-employment tax (SECA) if they are paid $108.28 or more for the year. Churches hiring their first non-minister employee after 1984 have until the day before the due date for their first quarterly 941 form to file the exemption application. Churches can revoke their exemption by filing a Form 941 accompanied by full payment of Social Security and Medicare taxes for that quarter. Many churches have done so, often inadvertently.

Step 8. The church must deposit the taxes it withholds.
Churches accumulate three kinds of federal payroll taxes:

- income taxes withheld from employees' wages,
- the employees' share of Social Security and Medicare taxes (withheld from employees' wages), and
- the employer's share of Social Security and Medicare taxes.

Most employers must deposit payroll taxes on a monthly or biweekly basis. An employer's deposit status is determined by the total taxes reported in a four-quarter lookback period. For 2016, the lookback period will be July 1, 2014 through June 30, 2015.

Monthly depositor rule. Churches that reported payroll taxes of $50,000 or less in the lookback period will deposit their withheld taxes for 2016 on a monthly basis. Payroll taxes withheld during each calendar month, along with the employer's share of FICA taxes, must be deposited by the 15th day of the following month.

Biweekly depositor rule. Churches that reported payroll taxes of more than $50,000 in the lookback period must deposit their withheld taxes on a biweekly basis. This means that for paydays falling on Wednesday, Thursday,

or Friday, the payroll taxes must be deposited on or by the following Wednesday. For all other paydays, the payroll taxes must be deposited on the Friday following the payday.

Payment with return rule. If you accumulate less than a $2,500 tax liability during the current or previous quarter, you may make a payment with Form 941 instead of depositing monthly. See IRS Publication 15 for more information.

✓ ***Key Point.*** All deposits must be made using the Electronic Federal Tax Payment System (EFTPS). There are penalties for depositing late, or for mailing payments directly to the IRS that are required to be deposited, unless you have reasonable cause for doing so. To enroll in EFTPS, call **1.800.555.4477**, or to enroll online, visit **www.eftps.gov**. If you do not want to use EFTPS, you can arrange for your tax professional, financial institution, payroll service, or other trusted third party to make deposits on your behalf.

Step 9. All employers subject to income tax withholding, Social Security and Medicare taxes, or both, must file Form 941 quarterly.

Form 941 reports the number of employees and amount of Social Security and Medicare taxes and withheld income taxes that are payable. Form 941 is due on the last day of the month following the end of each calendar quarter.

Quarter	Ending	Due Date of Form 941
1st (January-March)	March 31	April 30
2nd (April-June)	June 30	July 31
3rd (July-September)	September 30	October 31
4th (October-December)	December 31	January 31

If any due date for filing shown above falls on a Saturday, Sunday, or legal holiday, you may file your return on the next business day.

Form 941 may be filed electronically. For more information, visit the IRS website at **www.irs.gov** or call **1.866.255.0654**.

✓ ***Key Point.*** Form 944 replaces Form 941 for eligible small employers. The purpose of new Form 944 is to reduce burdens on the smallest employers by allowing them to file their employment tax returns annually, and in most cases pay the employment tax due with their return. Generally, you are eligible to file this form only if your payroll taxes for the year are $1,000 or less. Do not file Form 944 unless the IRS has sent you a notice telling you to file it.

Step 10. Prepare a Form W-2 for every employee, including ministers employed by the church.

✓ ***Key Point.*** If your employees give their consent, you may be able to furnish Forms W-2 to your employees electronically. See IRS Publication 15-A for additional information. If you file your 2015 Forms W-2 with the Social Security Administration electronically, the due date is extended to March 31, 2016. For information on how to file electronically, call the SSA at **1.800.772.6270**. You may file a limited number of Forms W-2 and W-3 online using the SSA website at **www.ssa.gov/employer**. The site also allows you to print out copies of the forms for filing with state or local governments, distribution to your employees, and for your records.

A church reports each employee's taxable income and withheld income taxes as well as Social Security and Medicare taxes on this form. A church should furnish copies B, C, and 2 of the 2015 Form W-2 to each employee by February 1, 2016. File Copy A with the Social Security Administration by February 29, 2016. Send all Copies A with Form W-3, Transmittal of Wage and Tax Statements. If you file electronically the due date is March 31, 2016.

✓ ***Key Point.*** Be sure to add cents to all amounts. Make all dollar entries without a dollar sign and comma, but with a decimal point and cents. For example, $1,000 should read "1000.00." Government scanning equipment assumes that the last two figures of any amount are cents. If you report $40,000 of income as "40000," the scanning equipment would interpret this as 400.00 ($400).

You may need some assistance with some of the boxes on the Form W-2. Consider the following:

Box a. Report the employee's Social Security number. Insert "applied for" if an employee does not have a Social Security number but has applied for one. If you do not provide the correct employee name and Social Security number on Form W-2, you may owe a penalty unless you have reasonable cause.

Box b. Insert your church's federal employer identification number (EIN). This is a nine-digit number that is assigned by the IRS. If you do not have one, you can obtain one by submitting a completed Form SS-4 to the IRS. Some churches have more than one EIN (for example, some churches that operate a private school have a number for both the church and the school). Be sure that the EIN

listed on an employee's Form W-2 is the one associated with the employee's actual employer.

Box c. Enter your church's name, address, and ZIP Code. This should be the same address reported on your Form 941.

Box d. You may use this box to identify individual W-2 forms. You are not required to use this box.

Box e. Enter the employee's name.

Box f. Enter the employee's address and ZIP Code.

Box 1. Report all wages paid to workers who are treated as employees for federal income tax reporting purposes. This includes:

- Salary, bonuses, prizes, and awards.
- Taxable fringe benefits (including cost of employer-provided group term life insurance coverage that exceeds $50,000).
- The value of the personal use of an employer-provided car.
- Most Christmas, birthday, anniversary, and other special occasion gifts paid by the church.
- Business expense reimbursements paid under a non-accountable plan (one that does not require substantiation of business expenses within a reasonable time, or does not require excess reimbursements to be returned to the church, or reimburses expenses out of salary reductions). Also note that such reimbursements are subject to income tax and Social Security withholding if paid to non-minister employees.

  If you reimburse employee travel expenses under an accountable plan using a per diem rate, include in Box 1 the amount by which your per diem rate reimbursements for the year exceed the IRS-approved per diem rates. Also note that such excess reimbursements are subject to income tax and Social Security withholding if paid to non-minister employees or ministers who have elected voluntary tax withholding. Use code L in Box 12 to report the amount equal to the IRS-approved rates.

  If you reimburse employee travel expenses under an accountable plan using a standard business mileage rate in excess of the IRS-approved rate (57.5 cents per mile in 2015; 54 cents per mile for 2016) include in Box 1 the amount by which your mileage rate reimbursements for the year exceed the IRS-approved rates. Also note that such excess reimbursements are subject to income tax and Social Security withholding if paid to non-minister employees or ministers who have elected voluntary tax withholding. Use code L in Box 12 to report the amount equal to the IRS-approved rates.
- Employer reimbursements of an employee's non-qualified (non-deductible) moving expenses.
- Any portion of a minister's self-employment taxes paid by the church.
- Amounts includible in income under a non-qualified deferred compensation plan because of section 409A.
- Designated Roth contributions made under a section 403(b) salary reduction agreement.
- Church reimbursements of a spouse's travel expenses incurred while accompanying a minister on a business trip represent income to the minister unless the spouse's presence serves a legitimate and necessary business purpose and the spouse's expenses are reimbursed by the church under an accountable plan.
- Churches that make a below-market loan to a minister of at least $10,000 create taxable income to the minister (some exceptions apply). A below-market loan is a loan on which no interest is charged, or on which interest is charged at a rate below the applicable federal rate.
- Churches that forgive a minister's debt to the church create taxable income to the minister.
- Severance pay.
- Payment of a minister's personal expenses by the church.
- Employee contributions to a health savings account (HSA).
- Employer contributions to an HSA if includable in the income of the employee.
- Love gifts from the church to a pastor.

For ministers who report their income taxes as employees, do not report in Box 1 the annual fair rental value of a parsonage or any portion of a minister's compensation that was designated (in advance) as a housing allowance by the church. Also, some contributions made to certain retirement plans out of an employee's wages are not reported.

Caution. Taxable fringe benefits not reported as income in Box 1 may constitute an automatic excess benefit transaction exposing the recipient and members of the church board to intermediate sanctions in the form of substantial excise taxes.

- ✓ ***Key Point.*** Churches should not include in Box 1 the annual fair rental value of a parsonage or a housing allowance provided to a minister as compensation for ministerial services.

Box 2. List all federal income taxes that you withheld from the employee's wages. The amounts reported in this box (for all employees) should correspond to the amount of withheld income taxes reported on your four 941 forms.

Box 3. Report an employee's wages subject to the Social Security component (the 6.2 percent rate for 2015) of FICA taxes. Box 3 should not list more than the maximum wage base for the Social Security component of FICA taxes ($118,500 for 2015 and 2016). This box usually will be the same as Box 1, but not always. For example, certain retirement contributions are included in Box 3 that are not included in Box 1. To illustrate, contributions to a 403(b) plan by salary reduction agreement may be excludable from income and not reportable in Box 1, but they are subject to FICA taxes and accordingly they represent Social Security and Medicare wages for non-minister employees.

- ✓ ***Key Point.*** Remember that ministers (including those who report their income taxes as employees) are self-employed for Social Security with respect to their ministerial services, and so they pay self-employment taxes rather than the employee's share of Social Security and Medicare taxes.

Churches that filed a timely Form 8274 exempting themselves from the employer's share of FICA taxes do not report the wages of non-minister employees in this box since such employees are considered self-employed for Social Security purposes.

Box 4. Report the Social Security component (6.2 percent in 2015) of FICA taxes that you withheld from the employee's wages. This tax is imposed on all wages up to a maximum of $118,500 for 2015 and 2016. Do not report the church's portion (the employer's share) of Social Security and Medicare taxes. Ministers who report their income taxes as employees are still treated as self-employed for Social Security purposes with respect to their ministerial services. For ministers, this box should be left blank.

Box 5. Report a non-minister employee's current and deferred (if any) wages subject to the Medicare component (1.45 percent) of FICA taxes. This will be an employee's entire wages regardless of amount. There is no ceiling. For most workers (earning less than $118,500 in 2015 and 2016) the maximum amount of wages subject to the Social Security tax (Boxes 3 and 5) should show the same amount. If you paid more than $118,500 to a non-minister employee in 2015, Box 3 should show $118,500 and Box 5 should show the full amount of wages paid. This amount remains at $118,500 for 2016.

Box 6. Report the Medicare component of FICA taxes that you withheld from the non-minister employee's wages. This tax is imposed on all wages, current and deferred (if any), regardless of amount.

Box 10. Show the total dependent care benefits under a dependent care assistance program (section 129) paid or incurred by you for your employee. Include the fair market value of employer-provided daycare facilities and amounts paid or incurred for dependent care assistance in a section 125 cafeteria plan. Report all amounts paid or incurred including those in excess of the $5,000 exclusion. Include any amounts over $5,000 in Boxes 1, 3, and 5. For more information, see IRS Publication 15-B.

Box 11. The purpose of Box 11 is for the Social Security Administration (SSA) to determine if any part of the amount reported in Box 1 or Boxes 3 or 5 was earned in a prior year. The SSA uses this information to verify that they have properly applied the Social Security earnings test and paid the correct amount of benefits. Report distributions to an employee from a non-qualified plan in Box 11. Also report these distributions in Box 1. Under non-qualified plans, deferred amounts that are no longer subject to a substantial risk of forfeiture are taxable even if not distributed. Report these amounts in Boxes 3 (up to the Social Security wage base) and 5. Do not report in Box 11 deferrals included in Boxes 3 or 5 and deferrals for current year services (such as those with no risk of forfeiture).

If you made distributions and also are reporting any deferrals in Boxes 3 or 5, do not complete Box 11. See IRS Publication 957.

Unlike qualified plans, non-qualified plans do not meet the qualification requirements for tax-favored status. Non-qualified plans include those arrangements traditionally viewed as deferring the receipt of current compensation, such as a rabbi trust. Welfare benefit plans and plans providing termination pay, or early retirement pay, are not generally non-qualified plans.

For additional information, see IRS Publications 15 and 957.

Box 12. Insert the appropriate code and dollar amount in this box. Insert the code letter followed by a space and then insert the dollar amount on the same line within the box. Do not enter more than three codes in this box. If more are needed, use another Form W-2. Use capital letters for the codes, and remember not to use dollar signs

or commas. For example, to report a $3,000 contribution to a section 403(b) tax-sheltered annuity, you would report "E 3000.00" in this box. The codes are as follows:

A – This will not apply to church employees.

B – This will not apply to church employees.

C – You (the church) provided your employee with more than $50,000 of group term life insurance. Report the cost of coverage in excess of $50,000. It should also be included in Box 1 (and in Boxes 3 and 5 for non-minister employees). See page 24 for additional information.

D – Generally not applicable to churches.

E – The church made contributions to a 403(b) plan (e.g., TSA contributions made to the Annuity Plan for the United Church of Christ) pursuant to a salary reduction agreement on behalf of the employee. Report the amount of the contributions. While this amount ordinarily is not reported in Box 1, it is included in Boxes 3 and 5 for non-minister employees since it is subject to Social Security and Medicare taxes with respect to such workers.

F – Generally not applicable to churches.

G – Generally not applicable to churches.

H – Generally not applicable to churches.

J – You (the church) are reporting sick pay. Show the amount of any sick pay that is not includable in the employee's income because he or she contributed to the sick pay plan.

K – Generally not applicable to churches.

L – You (the church) reimbursed the employee for employee business expenses using the standard mileage rate or the per diem rates, and the amount you reimbursed exceeds the amounts allowed under these methods. Enter code "L" in Box 12, followed by the amount of the reimbursements that equal the allowable standard mileage or per diem rates. Any excess should be included in Box 1. For non-minister employees, report the excess in Boxes 3 (up to the Social Security wage base) and 5 as well. Do not include any per diem or mileage allowance reimbursements for employee business expenses in Box 12 if the total reimbursements are less than or equal to the amount deemed substantiated under the IRS-approved standard mileage rate or per diem rates.

M, N – Generally not applicable to churches.

P – You (the church) paid qualified moving expenses reimbursements directly to an employee. Report the amount of these reimbursements but only if they were made under a non-accountable arrangement. Do not report reimbursements of qualified moving expenses that you paid directly to a third party on behalf of the employee (for example, to a moving company), or the employee under an accountable arrangement.

Q – Generally not applicable to churches.

R – Report employer contributions to a medical savings account on behalf of the employee. Any portion that is not excluded from the employee's income also should be included in Box 1.

S – Report employee salary reduction contributions to a SIMPLE retirement account. However, if the SIMPLE account is part of a 401(k) plan, use code D.

T – Report amounts paid (or expenses incurred) by an employer for qualified adoption expenses furnished to an employee under an adoption assistance program.

V – Generally not applicable to churches.

W – Report employer contributions to a health savings account (HSA). Include amounts the employee elected to contribute using a cafeteria plan.

Y – It is no longer necessary to report deferrals under a section 409A non-qualified deferred compensation plan in Box 12 using code Y.

Z – Report all amounts deferred (including earnings on deferrals) under a non-qualified deferred compensation plan (NQDC) that are included in income under section 409A of the Tax Code because the NQDC fails to satisfy the requirements of section 409A. Do not include amounts properly reported on Forms 1099-MISC or W-2 for a prior year. Also, do not include amounts considered to be subject to a substantial risk of forfeiture for purposes of section 409A. The amount reported in Box 12 using code Z is also reported in Box 1.

AA– Generally not applicable to churches.

BB – Report designated Roth contributions under a section 403(b) salary reduction agreement. Do

not use this code to report elective deferrals under code E.

DD – Starting in tax year 2011, the Affordable Care Act requires employers to report the cost of coverage under an employer-sponsored group health plan. To give employers more time to update their payroll systems, IRS Notice 2010-69 made this requirement optional for all employers in 2011. IRS Notice 2012-9 provided further relief for smaller employers filing fewer than 250 W-2 forms by making the reporting requirement optional for them until further guidance is issued by the IRS. The reporting under this provision is for information only; the amounts reported are not included in taxable wages and are not subject to new taxes.

EE – Generally not applicable to churches.

Box 13. Check the appropriate box.

- **Statutory employee.** Churches rarely if ever have statutory employees. These include certain drivers, insurance agents, and salespersons.
- **Retirement plan.** Mark this checkbox if the employee was an active participant (for any part of the year) in any of the following: (1) a qualified pension, profit-sharing, or stock bonus plan described in section 401(a) (including a 401(k) plan); (2) an annuity contract or custodial account described in section 403(b); (3) a simplified employee pension (SEP) plan; or (4) a SIMPLE retirement account.
- **Third-party sick pay.** Churches generally will not check this box.

Box 14. This box is optional. Use it to provide information to the church employee. Some churches report a church-designated housing allowance in this box. The IRS uses Box 14 for this purpose in a comprehensive minister tax example in the current edition of its Publication 517, but this is not a requirement.

✓ ***Tax Tip.*** The IRS has provided the following suggestions to reduce the discrepancies between amounts reported on Forms W-2, W-3, and Form 941: First, be sure the amounts on Form W-3 are the total amounts from Forms W-2. Second, reconcile Form W-3 with your four quarterly Forms 941 by comparing amounts reported for: (1) Income tax withholding (Box 2). (2) Social Security and Medicare wages (Boxes 3, 5, and 7). (3) Social Security and Medicare taxes (Boxes 4 and 6). Amounts reported on Forms W-2, W-3, and 941 may not match for valid reasons. If they do not match, you should determine that the reasons are valid.

Step 11. Prepare a Form 1099-MISC for every self-employed person receiving non-employee compensation of $600 or more.

A Form 1099-MISC must be issued to any non-employee who is paid self-employment earnings of at least $600 during any year. For compensation paid in 2015, furnish Copy B of this form to the recipient by February 1, 2016, and file Copy A with the IRS by February 29, 2016. If you file electronically, the due date for filing Copy A with the IRS is March 31, 2016. Form 1099-MISC is designed to induce self-employed persons to report their full taxable income.

Self-employment earnings include compensation paid to any individual other than an employee. Examples include ministers who report their income as self-employed for income tax reporting purposes, some part-time custodians, and certain self-employed persons who perform miscellaneous services for the church (plumbers, carpenters, lawn maintenance providers, etc.) and who are not incorporated.

To illustrate, if a guest speaker visited a church in 2015 and received compensation from the church in an amount of $600 or more (net of any housing allowance or travel expense reimbursed under an accountable plan) then the church must issue the person Copy B of Form 1099-MISC by February 1, 2016.

Exceptions apply. For example, a church need not issue a 1099-MISC to a corporation, or to a person who will be receiving a Form W-2 for services rendered to the church. Also, travel expense reimbursements paid to a self-employed person under an accountable reimbursement plan do not count toward the $600 figure.

To complete Form 1099-MISC the church will need to obtain the recipient's name, address, and Social Security number. Churches should obtain this information at the time of the person's visit, since it often can be difficult to obtain the necessary information at a later date. IRS Form W-9 can be used to obtain this information. If a self-employed person who is paid $600 or more during the course of a year by a church refuses to provide a Social Security number, then the church is required to withhold a percentage of the person's total compensation as backup withholding. See "Step 2," above. The backup withholding rate is 28 percent for 2016.

NEED HELP COMPLETING A W-2, 1099 or other tax form?

The IRS operates a centralized call site to answer questions about reporting information on these forms. If you have any questions about completing these forms, call the IRS at **1.866.455.7438,** Monday through Friday, 8:30 a.m. to 4:30 p.m. (Eastern Time).

REPORTING GROUP TERM LIFE INSURANCE

You must include in the income of employees an imputed cost of employer-provided group term life insurance coverage (including death benefits under the UCC Life Insurance and Disability Income Benefit Plan) that exceeds $50,000. You must also include the imputed cost of all employer-provided group term life insurance on the life of a spouse or dependent if the coverage provided exceeds $2,000. The imputed cost can be determined according to the following table.

Cost per $1,000 of protection for 1-month period	
Age Brackets	**Cost**
Under 25	5 cents
25 to 29	6 cents
30 to 34	8 cents
35 to 39	9 cents
40 to 44	10 cents
45 to 49	15 cents
50 to 54	23 cents
55 to 59	43 cents
60 to 64	66 cents
65 to 69	$1.27
70 and above	$2.06

Example. First Congregational United Church of Christ pays the premiums on a $70,000 group term insurance policy on the life of Pastor Bailey with his wife as beneficiary. Pastor Bailey is 29 years old. First Congregational also pays the premium on a $5,000 group term policy which covers Pastor Bailey's wife who is 30 years old. The church would have to report $19.20 as the imputed cost of the insurance provided to the pastor and his wife. This amount is computed as follows: (1) For Pastor Bailey, the table shows the cost per month for each $1,000 of group term life insurance in excess of $50,000. To compute the cost for the pastor, take 6 cents x 12 months = 72 cents x 20 (corresponding to $20,000 of group term insurance in excess of $50,000) = $14.40. (2) In addition, the cost of the entire $5,000 of insurance provided to Pastor Bailey's wife would have to be computed. Take 8 cents x 12 months = 96 cents x 5 = $4.80. Combine this amount with the cost of Pastor Bailey's excess insurance to obtain the taxable amount of $19.20. First Congregational should include this amount with wages in Box 1 of Form W-2. This amount should also be reported in Box 12 and labeled code C. Any includable amount is subject to income tax as well as Social Security and Medicare withholding for non-minister church employees.

FORM I-9

All employers are responsible for verifying the identity and eligibility of employees to work in the United States. As employers, churches must complete an Employment Eligibility Verification form for each new employee. This form is better known as Form I-9.

Form I-9 is not an IRS form and is not filed with any government agency. However, it is important for churches to be familiar with this form because they can be assessed fines for failing to comply with the requirements summarized below.

Churches should:

- Ensure that each new employee completes Section 1 of the Form I-9 on or before his or her first day of compensated work. Review the employee's documents and fully complete Section 2 of the Form I-9 within 3 business days of the hire. Collect a Form I-9 for all employees, including ministers, hired after November 6, 1986, even if the church has no doubt that someone is a U.S. citizen. An employee signs part of the form and the employer signs part of the form. The form's instructions list documents employees may show to verify their identity and eligibility to work in the United States.
- Review the United States Citizenship and Immigration Services (USCIS) website 0(**www.uscis.gov**) for instructions that will assist you in completing the Form I-9. You can also download Form I-9 from the USCIS website.
- Collect forms from new employees only, not from all applicants. When extending job offers, churches should clarify that employment is conditioned on completion of a Form I-9. Employers should remind new employees to bring their documents the first day of work. Forms should be completed no later than the end of the employee's third day at work.
- Accept documents that appear to be genuine and relate to the employee. If churches act reasonably when deciding that a document is genuine, they will not be held responsible for a mistake. Churches may keep photocopies of original identification and verification documents with each employee form. This is not required by law but may be helpful in case there is ever a question about whether a document was genuine.
- Employers must retain an employee's completed Form I-9 for as long as the individual works for the employer. Once the individual's employment has terminated, the employer must determine how long after termination the Form I-9 must be retained, which is either three years after the date of hire, or one year after the date employment is terminated,

whichever is later. Forms I-9 can be retained either on paper or microform, or electronically.

- Upon request, show completed forms to authorized officials of the Department of Homeland Security (DHS), Department of Labor, or the Justice Department's Office of Special Counsel for Unfair Immigration-Related Employment Practices (OSC). Officials will give a minimum of three days' notice before inspection.

Churches, like any employer, can be penalized for failing to comply with the I-9 requirement. If you fail to complete, retain, or make available for inspection a Form I-9 as required by law, you may face a civil penalty for each violation. There are additional penalties for knowingly hiring unauthorized aliens.

ANNUAL CERTIFICATION OF RACIAL NONDISCRIMINATION

Churches and other religious organizations that operate, supervise, or control a private school must file a certificate of racial nondiscrimination (Form 5578) each year with the IRS. The certificate is due by the 15th day of the 5th month following the end of the organization's fiscal year. This is May 15 of the following year for organizations that operate on a calendar year basis. For example, the Form 5578 for 2015 is due May 16, 2016 (May 15 is a Sunday).

A private school is defined as an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly conducted. The term includes primary, secondary, preparatory, or high schools; and colleges and universities, whether operated as a separate legal entity or an activity of a church.

✓ ***Key Point.*** The term "school" also includes preschools, and this is what makes the reporting requirement relevant for many churches. As many as 25 percent of all churches operate a preschool program.

✓ ***Key Point.*** Independent religious schools that are not affiliated with a church or denomination, and that file Form 990, do not file Form 5578. Instead, they make their annual certification of racial nondiscrimination directly on Form 990.

Form 5578 is easy to complete. A church official simply identifies the church and the school and certifies that the school has "satisfied the applicable requirements of sections 4.01 through 4.05 of Revenue Procedure 75-50." This reference is to the following requirements:

- The school has a statement in its charter, bylaws, or other governing instrument, or in a resolution of its governing body, that it has a racially nondiscriminatory policy toward students.
- The school has a statement of its racially nondiscriminatory policy toward students in all its brochures and catalogs dealing with student admissions, programs, and scholarships.
- The school makes its racially nondiscriminatory policy known to all segments of the general community served by the school through the publication of a notice of its racially nondiscriminatory policy at least annually in a newspaper of general circulation or through utilization of the broadcast media. However, such notice is not required if one or more exceptions apply. These include the following: (1) During the preceding three years, the enrollment consists of students at least 75 percent of whom are members of the sponsoring church or religious denomination, and the school publicizes its nondiscriminatory policy in religious periodicals distributed in the community. (2) The school draws its students from local communities and follows a racially nondiscriminatory policy toward students and demonstrates that it follows a racially nondiscriminatory policy by showing that it currently enrolls students of racial minority groups in meaningful numbers.
- The school can demonstrate that all scholarships or other comparable benefits are offered on a racially nondiscriminatory basis.

Filing the certificate of racial nondiscrimination is one of the most commonly ignored federal reporting requirements. Churches that operate a private school (including a preschool), as well as independent schools, may obtain copies of Form 5578 by calling the IRS forms number (**1.800.829.3676**).

CHARITABLE CONTRIBUTION SUBSTANTIATION RULES

Several important rules apply to the substantiation of charitable contributions, including the following:

Cash contributions. All cash contributions, regardless of amount, must be substantiated by either a bank record (such as a cancelled check) or a written communication from the charity showing the name of the charity, the date of the contribution, and the amount of the contribution. The recordkeeping requirements *may not be satisfied by maintaining other written records*. In the past, donors could substantiate cash contributions of less than $250 with "other reliable written records showing the name of the charity, the

date of the contribution, and the amount of the contribution if no cancelled check or receipt was available. This is no longer allowed. As noted below, additional substantiation requirements apply to contributions (of cash or property) of $250 or more, and these must be satisfied as well.

Substantiation of contributions of $250 or more. Donors will not be allowed a tax deduction for any individual cash (or property) contribution of $250 or more unless they receive a written acknowledgment from the church containing the following information:

- Name of the church.
- Name of the donor (a Social Security number is not required).
- Date of the contribution.
- Amount of any cash contribution.
- For contributions of property (not including cash) valued by the donor at $250 or more, the receipt must describe the property. No value should be stated.
- The receipt must contain one of the following: (1) a statement that no goods or services were provided by the church in return for the contribution; (2) a statement that goods or services that a church provided in return for the contribution consisted entirely of intangible religious benefits; or (3) a description and good faith estimate of the value of goods or services other than intangible religious benefits that the church provided in return for the contribution.

  The church may either provide separate acknowledgements for each single contribution of $250 or more or one acknowledgement to substantiate several single contributions of $250 or more. Separate contributions are not aggregated for purposes of measuring the $250 threshold.

  The written acknowledgment must be received by the donor on or before the earlier of the following two dates: (1) the date the donor files a tax return claiming a deduction for the contribution, or (2) the due date (including extensions) for filing the return.

***Quid pro quo* contributions of more than $75**. If a donor makes a *quid pro quo* contribution of more than $75 (that is, a payment that is partly a contribution and partly a payment for goods or services received in exchange), the church must provide a written statement to the donor that satisfies two conditions:

- The statement must inform the donor that the amount of the contribution that is tax-deductible is limited to the excess of the amount of any money (or the value of any property other than money) contributed by the donor over the value of any goods or services provided by the church or other charity in return. The statement must provide the donor with a good faith estimate of the value of the goods or services furnished to the donor.
- A written statement need not be issued if only token goods or services are provided to the donor. For 2015, token goods or services were those having a value not exceeding the lesser of $104 or 2 percent of the amount of the contribution. This amount is adjusted annually for inflation. In addition, the rules do not apply to contributions in return for which the donor receives solely an intangible religious benefit that generally is not sold in a commercial context outside the donative context.

Gifts of property. Several additional rules apply to the substantiation of contributions of non-cash property valued by the donor at $500 or more. Donors who claim a deduction over $500 but not over $5,000 for a non-cash charitable contribution must retain certain records and complete the front side (Section A, Part I, and Part II if applicable) of IRS Form 8283 and enclose the completed form with the Form 1040 on which the charitable contribution is claimed.

Special rules apply to donations of cars, boats, and planes valued by the donor at more than $500. The church must provide the donor with a written acknowledgment, and send a Form 1098-C to the IRS containing required information about the donation. Form 1098-C can be used as the written acknowledgment that must be issued to a donor. See the instructions to Form 1098-C for more information.

For contributions of non-cash property valued at more than $5,000 ($10,000 for privately held stock), a donor must obtain a qualified appraisal of the donated property from a qualified appraiser and complete a qualified appraisal summary (Section B of Form 8283) and have the summary signed by the appraiser and a church representative. The completed Form 8283 is then enclosed with the Form 1040 on which the charitable contribution deduction is claimed. The appraisal must be enclosed for contributions of property (other than inventory and publicly traded securities) in excess of $500,000.

AFFORDABLE CARE ACT REPORTING

The ACA imposes the most significant reporting obligations since the introduction of Form W-2 in 1943. In fact, the new reporting obligations are similar to Form W-2 in that there are forms that must be issued to individual employees, and a transmittal form that is sent to the IRS along with copies of all the forms issued to employees. And, as with Form W-2, the IRS can assess penalties for failure to comply with the new reporting obligations. Because of the similarities of the new reporting requirements to Form W-2, some are calling them the "Health Care W-2s." Of course, the analogy is not perfect. The W-2 form reports compensation and tax withholding, while the new forms report health insurance information. The reporting requirements consist of the following forms:

- Providers of minimum essential coverage are required to file Forms 1094-B and 1095-B for 2015. Form 1094-B and 1095-B are used to report certain information to the IRS and to employees about individuals who are covered by minimum essential coverage and therefore aren't liable for the individual shared responsibility payment. These forms must be filed by February 29, 2016 (March 31, 2016 if filed electronically).

- Applicable Large Employers, generally employers with 50 or more full-time employees (including full-time equivalent employees) in the previous year, must file one or more Forms 1094-C (including a Form 1094-C designated as the Authoritative Transmittal, whether or not filing multiple Forms 1094-C), and must file a Form 1095-C for each employee who was a full-time employee of the employer for any month of the calendar year. Generally, the employer is required to furnish a copy of the Form 1095-C (or a substitute form) to the employee. These forms must be filed by February 29, 2016 (March 31, 2016 if filed electronically). The information reported on Forms 1094-C and 1095-C is used to determine whether an employer owes a payment under the employer shared responsibility provisions of the ACA (the "employer mandate" or "play or pay" provisions).

See the instructions to these forms on the IRS website (**www.irs.gov**) for more information.

✓ ***Key Point.*** Churches with fewer than 50 full-time employees, and an insured group health plan, generally have no reporting obligation. They are not required to file Forms 1094-C and 1095-C since they have fewer than 50 employees, and their group plan insurer files the Forms 1094-B and 1095-B.

	a Employee's social security number	OMB No. 1545-0008	**Safe, accurate, FAST! Use** IRS e-file Visit the IRS website at *www.irs.gov/efile*
b Employer identification number (EIN)		**1** Wages, tips, other compensation	**2** Federal income tax withheld
c Employer's name, address, and ZIP code		**3** Social security wages	**4** Social security tax withheld
		5 Medicare wages and tips	**6** Medicare tax withheld
		7 Social security tips	**8** Allocated tips
d Control number		**9**	**10** Dependent care benefits
e Employee's first name and initial Last name Suff.		**11** Nonqualified plans	**12a** See instructions for box 12
			12b
			12c
			12d
f Employee's address and ZIP code			
15 State Employer's state ID number	**16** State wages, tips, etc.	**17** State income tax	**18** Local wages, tips, etc. **19** Local income tax **20** Locality name

Form **W-2** **Wage and Tax Statement** 2015 Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	**1** Rents $	OMB No. 1545-0115	**Miscellaneous Income**
	2 Royalties $	2015 Form **1099-MISC**	
	3 Other income $	**4** Federal income tax withheld $	**Copy B For Recipient**
PAYER'S federal identification number / RECIPIENT'S identification number	**5** Fishing boat proceeds $	**6** Medical and health care payments $	
RECIPIENT'S name Street address (including ar City or town, state or prov cour nd ost de	**7** Nonemployee compensation yer dire es ,000 nsur odu a buyer cipi r resale ▶	**8** Substitute payments in lieu of dividends or interest $ **10** Crop ins ce proceeds $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Account number (see instructions) / FATCA filing requirement ☐	**13** Excess golden parachute payments $	**14** Gross proceeds paid to an attorney $	
15a Section 409A deferrals $ / **15b** Section 409A income $	**16** State tax withheld $ $	**17** State/Payer's state no.	**18** State income $ $

Form **1099-MISC** (keep for your records) www.irs.gov/form1099misc Department of the Treasury - Internal Revenue Service

Form W-4 (2016)

Purpose. Complete Form W-4 so that your employer can withhold the correct federal income tax from your pay. Consider completing a new Form W-4 each year and when your personal or financial situation changes.

Exemption from withholding. If you are exempt, complete **only** lines 1, 2, 3, 4, and 7 and sign the form to validate it. Your exemption for 2016 expires February 15, 2017. See Pub. 505, Tax Withholding and Estimated Tax.

Note: If another person can claim you as a dependent on his or her tax return, you cannot claim exemption from withholding if your income exceeds $1,050 and includes more than $350 of unearned income (for example, interest and dividends).

Exceptions. An employee may be able to claim exemption from withholding even if the employee is a dependent, if the employee:

- Is age 65 or older,
- Is blind, or
- Will claim adjustments to income; tax credits; or itemized deductions, on his or her tax return.

The exceptions do not apply to supplemental wages greater than $1,000,000.

Basic instructions. If you are not exempt, complete the **Personal Allowances Worksheet** below. The worksheets on page 2 further adjust your withholding allowances based on itemized deductions, certain credits, adjustments to income, or two-earners/multiple jobs situations.

Complete all worksheets that apply. However, you may claim fewer (or zero) allowances. For regular wages, withholding must be based on allowances you claimed and may not be a flat amount or percentage of wages.

Head of household. Generally, you can claim head of household filing status on your tax return only if you are unmarried and pay more than 50% of the costs of keeping up a home for yourself and your dependent(s) or other qualifying individuals. See Pub. 501, Exemptions, Standard Deduction, and Filing Information, for information.

Tax credits. You can take projected tax credits into account in figuring your allowable number of withholding allowances. Credits for child or dependent care expenses and the child tax credit may be claimed using the **Personal Allowances Worksheet** below. See Pub. 505 for information on converting your other credits into withholding allowances.

Nonwage income. If you have a large amount of nonwage income, such as interest or dividends, consider making estimated tax payments using Form 1040-ES, Estimated Tax for Individuals. Otherwise, you may owe additional tax. If you have pension or annuity income, see Pub. 505 to find out if you should adjust your withholding on Form W-4 or W-4P.

Two earners or multiple jobs. If you have a working spouse or more than one job, figure the total number of allowances you are entitled to claim on all jobs using worksheets from only one Form W-4. Your withholding usually will be most accurate when all allowances are claimed on the Form W-4 for the highest paying job and zero allowances are claimed on the others. See Pub. 505 for details.

Nonresident alien. If you are a nonresident alien, see Notice 1392, Supplemental Form W-4 Instructions for Nonresident Aliens, before completing this form.

Check your withholding. After your Form W-4 takes effect, use Pub. 505 to see how the amount you are having withheld compares to your projected total tax for 2016. See Pub. 505, especially if your earnings exceed $130,000 (Single) or $180,000 (Married).

Future developments. Information about any future developments affecting Form W-4 (such as legislation enacted after we release it) will be posted at *www.irs.gov/w4*.

Personal Allowances Worksheet (Keep for your records.)

A Enter "1" for **yourself** if no one else can claim you as a dependent . . . . . **A** _____

B Enter "1" if:
- You are single and have only one job; or
- You are married, have only one job, and your spouse does not work; or
- Your wages from a second job or your spouse's wages (or the total of both) are $1,500 or less. . . . **B** _____

C Enter "1" for your **spouse.** But, you may choose to enter "-0-" if you are married and have either a working spouse or more than one job. (Entering "-0-" may help you avoid having too little tax withheld.) . . . . . **C** _____

D Enter number of **dep** ther tha spou our ou v yo x return . . . . **D** _____

E Enter "1" if you will fi **ead of hou** on yo et e c tion de **ad of hou old** above) . . **E** _____

F Enter "1" if you have at lea 00 **hild dep le e ber** hich plan to cla credit . . . **F** _____
(**Note:** Do **not** includ ild s ort ee p. Ch and pendent Ca es, details.)

G **Child Tax Credit** (including additional child tax credit). See Pub. 972, Child Tax Credit, for more information.
- If your total income will be less than $70,000 ($100,000 if married), enter "2" for each eligible child; then **less** "1" if you have two to four eligible children or **less** "2" if you have five or more eligible children.
- If your total income will be between $70,000 and $84,000 ($100,000 and $119,000 if married), enter "1" for each eligible child . . **G** _____

H Add lines A through G and enter total here. (**Note:** This may be different from the number of exemptions you claim on your tax return.) ► **H** _____

For accuracy, complete all worksheets that apply.
- If you plan to **itemize** or **claim adjustments to income** and want to reduce your withholding, see the **Deductions and Adjustments Worksheet** on page 2.
- If you are **single and have more than one job** or are **married and you and your spouse both work** and the combined earnings from all jobs exceed $50,000 ($20,000 if married), see the **Two-Earners/Multiple Jobs Worksheet** on page 2 to avoid having too little tax withheld.
- If **neither** of the above situations applies, **stop here** and enter the number from line H on line 5 of Form W-4 below.

---------- **Separate here and give Form W-4 to your employer. Keep the top part for your records.** ----------

Form **W-4** Department of the Treasury Internal Revenue Service

Employee's Withholding Allowance Certificate

► **Whether you are entitled to claim a certain number of allowances or exemption from withholding is subject to review by the IRS. Your employer may be required to send a copy of this form to the IRS.**

OMB No. 1545-0074

2016

1 Your first name and middle initial	Last name	2 Your social security number

Home address (number and street or rural route)

City or town, state, and ZIP code

3 ☐ Single ☐ Married ☐ Married, but withhold at higher Single rate.
Note: If married, but legally separated, or spouse is a nonresident alien, check the "Single" box.

4 If your last name differs from that shown on your social security card, check here. You must call 1-800-772-1213 for a replacement card. ► ☐

5 Total number of allowances you are claiming (from line **H** above **or** from the applicable worksheet on page 2) **5**

6 Additional amount, if any, you want withheld from each paycheck . . . . . **6** $

7 I claim exemption from withholding for 2016, and I certify that I meet **both** of the following conditions for exemption.
- Last year I had a right to a refund of **all** federal income tax withheld because I had **no** tax liability, **and**
- This year I expect a refund of **all** federal income tax withheld because I expect to have **no** tax liability.

If you meet both conditions, write "Exempt" here . . . . . ► **7**

Under penalties of perjury, I declare that I have examined this certificate and, to the best of my knowledge and belief, it is true, correct, and complete.

Employee's signature
(This form is not valid unless you sign it.) ► **Date** ►

8 Employer's name and address (Employer: Complete lines 8 and 10 only if sending to the IRS.)	9 Office code (optional)	10 Employer identification number (EIN)

For Privacy Act and Paperwork Reduction Act Notice, see page 2. Cat. No. 10220Q Form **W-4** (2016)

Form W-4 (2016) Page **2**

Deductions and Adjustments Worksheet

Note: Use this worksheet *only* if you plan to itemize deductions or claim certain credits or adjustments to income.

1	Enter an estimate of your 2016 itemized deductions. These include qualifying home mortgage interest, charitable contributions, state and local taxes, medical expenses in excess of 10% (7.5% if either you or your spouse was born before January 2, 1952) of your income, and miscellaneous deductions. For 2016, you may have to reduce your itemized deductions if your income is over $311,300 and you are married filing jointly or are a qualifying widow(er); $285,350 if you are head of household; $259,400 if you are single and not head of household or a qualifying widow(er); or $155,650 if you are married filing separately. See Pub. 505 for details	**1**	$
2	Enter: { $12,600 if married filing jointly or qualifying widow(er); $9,300 if head of household; $6,300 if single or married filing separately }	**2**	$
3	**Subtract** line 2 from line 1. If zero or less, enter "-0-"	**3**	$
4	Enter an estimate of your 2016 adjustments to income and any additional standard deduction (see Pub. 505)	**4**	$
5	**Add** lines 3 and 4 and enter the total. (Include any amount for credits from the *Converting Credits to Withholding Allowances for 2016 Form W-4* worksheet in Pub. 505.)	**5**	$
6	Enter an estimate of your 2016 nonwage income (such as dividends or interest)	**6**	$
7	**Subtract** line 6 from line 5. If zero or less, enter "-0-"	**7**	$
8	**Divide** the amount on line 7 by $4,050 and enter the result here. Drop any fraction	**8**	
9	Enter the number from the **Personal Allowances Worksheet,** line H, page 1	**9**	
10	**Add** lines 8 and 9 and enter the total here. If you plan to use the **Two-Earners/Multiple Jobs Worksheet,** also enter this total on line 1 below. Otherwise, **stop here** and enter this total on Form W-4, line 5, page 1	**10**	

Two-Earners/Multiple Jobs Worksheet (See *Two earners or multiple jobs* on page 1.)

Note: Use this worksheet *only* if the instructions under line H on page 1 direct you here.

1	Enter the number from line H, page 1 (or from line 10 above if you used the **Deductions and Adjustments Worksheet**)	**1**	
2	Find the number in **Table 1** below that applies to the **LOWEST** paying job and enter it here. **However,** if you are married filing jointly and wages from the highest paying job are $75,000 or less, do not enter more than "3"	**2**	
3	If line 1 is **more than or equal to** line 2, subtract line 2 from line 1. Enter the result here (if zero, enter "-0-") and on Form W-4, line 5, page 1. If you use this worksheet	**3**	

Note: If line 1 is **less than** line 2, enter "-0-" on Form W-4, line 5, page 1. Complete lines 4 through 9 below to figure the additional withholding amount necessary to avoid a year-end tax bill.

4	Enter the number from line 2 of this worksheet	**4**			
5	Enter the number from line 1 of this worksheet	**5**			
6	**Subtract** line 5 from line 4			**6**	
7	Find the amount in **Table 2** below that applies to the **HIGHEST** paying job and enter it here			**7**	$
8	**Multiply** line 7 by line 6 and enter the result here. This is the additional annual withholding needed			**8**	$
9	Divide line 8 by the number of pay periods remaining in 2016. For example, divide by 25 if you are paid every two weeks and you complete this form on a date in January when there are 25 pay periods remaining in 2016. Enter the result here and on Form W-4, line 6, page 1. This is the additional amount to be withheld from each paycheck			**9**	$

Table 1

Married Filing Jointly		All Others	
If wages from **LOWEST** paying job are—	Enter on line 2 above	If wages from **LOWEST** paying job are—	Enter on line 2 above
$0 - $6,000	0	$0 - $9,000	0
6,001 - 14,000	1	9,001 - 17,000	1
14,001 - 25,000	2	17,001 - 26,000	2
25,001 - 27,000	3	26,001 - 34,000	3
27,001 - 35,000	4	34,001 - 44,000	4
35,001 - 44,000	5	44,001 - 75,000	5
44,001 - 55,000	6	75,001 - 85,000	6
55,001 - 65,000	7	85,001 - 110,000	7
65,001 - 75,000	8	110,001 - 125,000	8
75,001 - 80,000	9	125,001 - 140,000	9
80,001 - 100,000	10	140,001 and over	10
100,001 - 115,000	11		
115,001 - 130,000	12		
130,001 - 140,000	13		
140,001 - 150,000	14		
150,001 and over	15		

Table 2

Married Filing Jointly		All Others	
If wages from **HIGHEST** paying job are—	Enter on line 7 above	If wages from **HIGHEST** paying job are—	Enter on line 7 above
$0 - $75,000	$610	$0 - $38,000	$610
75,001 - 135,000	1,010	38,001 - 85,000	1,010
135,001 - 205,000	1,130	85,001 - 185,000	1,130
205,001 - 360,000	1,340	185,001 - 400,000	1,340
360,001 - 405,000	1,420	400,001 and over	1,600
405,001 and over	1,600		

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. Internal Revenue Code sections 3402(f)(2) and 6109 and their regulations require you to provide this information; your employer uses it to determine your federal income tax withholding. Failure to provide a properly completed form will result in your being treated as a single person who claims no withholding allowances; providing fraudulent information may subject you to penalties. Routine uses of this information include giving it to the Department of Justice for civil and criminal litigation; to cities, states, the District of Columbia, and U.S. commonwealths and possessions for use in administering their tax laws; and to the Department of Health and Human Services for use in the National Directory of New Hires. We may also disclose this information to other countries under a tax treaty, to federal and state agencies to enforce federal nontax criminal laws, or to federal law enforcement and intelligence agencies to combat terrorism.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Code section 6103.

The average time and expenses required to complete and file this form will vary depending on individual circumstances. For estimated averages, see the instructions for your income tax return.

If you have suggestions for making this form simpler, we would be happy to hear from you. See the instructions for your income tax return.

Form **5578**
(Rev. August 2013)
Department of the Treasury
Internal Revenue Service

Annual Certification of Racial Nondiscrimination for a Private School Exempt From Federal Income Tax

► **Information about Form 5578 and its instructions is at *www.irs.gov/form5578.***
(For use by organizations that do not file Form 990 or Form 990-EZ)

OMB No. 1545-0213
Open to Public Inspection
For IRS Use Only ►

For the period beginning , and ending ,

1a Name of organization that operates, supervises, and/or controls school(s). | **1b Employer identification number**

Address (number and street or P.O. box no., if mail is not delivered to street address) | Room/suite

City or town, state, and ZIP + 4 (If foreign address, list city or town, state or province, and country. Include postal code.)

2a Name of central organization holding group exemption letter covering the school(s). (If same as 1a above, write "Same" and complete 2c.) If the organization in 1a holds an individual exemption letter, write "Not Applicable." | **2b Employer identification number**

Address (number and str r P.O. x no., if ot deliv stre ss) Ro uite | roup exemption number (see structions under *Definitions*)

City or town, state, and ZIP + 4 (If f n ad or to st. orc e, a untry. Includ tal code.)

3a Name of school. (If more than one school, write "See Attached," and attach a list of the names, complete addresses, including postal codes, and employer identification numbers of the schools.) If same as 1a, write "Same." | **3b Employer identification number,** if any

Address (number and street or P.O. box no., if mail is not delivered to street address) | Room/suite

City or town, state, and ZIP + 4 (If foreign address, list city or town, state or province, and country. Include postal code.)

Under penalties of perjury, I hereby certify that I am authorized to take official action on behalf of the above school(s) and that to the best of my knowledge and belief the school(s) has (have) satisfied the applicable requirements of sections 4.01 through 4.05 of Rev. Proc. 75-50, 1975-2 C.B. 587, for the period covered by this certification.

(Signature) | (Type or print name and title.) | (Date)

For Paperwork Reduction Act Notice, see instructions. Cat. No. 42658A Form **5578** (Rev. 8-2013)

Employment Eligibility Verification

Department of Homeland Security
U.S. Citizenship and Immigration Services

USCIS
Form I-9
OMB No. 1615-0047
Expires 03/31/2016

►**START HERE.** **Read instructions carefully before completing this form. The instructions must be available during completion of this form.**
ANTI-DISCRIMINATION NOTICE: It is illegal to discriminate against work-authorized individuals. Employers **CANNOT** specify which document(s) they will accept from an employee. The refusal to hire an individual because the documentation presented has a future expiration date may also constitute illegal discrimination.

Section 1. Employee Information and Attestation *(Employees must complete and sign Section 1 of Form I-9 no later than the **first day of employment**, but not before accepting a job offer.)*

Last Name (*Family Name*)	First Name *(Given Name)*	Middle Initial	Other Names Used *(if any)*

Address (*Street Number and Name*)	Apt. Number	City or Town	State	Zip Code

Date of Birth *(mm/dd/yyyy)*	U.S. Social Security Number	E-mail Address	Telephone Number
	___ - ___ - ____		

I am aware that federal law provides for imprisonment and/or fines for false statements or use of false documents in connection with the completion of this form.

I attest, under penalty of perjury, that I am (check one of the following):

☐ A citizen of the United States

☐ A noncitizen nationality of the United States *(See instructions)*

☐ A lawful permanent resident Alien Registration Number/USCIS Number: _____

☐ An alien authorized to work until (expiration date, if applicable, mm/dd/yyyy) _____ Some aliens may write "N/A" in this field. *(See instructions)*

*For aliens authorized to work, provide your Alien Registration Number/USCIS Number **OR** Form I-94 Admission Number:*

1. Alien Registration Number/USCIS Number: _____

OR

2. Form I-94 Admission Number: _____

If you obtained your admission number from CBP in connection with your arrival in the United States, include the following:

Foreign Passport Number: _____

Country of Issuance: _____

Some aliens may write "N/A" on the Foreign Passport Number and Country of Issuance fields. (*See instructions*)

3-D Barcode
Do Not Write in This Space

Signature of Employee:	Date *(mm/dd/yyyy):*

Preparer and/or Translator Certification *(To be completed and signed if Section 1 is prepared by a person other than the employee.)*

I attest, under penalty of perjury, that I have assisted in the completion of this form and that to the best of my knowledge the information is true and correct.

Signature of Preparer or Translator:	Date *(mm/dd/yyyy):*

Last Name *(Family Name)*	First Name *(Given Name)*

Address *(Street Number and Name)*	City or Town	State	Zip Code

STOP *Employer Completes Next Page* STOP

LISTS OF ACCEPTABLE DOCUMENTS
All documents must be UNEXPIRED

Employees may present one selection from List A
or a combination of one selection from List B and one selection from List C.

LIST A Documents that Establish Both Identity and Employment Authorization	OR	LIST B Documents that Establish Identity	AND	LIST C Documents that Establish Employment Authorization
1. U.S. Passport or U.S. Passport Card		**1.** Driver's license or ID card issued by a State or outlying possession of the United States provided it contains a photograph or information such as name, date of birth, gender, height, eye color, and address		**1.** A Social Security Account Number card, unless the card includes one of the following restrictions: (1) NOT VALID FOR EMPLOYMENT (2) VALID FOR WORK ONLY WITH INS AUTHORIZATION (3) VALID FOR WORK ONLY WITH DHS AUTHORIZATION
2. Permanent Resident Card or Alien Registration Receipt Card (Form I-551)		**2.** ID card issued by federal, state or local government agencies or entities, provided it contains a photograph or information such as name, date of birth, gender, height, eye color, and address		**2.** Certification of Report of Birth issued by the Department of State (Form DS-1350)
3. Foreign passport that contains a temporary I-551 stamp or temporary I-551 printed notation on a machine-readable immigrant visa		**3.** School ID card with a photograph		**3.** Certification of Report of Birth issued by the Department of State (Form DS-1350)
4. Employment Authorization Document that contains a photograph (Form I-766)		**4.** Voter's registration card		**4.** Original or certified copy of birth certificate issued by a State, county, municipal authority, or territory of the United States bearing an official seal
5. For a nonimmigrant alien authorized to work for a specific employer because of his or her status: **a.** Foreign passport; and **b.** Form I-94 or Form I-94A that has the following: (1) The same name as the passport; and (2) An endorsement of the alien's nonimmigrant status as long as that period of endorsement has not yet expired and the proposed employment is not in conflict with any restrictions or limitations identified on the form.		**5.** U.S. Military card or draft record		**5.** Native American tribal document
		6. Military dependent's ID card		**6.** U.S. Citizen ID Card (Form I-197)
		7. U.S. Coast Guard Merchant Mariner Card		**7.** Identification Card for Use of Resident Citizen in the United States (Form I-179)
		8. Native American tribal document		**8.** Employment authorization document issued by the Department of Homeland Security
		9. Driver's license issued by a Canadian government authority		
		For persons under age 18 who are unable to present a document listed above:		
		10. School record or report card		
		11. Clinic, doctor, or hospital record		
		12. Day-care or nursery school record		
6. Passport from the Federated States of Micronesia (FSM) or the Republic of the Marshall Islands (RMI) with Form I-94 or Form I-94A indicating nonimmigrant admission under the Compact of Free Association Between the United States and the FSM or RMI				

Illustrations of many of these documents appear in Part 8 of the Handbook for Employers (M-274).

Refer to Section 2 of the instructions, titled "Employer or Authorized Representative Review and Verification," for more information about acceptable receipts.

CALCULATION OF THE IMPUTED INCOME FOR EMPLOYER-PAID LIFE INSURANCE BENEFITS

The IRS considers the annual cost of employer-provided death benefits in amounts over $50,000 to be imputed income. This is considered taxable income to the employee and must be reported to the IRS in Section 12 of Form W-2. The following are the steps to calculate the amount for the life insurance option of the UCC Life Insurance and Disability Income (LIDI) Benefit Plan.

Death Benefit Table (c)	
Age	Death Benefit As a Percent of Annual Salary Basis*
Under 45	200%
45-54	150%
55-64	100%
65 and Up	50%

**Death Benefit not more than $300,000, rounded to the nearest $100.*

Step 1. Member's age: (a) _____

Step 2. Member's annual salary basis (cash plus housing allowance): (b) _____

Step 3. Member's death benefit: (c) _____

Step 4. Death benefit amount: (c) in step 3 _____ minus $50,000 equals the excess death benefit (d): _____

Step 5. Excess death benefit amount (d) in step 4: _____ divided by $1,000 equals the excess death benefit in thousands (e): _____

Step 6. Excess death benefit amount (e) in step 5: _____ multiplied by the cost from the IRS Cost Table below (f): _____ equals monthly cost of excess benefit amount (g): _____

Step 7. Monthly cost of excess benefit amount (g) multiplied by 12** equals imputed income or annual cost of excess benefit amount (h): _____

IRS Cost Table (f)	
Age Bracket	Cost per $1,000 of Protection for 1 Month
Under age 25	$.05
25-29	.06
30-34	.08
35-39	.09
40-44	.10
45-49	.15
50-54	.23
55-59	.43
60-64	.66
65-69	1.27
70 and Above	2.06

***Adjust this multiplier if calculating for an employment period of less than one year.*

List of related forms

The following forms, referenced in the preceding pages, along with their respective instructions, may be downloaded from the IRS website, **www.irs.gov**:

- Form 941
- Form 944
- Form 945
- Form 990
- Form 1040
- Form 1098-C
- Form 1099-MISC
- Form 5578
- Form 8274
- Form 8283
- Form SS-4
- Form W-2
- Form W-3
- Form W-4
- Form W-9

The following form, referenced in the preceding pages, may be downloaded from the U.S. Citizenship and Immigration Services website, **www.uscis.gov**:

- Form I-9

The following form, referenced in the preceding pages, may be downloaded from the Social SecurityAdministration website, **www.ssa.gov**:

- Form SS-5

HELPFUL NUMBERS AND RESOURCES

To request IRS forms **1.800.TAX.FORM** or **1.800.829.3676**.

IRS Home Page – **www.irs.gov**

ChurchLawandTax.com – A Christianity Today website featuring Richard Hammar and a host of other professionals who provide information on church law, tax, finance, and risk management

ChurchLawandTaxStore.com – Christianity Today's online store with church management resources to keep your church safe, legal, and financially sound

Church & Clergy Tax Guide – Richard Hammar's comprehensive tax guide published annually by Christianity Today International

Manage Your Church with Financial Integrity

Overseeing the financial health of a church is no simple task. Increased regulations, IRS audits, and changing technology are a few of the challenges facing both new and experienced treasurers, bookkeepers, business administrators and executive pastors.

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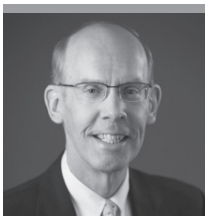
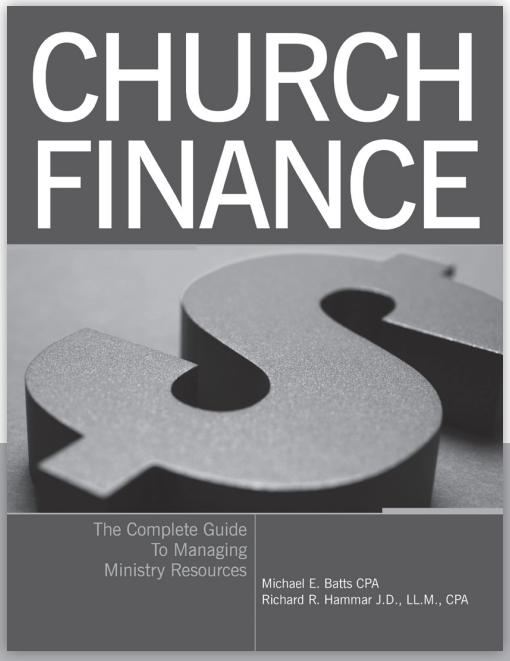
Strengthen your church's finances.

Michael E. Batts CPA



Richard R. Hammar
J.D., L.L.M., CPA



Visit ChurchLawAndTaxStore.com to order the *Church Finance* book today!

Partnering with those engaged in the life of the Church

The Pension Boards
United Church of Christ, Inc.
475 Riverside Drive, Room 1020
New York, NY 10115-0059

STATE OF HAWAII
DEPARTMENT OF LABOR AND INDUSTRIAL RELATIONS
DISABILITY COMPENSATION DIVISION
Princess Keelikolani Building, 830 Punchbowl Street, Room 209, Honolulu, Hawaii 96813

FORM HC-5 EMPLOYEE NOTIFICATION TO EMPLOYER FOR CALENDAR YEAR 2016

Instructions to employer: See employee's selection below and take appropriate action. Keep this completed, signed form and give a copy to the employee. You must keep this form for 2 years. The employee's selection below is applicable only within calendar year 2016. If the employee will be renewing the selection after 2016, have the employee complete the form for the appropriate year.

Employer name	DOL account number
Address	Phone no.

Instructions to employee: Keep a copy of your completed, signed form for yourself. Give the completed form to your employer.

Use this form if any of these apply to you:

- You work for 2 or more employers**
- You are claiming an exemption or waiver from health care coverage
- You are terminating your exemption
- You are changing your principal and/or secondary employer designation**

**The principal employer is the employer who pays you the most wages. Or if you work for 1 of your employers at least 35 hours per week but that employer does not pay you the most wages, you choose the principal employer.

Do **not** use this form if either:

- You work for only 1 employer and that employer provides your health care coverage
- You work less than 20 hours per week for your employer

In accordance with the provisions of the Hawaii Prepaid Health Care Act (Chapter 393, Hawaii Revised Statutes), this is to notify my employer that: (Check appropriate box.)

☐ 1. Of the two or more concurrent employers that I work for (at least 20 hours a week), you have been selected as the **principal** employer and are required to provide me health care coverage (Section 393-6).

☐ 2. Of the two or more concurrent employers that I work for (at least 20 hours a week), you have been selected as the **secondary** employer and are therefore relieved of the responsibility to provide me health care coverage until you are otherwise notified (Section 393-16).

☐ 3. I am **exempt** from health care coverage because I am: (Check appropriate box.) (Sections 393-17 and 393-22)

- ☐ a. covered by a Federally established health insurance or prepaid health care plan, such as Medicare, Medicaid or medical care benefits provided for military dependents and military retirees and their dependents.
- ☐ b. covered as a dependent under a qualified health care plan.
- ☐ c. a recipient of public assistance or covered by a State-legislated health care plan governing medical assistance.
- ☐ d. a follower of a religious group who depends upon prayer or other spiritual means for healing.

☐ 4. I waive coverage from my employer's health care plan because I have obtained the plan named _____ _____ from the health care plan contractor named _____.
I understand this waiver is binding for the 2016 calendar year. I submitted a copy of my plan to my employer to forward to the Dept of Labor and Industrial Relations with this form. (Section 393-21).

☐ 5. The coverage exemption/waiver previously indicated in items 2, 3 or 4 is no longer applicable; you are therefore required to provide me health care coverage (Section 393-18).
Requested effective date of coverage: _____.

Print employee name	Employee signature	
Address	Phone no.	Date

Call (808) 586-9188 with any questions about this form.

Auxiliary aids and services are available upon request. Please call: (808) 586-9188; TTY (808) 586-8844; TTY neighbor islands (888) 569-6859. A request for reasonable accommodation(s) should be made no later than ten working days prior to the needed accommodation(s).

Important Notice about Language Assistance: This document contains important information. If you need language assistance at no cost to you, please contact us by phone or in person immediately.

It is the policy of the Department of Labor and Industrial Relations that no person shall, on the basis of race, color, sex, marital status, religion, creed, ethnic origin, national origin, age, disability, ancestry, arrest/court record, sexual orientation, and National Guard participation, be subjected to discrimination, excluded from participation in, or denied the benefits of the Department's services, programs, activities, or employment.

Tax Exempt and Government Entities

EXEMPT ORGANIZATIONS

501(c)(3)

Tax Guide for Churches & Religious Organizations

Publication 1828 (Rev. 8-2015) Catalog Number 21096G Department of the Treasury **Internal Revenue Service** www.irs.gov

Congress has enacted special tax laws that apply to churches, religious organizations and ministers in recognition of their unique status in American society and of their rights guaranteed by the First Amendment of the Constitution of the United States. Churches and religious organizations are generally exempt from income tax and receive other favorable treatment under the tax law; however, certain income of a church or religious organization may be subject to tax, such as income from an unrelated business.

The Internal Revenue Service offers this quick reference guide of federal tax law and procedures for churches and religious organizations to help them voluntarily comply with tax rules. The contents of this publication reflect the IRS interpretation of tax laws enacted by Congress, Treasury regulations and court decisions. The information given is not comprehensive, however, and doesn't cover every situation. Thus, it isn't intended to replace the law or be the sole source of information. The resolution of any particular issue may depend on the specific facts and circumstances of a given taxpayer. In addition, this publication covers subjects on which a court may have made a decision more favorable to taxpayers than the interpretation by the IRS. Until these differing interpretations are resolved by higher court decisions, or in some other way, this publication will present the interpretation of the IRS.

For more detailed tax information, the IRS has assistance programs and tax information products for churches and religious organizations, as noted at the end of this publication. Most IRS publications and forms can be downloaded from the IRS website at www.irs.gov. Specialized information can be accessed through the Exempt Organizations (EO) website under the IRS Tax Exempt and Government Entities division at www.irs.gov/eo or by calling EO Customer Account Services toll free at 877-829-5500.

The IRS considers this publication a living document, one that will be revised to take into account future developments and feedback. Comments on the publication may be submitted to the IRS at:

Internal Revenue Service

1111 Constitution Avenue, NW

Washington, DC 20224 Attn: SE:T:C&L

Contents

Introduction

This publication explains the benefits and the responsibilities under the federal tax system for churches and religious organizations. The term church is found, but not specifically defined, in the Internal Revenue Code (IRC). The term is not used by all faiths; however, in an attempt to make this publication easy to read, we use it in its generic sense as a place of worship including, for example, mosques and synagogues. With the exception of the special rules for church audits, the use of the term church throughout this publication also includes conventions and associations of churches as well as integrated auxiliaries of a church.

Because special tax rules apply to churches, it's important to distinguish churches from other religious organizations. Therefore, when this publication uses the term "religious organizations," it isn't referring to churches or integrated auxiliaries. Religious organizations that are not churches typically include nondenominational ministries, interdenominational and ecumenical organizations, and other entities whose principal purpose is the study or advancement of religion.

Churches and religious organizations may be legally organized in a variety of ways under state law, such as unincorporated associations, nonprofit corporations, corporations sole and charitable trusts.

Certain terms used throughout this publication—church, integrated auxiliary of a church, minister and IRC Section 501(c)(3) — are defined in the Glossary.

Tax-Exempt Status

Churches and religious organizations, like many other charitable organizations, qualify for exemption from federal income tax under IRC Section 501(c)(3) and are generally eligible to receive tax-deductible contributions. To qualify for tax-exempt status, the organization must meet the following requirements (covered in greater detail throughout this publication):

- the organization must be organized and operated exclusively for religious, educational, scientific or other charitable purposes;
- net earnings may not inure to the benefit of any private individual or shareholder;
- no substantial part of its activity may be attempting to influence legislation;
- the organization may not intervene in political campaigns; and
- the organization's purposes and activities may not be illegal or violate fundamental public policy.

Recognition of Tax-Exempt Status

Automatic Exemption for Churches

Churches that meet the requirements of IRC Section 501(c)(3) are automatically considered tax exempt and are not required to apply for and obtain recognition of tax-exempt status from the IRS.

Although there is no requirement to do so, many churches seek recognition of tax-exempt status from the IRS because this recognition assures church leaders, members and contributors that the church is recognized as exempt and qualifies for related tax benefits. For example, contributors to a church that has been recognized as tax exempt would know that their contributions generally are tax-deductible.

Church Exemption Through a Central/Parent Organization

A church with a parent organization may wish to contact the parent to see if it has a *group ruling.* If the parent holds a group ruling, then the IRS may already recognize the church as tax exempt. Under the group exemption process, the parent organization becomes the holder of a group ruling that identifies other affiliated churches or other affiliated organizations. A church is recognized as tax exempt if it is included in a list provided by the parent organization. If the church or other affiliated organization is included on the list, it doesn't need to take further action to obtain recognition of tax-exempt status.

An organization that isn't covered under a group ruling should contact its parent organization to see if it's eligible to be included in the parent's application for the group ruling. For general information on the group exemption process, see Publication 4573, *Group Exemptions*, and Revenue Procedure 80-27, 1980-1 C.B. 677.

Religious Organizations

Unlike churches, religious organizations that wish to be tax exempt generally must apply to the IRS for tax-exempt status unless their gross receipts do not normally exceed $5,000 annually.

Applying for Tax-Exempt Status

Employer Identification Number (EIN)

Every tax-exempt organization, including a church, should have an employer identification number whether or not the organization has any employees. There are many instances in which an EIN is necessary. For example, a church needs an EIN when it opens a bank account, to be listed as a subordinate in a group ruling or if it files returns with the IRS (for example, Forms W-2, 1099, 990-T).

An organization may obtain an EIN by filing Form SS-4, *Application for Employer Identification Number,* according to its instructions. If the organization is submitting IRS Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, Form SS-4 should be included with the application.

Application Form

When applying for recognition as tax exempt under IRC Section 501(c)(3), churches and some religious organizations must use Form 1023. Smaller religious organizations may be eligible to use Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*

A religious organization generally must submit its application within 27 months from the end of the month in which the organization is formed to be considered tax exempt and qualified to receive deductible contributions as of the date the organization was formed. On the other hand, a church may obtain recognition of exemption from the date of its formation as a church, even though that date may be prior to 27 months from the end of the month in which its application is submitted.

Cost of applying for exemption. The IRS is required to collect a non-refundable fee from any organization seeking a determination of tax-exempt status under IRC Section 501(c)(3). Although churches are not required by law to file an application for exemption, if they choose to do so voluntarily, they're required to pay the fee for determination.

The fee must be submitted with Form 1023; otherwise, the application will be returned to the submitter. Fees change periodically. The most recent user fee can be found at the Exempt Organizations (EO) website under the IRS Tax Exempt and Government Entities Division via www.irs.gov/eo (key word "user fee") or by calling EO Customer Account Services toll-free at 877-829-5500.

IRS Approval of Exemption Application

If the application for tax-exempt status is approved, the IRS will notify the organization of its status, any requirement to file an annual information return and its eligibility to receive deductible contributions. The IRS does not assign a special number or other identification as evidence of an organization's tax-exempt status.

Public Listing of Tax-Exempt Organizations

Exempt Organizations Select Check is an online search tool that allows users to search for organizations that are eligible to receive tax-deductible charitable contributions. Note that not every organization that is eligible to receive tax-deductible contributions is listed on *Select Check*. For example, churches that have not applied for recognition of tax-exempt status are not included in the publication. Only the parent organization in a group ruling is included by name on *Select Check*.

Select Check also allows users to search for organizations whose tax-exempt status has been automatically revoked because they have not met their annual filing requirement for three consecutive years. In addition, users may search *Select Check* for organizations that have filed a Form 990-N *(e-Postcard)* annual electronic notice.

If you have questions about listing an organization, correcting an erroneous entry or deleting a listing on *Select Check*, contact EO Customer Account Services toll-free at 877-829-5500.

Jeopardizing Tax-Exempt Status

All IRC Section 501(c)(3) organizations, including churches and religious organizations, must abide by certain rules:

- their net earnings may not inure to any private shareholder or individual;
- they must not provide a substantial benefit to private interests;
- they must not devote a substantial part of their activities to attempting to influence legislation;
- they must not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office; and
- the organization's purposes and activities may not be illegal or violate fundamental public policy.

Inurement and Private Benefit

Inurement to Insiders

Churches and religious organizations, like all exempt organizations under IRC Section 501(c)(3), are prohibited from engaging in activities that result in inurement of the church's or organization's income or assets to insiders (such as persons having a personal and private interest in the activities of the organization). Insiders could include the minister, church board members, officers, and in certain circumstances, employees. Examples of prohibited inurement include the payment of dividends, the payment of unreasonable compensation to insiders and transferring property to insiders for less than fair market value. The prohibition against inurement to insiders is absolute; therefore, any amount of inurement is, potentially, grounds for loss of tax-exempt status. In addition, the insider involved may be subject to excise tax. See the following section on **Excess benefit transactions**. Note that prohibited inurement doesn't include reasonable payments for services rendered, payments that further tax-exempt purposes or payments made for the fair market value of real or personal property.

Excess benefit transactions. In cases where an IRC Section 501(c)(3) organization provides an excess economic benefit to an insider, both the organization and the insider have engaged in an excess benefit transaction. The IRS may impose an excise tax on any insider who improperly benefits from an excess benefit transaction, as well as on organization managers who participate in the transaction knowing that it's improper. An insider who benefits from an excess benefit transaction must return the excess benefits to the organization. Detailed rules on excess benefit transactions are contained in the Code of Federal Regulations, Title 26, sections 53.4958-0 through 53.4958-8.

Private Benefit

An IRC Section 501(c)(3) organization's activities must be directed exclusively toward charitable, educational, religious or other exempt purposes. The organization's activities may not serve the private interests of any individual or organization. Rather, beneficiaries of an organization's activities must be recognized objects of charity (such as the poor or the distressed) or the community at large (for example, through the conduct of religious services or the promotion of religion). Private benefit is different from inurement to insiders. Private benefit may occur even if the persons benefited are not insiders. Also, private benefit must be substantial to jeopardize tax-exempt status.

Substantial Lobbying Activity

In general, no organization, including a church, may qualify for IRC Section 501(c)(3) status if a substantial part of its activities is attempting to influence legislation (commonly known as lobbying). An IRC Section 501(c)(3) organization may engage in some lobbying, but too much lobbying activity risks loss of tax-exempt status.

Legislation includes action by Congress, any state legislature, any local council or similar governing body, with respect to acts, bills, resolutions or similar items (such as legislative confirmation of appointive offices), or by the public in a referendum, ballot initiative, constitutional amendment or similar procedure. It doesn't include actions by executive, judicial or administrative bodies.

A church or religious organization will be regarded as attempting to influence legislation if it contacts, or urges the public to contact, members or employees of a legislative body for the purpose of proposing, supporting or opposing legislation, or if the organization advocates the adoption or rejection of legislation.

Churches and religious organizations may, however, involve themselves in issues of public policy without the activity being considered as lobbying. For example, churches may conduct educational meetings, prepare and distribute educational materials, or otherwise consider public policy issues in an educational manner without jeopardizing their tax-exempt status.

Measuring Lobbying Activity

Substantial part test. Whether a church's or religious organization's attempts to influence legislation constitute a substantial part of its overall activities is determined on the basis of all the pertinent facts and circumstances in each case. The IRS considers a variety of factors, including the time devoted (by both compensated and volunteer workers) and the expenditures devoted by the organization to the activity, when determining whether the lobbying activity is substantial. Churches must use the substantial part test since they aren't eligible to use the expenditure test described in the next section.

Under the substantial part test, a church or religious organization that conducts excessive lobbying activity in any taxable year may lose its tax-exempt status, resulting in all its income being subject to tax. In addition, a religious organization is subject to an excise tax equal to five percent of its lobbying expenditures for the year in which it ceases to qualify for exemption. Further, a tax equal to five percent of the lobbying expenditures for the year may be imposed against organization managers, jointly and severally, who agree to the making of such expenditures knowing that the expenditures would likely result in loss of tax-exempt status.

Expendi*ture test.* Although churches aren't eligible, religious organizations may elect the expenditure test under IRC Section 501(h) as an alternative method for measuring lobbying activity. Under the expenditure test, the extent of an organization's lobbying activity won't jeopardize its tax-exempt status, provided its expenditures, related to the activity, do not normally exceed an amount specified in IRC Section 4911. This limit is generally based on the organization's size and may not exceed $1,000,000.

Religious organizations electing to use the expenditure test must file IRS Form 5768, *Election/Revocation of Election by an Eligible Section 501(c)(3) Organization To Make Expenditures To Influence Legislation*, at any time during the tax year for which it is to be effective. The election remains in effect for succeeding years unless it's revoked by the organization. Revocation of the election is effective beginning with the year following the year in which the revocation is filed. Religious organizations may wish to consult their tax advisors to determine their eligibility for, and the advisability of, electing the expenditure test.

Under the expenditure test, a religious organization that engages in excessive lobbying activity over a four-year period may lose its tax-exempt status, making all its income for that period subject to tax. Should the organization exceed its lobbying expenditure dollar limit in a particular year, it must pay an excise tax equal to 25 percent of the excess.

Political Campaign Activity

Under the Internal Revenue Code, all IRC Section 501(c)(3) organizations, including churches and religious organizations, are absolutely prohibited from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office. Contributions to political campaign funds or public statements of position (verbal or written) made by or on behalf of the organization in favor of (or in opposition to) any candidate for public office clearly violate the prohibition against political campaign activity. Violation of this prohibition may result in denial or revocation of tax-exempt status and the imposition of excise tax.

Certain activities or expenditures may not be prohibited depending on the facts and circumstances. For example, certain voter education activities (including the presentation of public forums and the publication of voter education guides) conducted in a non-partisan manner do not constitute prohibited political campaign activity. In addition, other activities intended to encourage people to participate in the electoral process, such as voter registration and get-out-the-vote drives, would not constitute prohibited political campaign activity if conducted in a non-partisan manner. On the other hand, voter education or registration activities with evidence of bias that: (a) would favor one candidate over another; (b) oppose a candidate in some manner; or (c) have the effect of favoring a candidate or group of candidates, will constitute prohibited participation or intervention.

Individual Activity by Religious Leaders

The political campaign activity prohibition isn't intended to restrict free expression on political matters by leaders of churches or religious organizations speaking for themselves, as individuals. Nor are leaders prohibited from speaking about important issues of public policy. However, for their organizations to remain tax exempt under IRC Section 501(c)(3), religious leaders can't make partisan comments in official organization publications or at official church functions. To avoid potential attribution of their comments outside of church functions and publications, religious leaders who speak or write in their individual capacity are encouraged to clearly indicate that their comments are personal and not intended to represent the views of the organization. The following are examples of situations involving endorsements by religious leaders.

EXAMPLE 1

Minister A is the minister of Church J, a Section 501(c)(3) organization, and is well known in the community. With their permission, Candidate T publishes a full-page ad in the local newspaper listing five prominent ministers who have personally endorsed Candidate T, including Minister A. Minister A is identified in the ad as the minister of Church J. The ad states, "Titles and affiliations of each individual are provided for identification purposes only." The ad is paid for by Candidate T's campaign committee. Since the ad was not paid for by Church J, the ad is not otherwise in an official publication of Church J, and the endorsement is made by Minister A in a personal capacity, the ad doesn't constitute political campaign intervention by Church J.

EXAMPLE 2

Minister B is the minister of Church K, a Section 501(c)(3) organization, and is well known in the community. Three weeks before the election, he attends a press conference at Candidate V's campaign headquarters and states that Candidate V should be re-elected. Minister B doesn't say he is speaking on behalf of Church K. His endorsement is reported on the front page of the local newspaper and he is identified in the article as the minister of Church K. Because Minister B didn't make the endorsement at an official church function, in an official church publication or otherwise use the church's assets, and did not state that he was speaking as a representative of Church K, his actions didn't constitute political campaign intervention by Church K.

EXAMPLE 3

Minister C is the minister of Church I, a Section 501(c)(3) organization. Church I publishes a monthly church newsletter that is distributed to all church members. In each issue, Minister C has a column titled "My Views." The month before the election, Minister C states in the "My Views" column, "It is my personal opinion that Candidate U should be re-elected." For that one issue, Minister C pays from his personal funds the portion of the cost of the newsletter attributable to the "My Views" column. Even though he paid part of the cost of the newsletter, the newsletter is an official publication of the church. Because the endorsement appeared in an official publication of Church I, it constitutes political campaign intervention by Church I.

EXAMPLE 4

Minister D is the minister of Church M, a Section 501(c)(3) organization. During regular services of Church M shortly before the election, Minister D preached on a number of issues, including the importance of voting in the upcoming election, and concluded by stating, "It is important that you all do your duty in the election and vote for Candidate W." Because Minister D's remarks indicating support for Candidate W were made during an official church service, they constitute political campaign intervention by Church M.

Issue Advocacy vs. Political Campaign Intervention

Like other Section 501(c)(3) organizations, some churches and religious organizations take positions on public policy issues, including issues that divide candidates in an election for public office. However, 501(c)(3) organizations must avoid any issue advocacy that functions as political campaign intervention. Even if a statement does not expressly tell an audience to vote for or against a specific candidate, an organization delivering the statement is at risk of violating the political campaign intervention prohibition if there is any message favoring or opposing a candidate. A statement can identify a candidate not only by stating the candidate's name but also by other means such as showing a picture of the candidate, referring to political party affiliations or other distinctive features of a candidate's platform or biography. All the facts and circumstances need to be considered to determine if the advocacy is political campaign intervention.

Key factors in determining whether a communication results in political campaign intervention include:

- whether the statement identifies one or more candidates for a given public office,
- whether the statement expresses approval or disapproval for one or more candidates' positions or actions,
- whether the statement is delivered close in time to the election,
- whether the statement makes reference to voting or an election,
- whether the issue addressed in the communication has been raised as an issue distinguishing candidates for a given office,
- whether the communication is part of an ongoing series of communications by the organization on the same issue that are made independent of the timing of any election, and
- whether the timing of the communication and identification of the candidate are related to a non-electoral event such as a scheduled vote on specific legislation by an officeholder who also happens to be a candidate for public office.

A communication is particularly at risk of political campaign intervention when it makes reference to candidates or voting in a specific upcoming election. Nevertheless, the communication must still be considered in context before arriving at any conclusions.

EXAMPLE 1

Church O, a Section 501(c)(3) organization, prepares and finances a full-page newspaper advertisement that is published in several large circulation newspapers in State V shortly before an election in which Senator C is the incumbent candidate for nomination in a party primary. The advertisement states that a pending bill in the United States Senate would provide additional opportunities for State V residents to participate in faith-based programs by providing funding to such church-affiliated programs. The advertisement ends with the statement "Call or write Senator C to tell him to vote for this bill, despite his opposition in the past." Funding for faith-based programs hasn't been raised as an issue distinguishing Senator C from any opponent. The bill is scheduled for a vote before the election. The advertisement identifies Senator C's position as contrary to O's position. Church O has not violated the political campaign intervention prohibition. The advertisement doesn't mention the election or the candidacy of Senator C or distinguish Senator C from any opponent. The timing of the advertising and the identification of Senator C are directly related to a vote on the identified legislation. The candidate identified, Senator C, is an officeholder who is in a position to vote on the legislation.

EXAMPLE 2

Church R, a Section 501(c)(3) organization, prepares and finances a radio advertisement urging an increase in state funding for faith-based education in State X, which requires a legislative appropriation. Governor E is the governor of State X. The radio advertisement is first broadcast on several radio stations in State X beginning shortly before an election in which Governor E is a candidate for re-election. The advertisement is not part of an ongoing series of substantially similar advocacy communications by Church R on the same issue. The advertisement cites numerous statistics indicating that faith-based education in State X is under funded. Although the advertisement doesn't say anything about Governor E's position on funding for faith-based education, it ends with "Tell Governor E what you think about our under-funded schools." In public appearances and campaign literature, Governor E's opponent has made funding of faith-based education an issue in the campaign by focusing on Governor E's veto of an income tax increase to increase funding for faith-based education. At the time the advertisement is broadcast, no legislative vote or other major legislative activity is scheduled in the State X legislature on state funding of faith-based education. Church R has violated the political campaign prohibition. The advertisement identifies Governor E, appears shortly before an election in which Governor E is a candidate, is not part of an ongoing series of substantially similar advocacy communications by Church R on the same issue, is not timed to coincide with a non-election event such as a legislative vote or other major legislative action on that issue, and takes a position on an issue that the opponent has used to distinguish himself from Governor E.

EXAMPLE 3

Candidate A and Candidate B are candidates for the state senate in District W of State X. The issue of State X funding for a faith-based indigent hospital care in District W is a prominent issue in the campaign. Both candidates have spoken out on the issue. Candidate A supports funding the care; Candidate B opposes the project and supports increasing State X funding for public hospitals instead. P is the head of the board of elders at Church C, a Section 501(c)(3) organization located in District W. At C's annual fundraising dinner in District W, which takes place in the month before the election, P gives a long speech about health care issues, including the issue of funding for faith-based programs. P doesn't mention the name of any candidate or any political party. However, at the end of the speech, P states, "For those of you who care about quality of life in District W and the desire of our community for health care responsive to their faith, there is a very important choice coming up next month. We need more funding for health care. Increased public hospital funding won't make a difference. You have the power to respond to the needs of this community. Use that power when you go to the polls and cast your vote in the election for your state senator." C has violated the political campaign intervention prohibition as a result of P's remarks at C's official function shortly before the election, in which P referred to the upcoming election after stating a position on a prominent issue in a campaign that distinguishes the candidates.

Inviting a Candidate to Speak

Depending on the facts and circumstances, a church or religious organization may invite political candidates to speak at its events without jeopardizing its tax-exempt status. Political candidates may be invited in their capacity as candidates, or individually (not as candidates). Candidates may also appear without an invitation at organization events that are open to the public.

Speaking as a candidate. Like any other IRC Section 501(c)(3) organization, when a candidate is invited to speak at a church or religious organization event as a political candidate, factors in determining whether the organization participated or intervened in a political campaign include:

- whether the church provides an equal opportunity to the political candidates seeking the same office,
- whether the church indicates any support of or opposition to the candidate. This should be stated explicitly when the candidate is introduced and in communications concerning the candidate's appearance,
- whether any political fundraising occurs,
- whether the individual is chosen to speak solely for reasons other than candidacy for public office,
- whether the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present, and
- whether the organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

Equal opportunity to participate. Like any other Section 501(c)(3) organization, in determining whether candidates are given an equal opportunity to participate, a church or religious organization should consider the nature of the event to which each candidate is invited, in addition to the manner of presentation. For example, a church or religious organization that invites one candidate to speak at its well attended annual banquet, but invites the opposing candidate to speak at a sparsely attended general meeting, will likely be found to have violated the political campaign prohibition, even if the manner of presentation for both speakers is otherwise neutral.

Public forum. Sometimes a church or religious organization invites several candidates to speak at a public forum. A public forum involving several candidates for public office may qualify as an exempt educational activity. However, if the forum is operated to show a bias for or against any candidate, then the forum would be prohibited campaign activity, as it would be considered intervention or

participation in a political campaign. When an organization invites several candidates to speak at a forum, it should consider:

- whether questions for the candidate are prepared and presented by an independent nonpartisan panel;

- whether the topics discussed by the candidates cover a broad range of issues that the candidates would address if elected to the office sought and are of interest to the public;

- whether each candidate is given an equal opportunity to present his or her views on the issues discussed;

- whether the candidates are asked to agree or disagree with positions, agendas, platforms or statements of the organization; and

- whether a moderator comments on the questions or otherwise implies approval or disapproval of the candidates.

A candidate may seek to reassure the organization that it's permissible for the organization to do certain things in connection with the candidate's appearance. An organization in this position should keep in mind that the candidate may not be familiar with the organization's tax-exempt status and that the candidate may be focused on compliance with the election laws that apply to the candidate's campaign rather than the federal tax law that applies to the organization. The organization will be in the best position to ensure compliance with the prohibition on political campaign intervention if it makes its own independent conclusion about its compliance with federal tax law.

The following are examples of situations where a church or religious organization invites candidates to speak before the congregation.

EXAMPLE 1

Minister E is the minister of Church N, a Section 501(c)(3) organization. In the month prior to the election, Minister E invited the three Congressional candidates for the district in which Church N is located to address the congregation, one each on three successive Sundays, as part of regular worship services. Each candidate was given an equal opportunity to address and field questions on a variety of topics from the congregation. Minister E's introduction of each candidate included no comments on their qualifications or any indication of a preference for any candidate. The actions do not constitute political campaign intervention by Church N.

EXAMPLE 2

The facts are the same as in Example 1 except there are four candidates in the race rather than three, and one of the candidates declines the invitation to speak. In the publicity announcing the dates for each of the candidate's speeches, Church N includes a statement that the order of the speakers was determined at random and the fourth candidate declined the church's invitation to speak. Minister E makes the same statement in his opening remarks at each of the meetings where one of the candidates is speaking. Church N's actions do not constitute political campaign intervention.

EXAMPLE 3

Minister F is the minister of Church O, a Section 501(c)(3) organization. The Sunday before the election, Minister F invited Senate Candidate X to preach to her congregation during worship services. During his remarks, Candidate X stated, "I am asking not only for your votes, but for your enthusiasm and dedication, for your willingness to go the extra mile to get a very large turnout on Tuesday." Minister F invited no other candidate to address her congregation during the Senatorial campaign. Because these activities took place during official church services, they are by Church O. By selectively providing church facilities to allow Candidate X to speak in support of his campaign, Church O's actions constitute political campaign intervention.

Speaking as a non-candidate. Like any other Section 501(c)(3) organization, a church or religious organization may invite political candidates (including church members) to speak in a non-candidate capacity. For instance, a political candidate may be a public figure because he or she: (a) currently holds, or formerly held, public office; (b) is considered an expert in a non-political field; or (c) is a celebrity or has led a distinguished military, legal or public service career. A candidate may choose to attend an event that is open to the public, such as a lecture, concert or worship service. The candidate's presence at a church-sponsored event does not, by itself, cause the organization to be involved in political campaign intervention. However, if the candidate is publicly recognized by the organization, or if the candidate is invited to speak, factors in determining whether the candidate's appearance results in political campaign intervention include:

- whether the individual speaks only in a non-candidate capacity,
- whether either the individual or any representative of the church makes any mention of his or her candidacy or the election,
- whether any campaign activity occurs in connection with the candidate's attendance,
- whether the individual is chosen to speak solely for reasons other than candidacy for public office,
- whether the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present, and
- whether the organization clearly indicates the capacity in which the candidate is appearing and doesn't mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

In addition, the church or religious organization should clearly indicate the capacity in which the candidate is appearing and shouldn't mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

Below are examples of situations where a public official appears at a church or religious organization.

EXAMPLE 1

Church P, a Section 501(c)(3) organization, is located in the state capital. Minister G customarily acknowledges the presence of any public officials present during services. During the state gubernatorial race, Lieutenant Governor Y, a candidate, attended a Wednesday evening prayer service in the church. Minister G acknowledged the Lieutenant Governor's presence in his customary manner, saying, "We are happy to have worshiping with us this evening Lieutenant Governor Y." Minister G made no reference in his welcome to the Lieutenant Governor's candidacy or the election. Minister G's actions do not constitute political campaign intervention by Church P.

EXAMPLE 2

Minister H is the minister of Church Q, a Section 501(c)(3) organization. Church Q is building a community center. Minister H invites Congressman Z, the representative for the district containing Church Q, to attend the groundbreaking ceremony for the community center. Congressman Z is running for re-election at the time. Minister H makes no reference in her introduction to Congressman Z's candidacy or the election. Congressman Z also makes no reference to his candidacy or the election and does not do any fundraising while at Church Q. Church Q has not intervened in a political campaign

EXAMPLE 3

Church X is a Section 501(c)(3) organization. Church X regularly publishes a member newsletter. Individual church members are invited to send in updates about their activities, which are printed in each edition of the newsletter. After receiving an update letter from Member Q, Church X prints the following: "Member Q is running for city council in Metropolis." The newsletter does not contain any reference to this election or to Member Q's candidacy other than this statement. Church X has not intervened in a political campaign.

EXAMPLE 4

Mayor G attends a concert performed by a choir of Church S, a Section 501(c)(3) organization, in City Park. The concert is free and open to the public. Mayor G is a candidate for re-election, and the concert takes place after the primary and before the general election. During the concert, Church S's minister addresses the crowd and says, "I am pleased to see Mayor G here tonight. Without his support, these free concerts in City Park would not be possible. We will need his help if we want these concerts to continue next year so please support Mayor G in November as he has supported us." As a result of these remarks, Church S has engaged in political campaign intervention.

Voter Education, Voter Registration and Get-Out-the-Vote Drives

Section 501(c)(3) organizations are permitted to conduct certain voter education activities (including the presentation of public forums and the publication of voter education guides) if they are carried out in a non-partisan manner. In addition, Section 501(c)(3) organizations may encourage people to participate in the electoral process through voter registration and get-out-the-vote drives, conducted in a non-partisan manner. On the other hand, voter education or registration activities conducted in a biased manner that favors (or opposes) one or more candidates is prohibited.

Like other Section 501(c)(3) organizations, some churches and religious organizations undertake voter education activities by distributing voter guides. Voter guides, generally, are distributed during an election campaign and provide information on how all candidates stand on various issues. These guides may be dis-

tributed with the purpose of educating voters; however, they may not be used to attempt to favor or oppose candidates for public elected office.

A careful review of the following facts and circumstances may help determine whether a church or religious organization's publication or distribution of voter guides constitutes prohibited political campaign activity:

- whether the candidates' positions are compared to the organization's position,
- whether the guide includes a broad range of issues that the candidates would address if elected to the office sought,
- whether the description of issues is neutral,
- whether all candidates for an office are included, and
- whether the descriptions of candidates' positions are either:

– the candidates' own words in response to questions, or

– a neutral, unbiased and complete compilation of all candidates' positions.

The following are examples of situations where churches distribute voter guides.

EXAMPLE 1

Church R, a Section 501(c)(3) organization, distributes a voter guide prior to elections. The voter guide consists of a brief statement from the candidates on each issue made in response to a questionnaire sent to all candidates for governor of State I. The issues on the questionnaire cover a wide variety of topics and were selected by Church R based solely on their importance and interest to the electorate as a whole. Neither the questionnaire nor the voter guide, through their content or structure, indicate a bias or preference for any candidate or group of candidates. Church R is not participating or intervening in a political campaign.

EXAMPLE 2

Church S, a Section 501(c)(3) organization, distributes a voter guide during an election campaign. The voter guide is prepared using the responses of candidates to a questionnaire sent to candidates for major public offices. Although the questionnaire covers a wide range of topics, the wording of the questions evidences a bias on certain issues. By using a questionnaire structured in this way, Church S is participating or intervening in a political campaign.

EXAMPLE 3

Church T, a Section 501(c)(3) organization, sets up a booth at the state fair where citizens can register to vote. The signs and banners in and around the booth give only the name of the church, the date of the next upcoming statewide election and notice of the opportunity to register. No reference to any candidate or political party is made by volunteers staffing the booth or in the materials available in the booth, other than the official voter registration forms which allow registrants to select a party affiliation. Church T is not engaged in political campaign intervention when it operates this voter registration booth.

EXAMPLE 4

Church C is a Section 501(c)(3) organization. Church C's activities include educating its members on family issues involving moral values. Candidate G is running for state legislature and an important ele-

ment of her platform is challenging the incumbent's position on family issues. Shortly before the election, Church C sets up a telephone bank to call registered voters in the district in which Candidate G is seeking election. In the phone conversations, Church C's representative tells the voter about the moral importance of family issues and asks questions about the voter's views on these issues. If the voter appears to agree with the incumbent's position, Church C's representative thanks the voter and ends the call. If the voter appears to agree with Candidate G's position, Church C's representative reminds the voter about the upcoming election, stresses the importance of voting in the election and offers to provide transportation to the polls. Church C is engaged in political campaign intervention when it conducts this get-out-the-vote drive.

Business Activity

The question of whether an activity constitutes participation or intervention in a political campaign may also arise in the context of a business activity of the church or religious organization, such as the selling or renting of mailing lists, the leasing of office space or the acceptance of paid political advertising. (The tax treatment of income from unrelated business activities follows.) In this context, some of the factors to be considered in determining whether the church or religious organization has engaged in prohibited political campaign activity include:

- whether the good, service or facility is available to the candidates equally;
- whether the good, service or facility is available only to candidates and not to the general public;
- whether the fees charged are at the organization's customary and usual rates; and
- whether the activity is an ongoing activity of the organization or is conducted only for the candidate.

EXAMPLE 1

Church K is a Section 501(c)(3) organization. It owns a building that has a large basement hall suitable for hosting dinners and receptions. For several years, Church K has made the hall available for rent to the public. It has standard fees for renting the hall based on the number of people in attendance. A number of different organizations have rented the hall. Church K rents the hall on a first come, first served basis. Candidate P's campaign pays the standard fee for the dinner. Church K isn't involved in political campaign intervention as a result of renting the hall to Candidate P for use as the site of a campaign fundraising dinner.

EXAMPLE 2

Church L is a Section 501(c)(3) organization. It maintains a mailing list of all its members. Church L has never rented the mailing list to a third party. The campaign committee of Candidate A, who supports funding for faith-based programs, approaches Church L and offers to rent Church L's mailing list for a fee that is comparable to fees charged by similar organizations. Church L rents the list to Candidate A's campaign committee, but declines similar requests from campaign committees of other candidates. Church L has intervened in a political campaign.

Websites. The Internet has become a widely used communications tool. Section 501(c)(3) organizations use their own websites to disseminate statements and information. They also routinely link their websites to websites maintained by other organizations as a way of providing additional information that the organizations believe is relevant to the public.

A website is a form of communication. If an organization posts something on its website that favors or opposes a candidate for public office, the organization will be treated the same as if it distributed printed material, oral statements or broadcasts that favored or opposed a candidate.

An organization has control over whether it establishes a link to another site. When an organization establishes a link to another website, the organization is responsible for the consequences of establishing and maintaining that link, even if the organization doesn't have control over the content of the linked site. Because the linked content may change over time, an organization may reduce the risk of political campaign intervention by monitoring the linked content and adjusting the links accordingly.

Links to candidate-related material, by themselves, do not necessarily constitute political campaign intervention. All the facts and circumstances must be taken into account when assessing whether a link produces that result. The facts and circumstances to be considered include, but are not limited to, the context for the link on the organization's website, whether all candidates are represented, any exempt purpose served by offering the link and the directness of the links between the organization's website and the Web page that contains material favoring or opposing a candidate for public office.

EXAMPLE 1

Church P, a Section 501(c)(3) organization, maintains a website that includes biographies of its ministers, times of services, details of community outreach programs and activities of members of its congregation. B, a member of Church P's congregation, is running for a seat on the town council. Shortly before the election, Church P posts the following message on its website, "Lend your support to B, your fellow parishioner, in Tuesday's election for town council." Church P has intervened in a political campaign.

EXAMPLE 2

Church N, a Section 501(c)(3) organization, maintains a website that includes staff listings, directions to the church and descriptions of its community outreach programs, schedules of services and school activities. On one page of the website, Church N describes a particular type of treatment program for homeless veterans. This section includes a link to an article on the website of O, a major national newspaper, praising Church N's treatment program for homeless veterans. The page containing the article on O's website doesn't refer to any candidate or election and has no direct links to candidate or election information. Elsewhere on O's website, there is a page displaying editorials that O has published. Several of the editorials endorse candidates in an election that hasn't yet occurred. Church N has not intervened in a political campaign by maintaining a link on O's website because the link is provided for the exempt purpose of educating the public about its programs; the context for the link, the relationship between Church N and O and the arrangement of the links going from Church N's website to the endorsement on O's website don't indicate that Church N was favoring or opposing any candidate.

EXAMPLE 3

Church M, a Section 501(c)(3) organization, maintains a website and posts an unbiased, nonpartisan voter guide. For each candidate covered in the voter guide, Church M includes a link to that candidate's official campaign website. The links to the candidate websites are presented on a consistent neutral basis for each candidate, with text saying "For more information on Candidate X, you may consult [URL]." Church M has not intervened in a political campaign because the links are provided for the exempt purpose of educating voters and are presented in a neutral, unbiased manner that includes all candidates for a particular office.

Consequences of Political Campaign Activity

When it participates in political campaign activity, a church or religious organization jeopardizes both its tax-exempt status under IRC Section 501(c)(3) and its eligibility to receive tax-deductible contributions. In addition, it may become subject to an excise tax on its political expenditures. This excise tax may be imposed in addition to revocation, or it may be imposed instead of revocation. Also, the church or religious organization should correct the violation.

Excise tax. An initial tax is imposed on an organization at the rate of 10 percent of the political expenditures. Also, a tax at the rate of 2.5 percent of the expenditures is imposed against the organization managers (jointly and severally) who, without reasonable cause, agreed to the expenditures knowing they were political expenditures. The tax on management may not exceed $5,000 with respect to any one expenditure.

In any case in which an initial tax is imposed against an organization, and the expenditures are not corrected within the period allowed by law, an additional tax equal to 100 percent of the expenditures is imposed against the organization. In that case, an additional tax is also imposed against the organization managers (jointly and severally) who refused to agree to make the correction. The additional tax on management is equal to 50 percent of the expenditures and may not exceed $10,000 with respect to any one expenditure.

Correction. Correction of a political expenditure requires the recovery of the expenditure, to the extent possible, and establishment of safeguards to prevent future political expenditures.

Please note that a church or religious organization that engages in any political campaign activity also needs to determine whether it complies with the appropriate federal, state or local election laws, as these may differ from the requirements under IRC Section 501(c)(3).

Unrelated Business Income Tax (UBIT)

Net Income Subject to the UBIT

Churches and religious organizations, like other tax-exempt organizations, may engage in income-producing activities unrelated to their tax-exempt purposes, as long as the unrelated activities aren't a substantial part of the organization's activities. However, the net income from these activities will be subject to the UBIT if the following three conditions are met:

- the activity constitutes a trade or business,
- the trade or business is regularly carried on, and
- the trade or business is not substantially related to the organization's exempt purpose. (The fact that the organization uses the income to further its charitable or religious purposes does not make the activity substantially related to its exempt purposes.)

Exceptions to UBIT

Even if an activity meets the above criteria, the income may not be subject to tax if it meets one of the following exceptions: (a) substantially all the work in operating the trade or business is performed by volunteers, (b) the activity is conducted by the organization primarily for the convenience of its members or (c) the trade or business involves the selling of merchandise substantially all of which was donated.

In general, rents from real property, royalties, capital gains, and interest and dividends aren't subject to the unrelated business income tax unless financed with borrowed money.

Examples of Unrelated Trade or Business Activities

Unrelated trade or business activities vary depending on types of activities.

Advertising

Many tax-exempt organizations sell advertising in their publications or other forms of public communication. Generally, income from the sale of advertising is unrelated trade or business income. This may include the sale of advertising space in weekly bulletins, magazines or journals, or on church or religious organization websites.

Gaming

Most forms of gaming, if regularly carried on, may be considered the conduct of an unrelated trade or business. This can include the sale of pull-tabs and raffles. Income derived from bingo games may be eligible for a special tax exception (in addition to the exception regarding uncompensated volunteer labor), if: (a) the

bingo game is the traditional type of bingo (as opposed to instant bingo, a variation of pull-tabs), (b) the conduct of the bingo game is not an activity carried out by for-profit organizations in the local area and (c) the operation of the bingo game does not violate any state or local law.

Sale of merchandise and publications

The sale of merchandise and publications (including the actual publication of materials) can be considered the conduct of an unrelated trade or business if the items involved do not have a substantial relationship to the exempt purposes of the organization.

Rental income

Generally, income derived from the rental of real property and incidental personal property is excluded from unrelated business income. However, there are certain situations in which rental income may be unrelated business taxable income:

- if a church rents out property on which there is debt outstanding (for example, a mortgage note), the rental income may constitute unrelated debt-financed income subject to UBIT. (However, if a church or convention or association of churches acquires debt-financed land and intends to use it for exempt purposes within 15 years of the time of acquisition, then income from the rental of the land may not constitute unrelated business income.)

- if personal services are rendered in connection with the rental, then the income may be unrelated business taxable income.

Parking lots

If a church owns a parking lot that is used by church members and visitors while attending church services, any parking fee paid to the church would not be subject to UBIT. However, if a church operates a parking lot that is used by members of the general public, parking fees would be taxable, as this activity would not be substantially related to the church's exempt purpose, and parking fees are not treated as rent from real property. If the church enters into a lease with a third party who operates the church's parking lot and pays rent to the church, these payments would not be subject to tax, as they would constitute rent from real property.

Whether an income-producing activity is an unrelated trade or business activity depends on all the facts and circumstances. For more information, see IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations.*

Tax on Income-Producing Activities

If a church, or other exempt organization, has gross income of $1,000 or more for any taxable year from the conduct of any unrelated trade or business, it must file IRS Form 990-T, *Exempt Organization Business Income Tax Return*, for that year.

If the church is part of a larger entity (such as a diocese), it must file a separate Form 990-T if it has a separate EIN. Form 990-T is due the l5th day of the 5th month following the end of the church's tax year. (IRC Section 512(b)(12) provides a special rule for parishes and similar local units of a church. A specific deduction is provided, which is equal to the lower of $1,000 or the gross income derived from any unrelated trade or business regularly carried on by the parish or local unit of a church.) See Filing Requirements.

Employment Tax

Generally, churches and religious organizations are required to withhold, report and pay income and Federal Insurance Contributions Act (FICA) taxes for their employees. Employment tax includes income tax and FICA taxes withheld and paid for an employee. Substantial penalties may be imposed against an organization that fails to withhold and pay the proper employment tax. Whether a church or religious organization must withhold and pay employment tax depends upon whether the church's workers are employees. Determination of worker status is important. Several facts determine whether a worker is an employee. For an in-depth explanation and examples of the common law employer-employee relationship, see IRS Publication 15-A, *Employer's Supplemental Tax Guide*. If a church or a worker wants the IRS to determine whether the worker is an employee, the church or worker should file IRS Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding,* with the IRS.

Social Security and Medicare Taxes — Federal Insurance Contributions Act (FICA)

FICA taxes consist of Social Security and Medicare taxes. Wages paid to employees of churches or religious organizations are subject to FICA taxes unless one of the following applies:

- wages are paid for services performed by a duly ordained, commissioned or licensed minister of a church in the exercise of his or her ministry, or by a member of a religious order in the exercise of duties required by such order; or

- a church that is opposed to the payment of Social Security and Medicare taxes for religious reasons files IRS Form 8274, *Certification by Churches and Qualified Church-Controlled Organizations Electing Exemption From Employer Social Security and Medicare Taxes.* Very specific timing rules apply to filing Form 8274. It must be filed before the first date on which the electing entity is required to file its first quarterly employment tax return. This election does not relieve the organization of its obligation to withhold income tax on wages paid to its employees. In addition, if an employee makes such an election and earns more than $108.28 in wages in a calendar year, he or she must pay Self-Employment Contributions Act (SECA) tax. For more information, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*

Withheld employee income tax and FICA taxes are reported on IRS Form 941, *Employer's Quarterly Federal Tax Return*. Some small employers are eligible to file an annual Form 944 instead of quarterly returns. For more information about employment tax, see;

- Publication 15, *Circular E, Employer's Tax Guide*
- Publication 15-A, *Employer's Supplemental Tax Guide*
- Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*
- Form 944 Instructions

Federal Unemployment Tax Act (FUTA)

Churches and religious organizations are not liable for FUTA tax. For further information on FUTA, see IRS Publication 15, *Circular E, Employer's Tax Guide*, IRS Publication 15-A, *Employer's Supplemental Tax Guide*, and IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*

Special Rules for Compensation of Ministers

Withholding Income Tax for Ministers

Unlike other exempt organizations or businesses, a church isn't required to withhold income tax from the compensation it pays to its duly ordained, commissioned or licensed ministers for performing services in the exercise of their ministry. An employee minister may, however, enter into a voluntary withholding agreement with the church by completing IRS Form W-4, *Employee's Withholding Allowance Certificate.* A church should report compensation paid to a minister on Form W-2, *Wage and Tax Statement,* if the minister is an employee, or on IRS Form 1099-MISC, *Miscellaneous Income,* if the minister is an independent contractor.

Parsonage or Housing Allowances

Generally, a minister's gross income does not include the fair rental value of a home (parsonage) provided, or a housing allowance paid, as part of the minister's compensation for services performed that are ordinarily the duties of a minister.

A minister who is furnished a parsonage may exclude from income the fair rental value of the parsonage, including utilities. However, the amount excluded can't be more than the reasonable pay for the minister's services.

A minister who receives a housing allowance may exclude the allowance from gross income to the extent it's used to pay expenses in providing a home. Generally, those expenses include rent, mortgage payments, utilities, repairs and other expenses directly relating to providing a home. If a minister owns a home, the amount excluded from the minister's gross income as a housing allowance is limited to the least of: (a) the amount actually used to provide a home, (b) the amount officially designated as a housing allowance or (c) the fair rental value of the home. The minister's church or other qualified organization must designate the housing allowance by official action taken *in advance* of the payment. If a minister is employed and paid by a local congregation, a designation by a national church agency won't be effective. The local congregation must make the designation. A national church agency may make an effective designation for ministers it directly employs. If none of the minister's salary has been officially designated as a housing allowance, the full salary must be included in gross income.

The fair rental value of a parsonage or housing allowance is excludable from income only for income tax purposes. These amounts are *not* excluded in determining the minister's net earnings from self-employment for Self-Employment Contributions Act (SECA) tax purposes. Retired ministers who receive either a parsonage or housing allowance aren't required to include the amounts for SECA tax purposes.

As mentioned above, a minister who receives a parsonage or rental allowance excludes that amount from his income. The portion of expenses allocable to the excludable amount is not deductible. This limitation, however, does not apply to interest on a home mortgage or real estate taxes, nor to the calculation of net earnings from self-employment for SECA tax purposes.

IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers,* has a detailed example of the tax treatment for a housing allowance and the related limitations on deductions. IRS Publication 525, *Taxable and Nontaxable Income*, has information on particular types of income for ministers.

Social Security and Medicare Taxes — Federal Insurance Contributions Act (FICA) vs. Self-Employment Contributions Act (SECA)

The compensation that a church or religious organization pays to its ministers for performing services in the exercise of ministry is not subject to FICA taxes. However, income that a minister earns in performing services in the exercise of his ministry is subject to SECA tax, unless the minister has timely applied for and received an exemption from SECA tax.

Payment of Employee Business Expenses

A church or religious organization is treated like any other employer as far as the tax rules on employee business expenses. The rules differ depending upon whether the expenses are paid through an accountable or non-accountable plan, and these plans determine whether the payment for these expenses is included in the employee's income.

Accountable Reimbursement Plan

An arrangement that an employer establishes to reimburse or advance employee business expenses will be an accountable plan if it: (1) involves a business connection, (2) requires the employee to substantiate expenses incurred and (3) requires the employee to return any excess amounts.

Employees must provide the organization with sufficient information to identify the specific business nature of each expense and to substantiate each element of an expenditure. It isn't sufficient for an employee to aggregate expenses into broad categories such as travel or to report expenses through the use of non-descriptive terms such as miscellaneous business expenses. Both the substantiation and the return of excess amounts must occur within a reasonable time.

Employee business expenses reimbursed under an accountable plan are: (a) excluded from an employee's gross income, (b) not required to be reported on the employee's IRS Form W-2, *Wage and Tax Statement,* and (c) exempt from the withholding and payment of wages subject to FICA taxes and income tax withholdings.

Non-accountable Reimbursement Plan

If the church or religious organization reimburses or advances the employee for business expenses, but the arrangement does not satisfy the three requirements of an accountable plan, the amounts paid to the employees are considered wages subject to FICA taxes and income tax withholding, if applicable, and are reportable on Form W-2. (Amounts paid to employee ministers are treated as wages reportable on Form W-2, but are not subject to FICA taxes or income tax withholding.)

For example, if a church or religious organization pays its secretary a $200 per month allowance to reimburse monthly business expenses the secretary incurs while conducting church or religious organization business, and the secretary is not required to substantiate the expenses or return any excess, then the entire $200 must be reported on Form W-2 as wages subject to FICA taxes and income tax withholding. In the same situation involving an employee-minister, the allowance must be reported on the minister's Form W-2, but no FICA or income tax withholding is required. For further information see IRS Publication 463, *Travel, Entertainment, Gift, and Car Expenses*.

One common business expense reimbursement is for automobile mileage. If a church or religious organization pays a mileage allowance at a rate that is less than or equal to the federal standard rate, the amount of the expense is deemed substantiated. (Each year, the federal government establishes a standard mileage reimbursement rate.) There are no income or employment tax consequences to the reimbursed individual provided that the employee substantiates the time, place and business purposes of the automobile mileage for which reimbursement is sought. Of course, reimbursement for automobile mileage incurred for personal purposes is includible in the individual's income.

If a church or religious organization reimburses automobile mileage at a rate exceeding the standard mileage rate, the excess is treated as paid under a non-accountable plan. This means that the excess is includible in the individual's income and is subject to the withholding and payment of income and employment taxes, if applicable.

In addition, any mileage reimbursement that is paid without requiring the individual to substantiate the time, place and business purposes of each trip is included in the individual's income, regardless of the rate of reimbursement.

No income is attributed to an employee or a volunteer who uses an automobile owned by the church or religious organization to perform church-related work.

Recordkeeping Requirements

Books of Accounting and Other Types of Records

All tax-exempt organizations, including churches and religious organizations (regardless of whether tax-exempt status has been officially recognized by the IRS), are required to maintain books of accounting and other records necessary to justify their claim for exemption in the event of an audit. See Special Rules Limiting IRS Authority to Audit a Church. Tax-exempt organizations are also required to maintain books and records that are necessary to accurately file any federal tax and information returns that may be required.

There is no specific format for keeping records. However, the types of required records frequently include organizing documents (charter, constitution, articles of incorporation) and bylaws, minute books, property records, general ledgers, receipts and disbursements journals, payroll records, banking records and invoices. The extent of the records necessary generally varies according to the type, size and complexity of the organization's activities.

Length of Time to Retain Records

The law does not specify a length of time that records must be retained; however, the following guidelines should be applied in the event that the records may be material to the administration of any federal tax law.

TYPE OF RECORD	LENGTH OF TIME TO RETAIN
Records of revenue and expenses, including payroll records.	Retain for at least four years after filing the returns to which they relate.
Records relating to acquisition and disposition of property (real and personal, including investments).	Retain for at least four years after the filing of the return for the year in which disposition occurs.

Filing Requirements

Information and Tax Returns — Forms to File and Due Dates

Churches or religious organizations may be required to report certain payments or information to the IRS. The following is a list of the most frequently required returns, who should use them, how they are used and when they should be filed.

Forms	Who Should Use Them	How They are Used	When to File
Form W-2 *Wage and Tax Statement* **Form W-3** *Transmittal of Wage and Tax Statement*	Organizations with employees.	Use Form W-2 to report employee wages and the taxes withheld from them. Use Form W-3 to transmit Forms W-2 to the Social Security Administration.	Furnish each employee with a completed Form W-2 by January 31; and file all Forms W-2 and Form W-3 with the Social Security Administration (SSA) by the last day of February.
Form W-2G *Certain Gaming Winnings* For more information on reporting requirements for gaming activities, see IRS Publication 3079, *Tax-Exempt Organizations and Gaming*.	Any charitable or religious organization, including a church, that sponsors a gaming event (raffles, bingo) must file Form W-2G when a participant wins a prize over a specific value amount.	The requirements for reporting and withholding depend on the type of gaming, the amount of winnings and the ratio of winnings to the wager.	For each winner meeting the filing requirement, the church or religious organization must furnish Form W-2G by January 31; and file Copy A of Form W-2G with the IRS by February 28.
Form 941 *Employer's Quarterly Federal Tax Return* or **Form 944** *Employer's Annual Federal Tax Return*	Small employers that have been notified by the IRS to file Form 944 (see form instructions) may use that form; other employers required to file must use Form 941.	Use Form 941 or 944 to report Social Security and Medicare taxes and income taxes withheld by the organization, and Social Security and Medicare taxes paid by the organization.	See form instructions for due dates.
Form 945 *Annual Return of Withheld Federal Income Tax*		If a church or religious organization withholds income tax, including backup withholding, from non-payroll payments, it must file Form 945.	File Form 945 by January 31. This form is not required for those years in which there is no non-payroll tax liability.
Form 990 *Return of Organization Exempt From Income Tax* **Form 990-EZ** *Short Form Return of Organization Exempt From Income Tax* **Form 990-N** *(e-Postcard) Electronic Notice for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ*	Generally, all religious organizations (see exceptions to file Form 990 below) must file Form 990, Form 990-EZ or Form 990-N.	The thresholds for determining which form to file, Form 990. 990-EZ or 990-N are found at www.irs.gov/charities.	Form 990, 990-EZ or 990-N must be filed on or before the 15th day of the 5th month following the end of the organization's tax year. For 990-N must be electronically filed.

Exceptions to file Form 990, 990-EZ and 990-N

The following is a list of some of the organizations that are not required to file Form 990, 990-EZ, or 990-N.

- Churches (as opposed to "religious organizations," defined earlier)
- Inter-church organizations of local units of a church
- Mission societies sponsored by or affiliated with one or more churches or church denomination, if more than half of the activities are conducted in, or directed at, persons in foreign countries
- An exclusively religious activity of any religious order

See the form instructions for a list of other organizations that are not required to file.

Forms	Who Should Use Them	How They are Used	When to File
Form 990-T *Exempt Organization Business Income Tax Return* For more information on unrelated business income, see Unrelated Business Income Tax (UBIT).	Churches and religious organizations.	Churches and religious organizations must file Form 990-T if they generate gross income from an unrelated business of $1,000 or more for a taxable year.	Form 990-T must be filed by the 15th day of the 5th month after the organization's accounting period ends (May 15 for a calendar year accounting period).
Form 990-W *Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations*	Churches and religious organizations.	If the tax on unrelated business income is expected to be $500 or more, the church or religious organization must make estimated tax payments. Use Form 990-W to compute the estimated tax liability.	Form 990-W is for computation purposes only and does not need to be filed.
Form 1096 *Annual Summary and Transmittal of U.S. Information Returns*	Churches and religious organizations.	Use Form 1096 to transmit Forms 1099-MISC, W-2G and certain other forms to the IRS.	Form 1096 must be filed by February 28 in the year following the calendar year in which the payments were made.
Form 1099-MISC *Miscellaneous Income* See the *Instructions for Form 1099-MISC* for details.	Churches and religious organizations.	A church or religious organization must use Form 1099-MISC if it pays an unincorporated individual or an entity $600 or more in any calendar year for gross rents; commissions, fees or other compensation paid to non-employees; prizes and awards; or other fixed and determinable income.	Churches or religious organizations must furnish each payee with a copy of Form 1099-MISC by January 31; and file Copy A of Form 1099-MISC with the IRS by February 28.
Form 5578 *Annual Certification of Racial Nondiscrimination for a Private School Exempt from Federal Income Tax* For information on racial and ethnic nondiscriminatory policies, see Revenue Procedure 75-50, 1975-2 C.B. 587 at www.irs.gov.	A church or religious organization that operates a private school, whether separately incorporated or operated as part of its overall operations, that teaches secular subjects and generally complies with state law requirements for public education. **Note:** It is not considered racially discriminatory for a parochial school to select students on the basis of membership in a religious denomination if membership in the denomination is open to all on a racially nondiscriminatory basis. Further, a seminary, or other purely religious school, that primarily teaches religious subjects usually with the purpose of training students for the ministry, is not subject to the racially nondiscriminatory requirements because it is considered to be a religious rather than an educational organization.	File Form 5578 to certify that the school does not discriminate based on race or ethnic origin.	Form 5578 must be filed on or before the 15th day of the 5th month following the end of the organization's taxable year (May 15 for a calendar year). If an organization files Form 990 or Form 990-EZ, the certification must be made on Schedule A (Form 990 or Form 990-EZ).
Form 8282 *Donee Information Return*	Churches and religious organizations.	A church or religious organization must file Form 8282 if it sells, exchanges, transfers or otherwise disposes of certain non-cash donated property within three years of the date it originally received the donation. This applies to non-cash property that had an appraised value of more than $5,000 at time of donation.	The church or religious organization must file Form 8282 with the IRS within 125 days of date of disposition of the property; and furnish the original donor with a copy of the form.
Treasury Form 90.22.1, *Report of Foreign Bank and Financial Accounts*	See form instructions	See form instructions	See form instructions

Charitable Contributions— Substantiation and Disclosure Rules

Recordkeeping

A church or religious organization should be aware of the recordkeeping and substantiation rules imposed on donors of charities that receive certain quid pro quo contributions.

Recordkeeping Rules

A donor cannot claim a tax deduction for any contribution of cash, a check or other monetary gift made on or after January 1, 2007, unless the donor maintains a record of the contribution in the form of either a bank record (such as a cancelled check) or a written communication from the charity (such as a receipt or a letter) showing the name of the charity, the date of the contribution and the amount of the contribution.

Substantiation Rules

A donor can't claim a tax deduction for any single contribution of $250 or more unless the donor obtains a contemporaneous, written acknowledgment of the contribution from the recipient church or religious organization. A church or religious organization that doesn't acknowledge a contribution incurs no penalty; but without a written acknowledgment, the donor can't claim a tax deduction. Although it's a donor's responsibility to obtain a written acknowledgment, a church or religious organization can assist the donor by providing a timely, written statement containing:

- name of the church or religious organization,
- date of the contribution,
- amount of any cash contribution, and
- description (but not the value) of non-cash contributions.

In addition, the timely, written statement must contain one of the following:

- statement that no goods or services were provided by the church or religious organization in return for the contribution,
- statement that goods or services that a church or religious organization provided in return for the contribution consisted entirely of intangible religious benefits, or
- description and good-faith estimate of the value of goods or services other than intangible religious benefits that the church or religious organization provided in return for the contribution.

The church or religious organization may either provide separate acknowledgments for each single contribution of $250 or more or one acknowledgment to substantiate several single contributions of $250 or more. Separate contributions aren't aggregated for purposes of measuring the $250 threshold.

Disclosure Rules that Apply to Quid Pro Quo Contributions

A contribution made by a donor in exchange for goods or services is known as a quid pro quo contribution. A donor may only take a contribution deduction to the extent that his or her contribution exceeds the fair market value of the goods and services the donor receives in return for the contribution. Therefore, donors need to know the value of the goods or services. A church or religious organization must provide a written statement to a donor who makes a payment exceeding $75 partly as a contribution and partly for goods and services provided by the organization.

EXAMPLE 1

If a donor gives a church a payment of $100 and, in return, receives a ticket to an event valued at $40, this is a contribution, and only $60 is deductible by the donor ($100 - $40 = $60). Even though the deductible amount does not exceed $75, since the contribution the church received is in excess of $75, the church must provide the donor with a written disclosure statement. The statement must: (1) inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of money (and the fair market value of any property other than money) contributed by the donor over the value of goods or services provided by the church or religious organization; and (2) provide the donor with a good-faith estimate of the value of the goods or services.

The church or religious organization must provide the written disclosure statement with either the solicitation or the receipt of the contribution and in a manner that is likely to come to the attention of the donor. For example, a disclosure in small print within a larger document may not meet this requirement.

Exceptions to Disclosure Statement

A church or religious organization isn't required to provide a disclosure statement for quid pro quo contributions when: (a) the goods or services meet the standards for insubstantial value or (b) the only benefit received by the donor is an intangible religious benefit. Additionally, if the goods or services the church or religious organization provides are intangible religious benefits (examples follow), the acknowledgment for contributions of $250 or more doesn't need to describe those benefits.

Generally, intangible religious benefits are benefits provided by a church or religious organization that are not usually sold in commercial transactions outside a donative (gift) context.

Intangible religious benefits include:

- admission to a religious ceremony
- de minimis tangible benefits, such as wine used in religious ceremony

Benefits that are not intangible religious benefits include:

- tuition for education leading to a recognized degree
- travel services
- consumer goods

IRS Publication 1771, *Charitable Contributions: Substantiation and Disclosure Requirements*, provides more information on substantiation and disclosure rules.

Special Rules Limiting IRS Authority to Audit a Church

Tax Inquiries and Examinations of Churches

Congress has imposed special limitations, found in IRC Section 7611, on how and when the IRS may conduct civil tax inquiries and examinations of churches. The IRS may only initiate a church tax inquiry if an appropriate high-level Treasury Department official reasonably believes, based on a written statement of the facts and circumstances, that the organization: (a) may not qualify for the exemption or (b) may not be paying tax on an unrelated business or other taxable activity.

Restrictions on Church Inquiries and Examinations

Restrictions on church inquiries and examinations apply only to churches (including organizations claiming to be churches if such status has not been recognized by the IRS) and conventions or associations of churches. They don't apply to related persons or organizations. Thus, for example, the rules don't apply to schools that, although operated by a church, are organized as separate legal entities. Similarly, the rules don't apply to integrated auxiliaries of a church.

Restrictions on church inquiries and examinations do not apply to all church inquiries by the IRS. The most common exception relates to routine requests for information. For example, IRS requests for information from churches about filing of returns, compliance with income or Social Security and Medicare tax withholding requirements, supplemental information needed to process returns or applications and other similar inquiries are not covered by the special church audit rules.

Restrictions on church inquiries and examinations don't apply to criminal investigations or to investigations of the tax liability of any person connected with the church, such as a contributor or minister.

The procedures of IRC Section 7611 will be used in initiating and conducting any inquiry or examination into whether an excess benefit transaction (as that term is used in IRC Section 4958) has occurred between a church and an insider.

Audit Process

The sequence of the audit process is:

1. If the reasonable belief requirement is met, the IRS must begin an inquiry by providing a church with written notice containing an explanation of its concerns.

2. The church is allowed a reasonable period in which to respond by furnishing a written explanation to alleviate IRS concerns.

3. If the church fails to respond within the required time, or if its response is not sufficient to alleviate IRS concerns, the IRS may, generally within 90 days, issue a second notice, informing the church of the need to examine its books and records.

4. After issuance of a second notice, but before commencement of an examination of its books and records, the church may request a conference with an IRS official to discuss IRS concerns. The second notice will contain a copy of all documents collected or prepared by the IRS for use in the examination and subject to disclosure under the Freedom of Information Act, as supplemented by IRC Section 6103 relating to disclosure and confidentiality of tax return information.

5. Generally, examination of a church's books and records must be completed within two years from the date of the second notice from the IRS.

If at any time during the inquiry process the church supplies information sufficient to alleviate the concerns of the IRS, the matter will be closed without examination of the church's books and records. There are additional safeguards for the protection of churches under IRC Section 7611. For example, the IRS can't begin a subsequent examination of a church for a five-year period unless the previous examination resulted in a revocation, notice of deficiency or assessment or a request for a significant change in church operations, including a significant change in accounting practices.

Glossary

Church. Certain characteristics are generally attributed to churches. These attributes of a church have been developed by the IRS and by court decisions. They include:

- distinct legal existence;
- recognized creed and form of worship;
- definite and distinct ecclesiastical government;
- formal code of doctrine and discipline;
- distinct religious history;
- membership not associated with any other church or denomination;
- organization of ordained ministers;
- ordained ministers selected after completing prescribed courses of study;
- literature of its own;
- established places of worship;
- regular congregations;
- regular religious services;
- Sunday schools for the religious instruction of the young; and
- schools for the preparation of its ministers.

The IRS generally uses a combination of these characteristics, together with other facts and circumstances, to determine whether an organization is considered a church for federal tax purposes.

The IRS makes no attempt to evaluate the content of whatever doctrine a particular organization claims is religious, provided the particular beliefs of the organization are truly and sincerely held by those professing them and the practices and rites associated with the organization's belief or creed are not illegal or contrary to clearly defined public policy.

Integrated Auxiliary of a Church. The term integrated auxiliary of a church refers to a class of organizations that are related to a church or convention or association of churches, but are not such organizations themselves. In general, the IRS will treat an organization that meets the following three requirements as an integrated auxiliary of a church. The organization must:

- be described both as an IRC Section 501(c)(3) charitable organization and as a public charity under IRC Sections 509(a)(1), (2) or (3);

- be affiliated with a church or convention or association of churches; and
- receive financial support primarily from internal church sources as opposed to public or governmental sources.

Men's and women's organizations, seminaries, mission societies and youth groups that satisfy the first two requirements above are considered integrated auxiliaries whether or not they meet the internal support requirements. More guidance as to the types of organizations the IRS will treat as integrated auxiliaries can be found in the Code of Regulations, 26 CFR Section 1.6033-2(h).

The same rules that apply to a church apply to the integrated auxiliary of a church, with the exception of those rules that apply to the audit of a church. See Special Rules Limiting IRS Authority to Audit a Church.

Minister. The term minister is not used by all faiths; however, as used in this booklet, the term minister denotes members of clergy of all religions and denominations and includes priests, rabbis, imams and similar members of the clergy.

IRC Section 501(c)(3). IRC section 501(c)(3) describes charitable organizations, including churches and religious organizations, which qualify for exemption from federal income tax and generally are eligible to receive tax-deductible contributions. This section provides that:

- an organization must be organized and operated exclusively for religious or other charitable purposes,
- net earnings may not inure to the benefit of any private individual or shareholder,
- no substantial part of its activity may be attempting to influence legislation,
- the organization may not intervene in political campaigns, and
- the organization's purposes and activities may not be illegal or violate fundamental public policy.

Help From The IRS

IRS Tax Publications

The IRS provides free tax publications and forms. Download publications and forms from the IRS website at www.irs.gov. The following publications may provide further information for churches and other religious organizations:

Publication 1	*Your Rights as a Taxpayer*
Publication 15	*Circular E, Employer's Tax Guide*
Publication 15-A	*Employer's Supplemental Tax Guide*
Publication 334	*Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*
Publication 463	*Travel, Entertainment, Gift, and Car Expenses*
Publication 517	*Social Security and Other Information for Members of the Clergy and Religious Workers*
Publication 525	*Taxable and Nontaxable Income*
Publication 526	*Charitable Contributions*
Publication 557	*Tax-Exempt Status for Your Organization*
Publication 561	*Determining the Value of Donated Property*
Publication 571	*Tax-Sheltered Annuity Plans (403(b) Plans) for Employees of Public Schools and Certain Tax-Exempt Organizations*
Publication 598	*Tax on Unrelated Business Income of Exempt Organizations*
Publication 910	*Guide to Free Tax Services*
Publication 1771	*Charitable Contributions: Substantiation and Disclosure Requirements*
Publication 3079	*Tax-Exempt Organizations and Gaming*
Publication 4221-PC	*Compliance Guide for 501(c)(3) Public Charities*
Publication 4573	*Group Exemptions*
Publication 4630	*The Exempt Organizations Product and Services Catalog*

IRS Customer Service

Telephone assistance for general tax information is available by calling: IRS Customer Service toll-free at 800-829-1040.

EO Customer Service

Telephone assistance specific to exempt organizations is available by calling: IRS Exempt Organizations Customer Account Services toll-free at 877-829-5500.

EO Website

Visit the IRS Exempt Organizations website at www.irs.gov/eo.

StayExempt —Tax Basics for Exempt Organizations — online courses available at www.stayexempt.irs.gov.

EO Update

To receive IRS *EO Update*, a periodic newsletter with information for tax-exempt organizations and tax practitioners who represent them, visit www.irs.gov/eo and click on “Free e-Newsletter.”

Department of the Treasury

Internal Revenue Service

Publication 598
(Rev. January 2015)

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Tax on Unrelated Business Income of Exempt Organizations

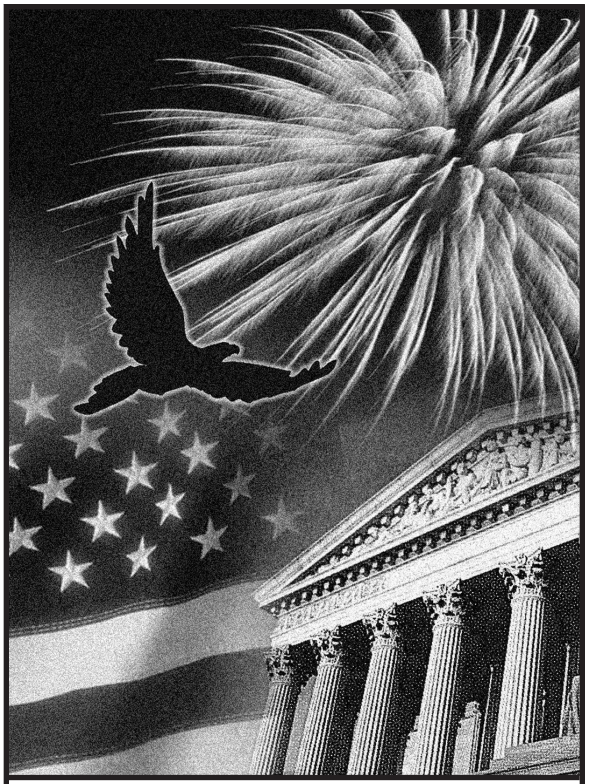
Contents

Future Developments

The IRS has created a page on IRS.gov for information about Pub. 598, at *www.irs.gov/pub598*. Information about any future developments affecting Pub. 598 (such as legislation enacted after we release it) will be posted on that page.

What's New

- The maximum cost of a low-cost article, for organizations eligible to receive charitable contributions, was increased to $10.40 for 2014. See *Distribution of low-cost articles*, later.
- The annual limit on associate member dues received by an agricultural or horticultural organization not treated as gross income was increased to $158 for 2014. See Exception under *Dues of Agricultural Organizations and Business Leagues* later.
- The extension of special rule for contributions of capital gain real property made for conservation purposes has been extended for one year for the payment received or accrued before January 1, 2015. You can claim the contribution of capital gain real property made for conservation purposes that occurred before January 1, 2015, on Form 990-T.
- The exclusion from unrelated business taxable income for qualifying specified payments under section 512(b)(13)(E) has been extended for one year for payments received or accrued before January 1, 2015. You can claim the qualifying specified payments that occurred before January 1, 2015, on Form 990-T.
- Effective 2014, if a private delivery service is used, only deliver Form 990-T to: Internal Revenue Submission Processing Center 1973 North Rulon White Blvd. Ogden, UT 84404



Jan 07, 2015

Introduction

An exempt organization is not taxed on its income from an activity substantially related to the charitable, educational, or other purpose that is the basis for the organization's exemption. Such income is exempt even if the activity is a trade or business.

However, if an exempt organization regularly carries on a trade or business not substantially related to its exempt purpose, except that it provides funds to carry out that purpose, the organization is subject to tax on its income from that unrelated trade or business.

This publication covers the rules for the tax on unrelated business income of exempt organizations. It explains:

1. Which organizations are subject to the tax (chapter 1),
2. What the requirements are for filing a tax return (chapter 2),
3. What an unrelated trade or business is (chapter 3), and
4. How to figure unrelated business taxable income (chapter 4).

All section references in this publication are to the Internal Revenue Code.

Useful Items

You may want to see:

Publication

❑ **557** Tax-Exempt Status for Your Organization

Form (and Instructions)

❑ **990-T** Exempt Organization Business Income Tax Return

See chapter 5 for information about getting these publications and forms.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

If you have suggestions for making this publication simpler, we would be happy to hear from you. You can send your comments from www.irs.gov/formspubs. Click on "More Information" and then on "Give us feedback." Or you can send your comments to:

Internal Revenue Service
Tax Forms and Publications
1111 Constitution Ave. NW, IR-6526
Washington, DC 20224

We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

Although we cannot respond individually to each comment received, we do appreciate your feedback and will consider your comments as we revise our tax products.

Reminders

An organization may elect to treat any GO Zone public utility loss as a specified liability loss. Certain other losses attributable to GO Zone losses, including those from Kiowa County, Kansas and other Midwestern disaster areas, are eligible for special carryback treatment. See *Net operating loss deduction*, later.

1.

Organizations Subject to the Tax

The tax on unrelated business income applies to most organizations exempt from tax under section 501(a). These organizations include charitable, religious, scientific, and other organizations described in section 501(c), as well as employees' trusts forming part of pension, profit-sharing, and stock bonus plans described in section 401(a).

In addition, the following are subject to the tax on unrelated business income.

- Individual retirement arrangements (IRAs), including traditional IRAs, Roth IRAs, Coverdell IRAs, simplified employee pensions (SEP-IRAs), and savings incentive match plans for employees (SIMPLE IRAs).
- State and municipal colleges and universities.
- Qualified state tuition programs.
- Medical savings accounts (MSAs) described in section 220(d).
- Coverdell savings accounts described in section 530.

U.S. instrumentalities. A corporation that is a U.S. instrumentality described in section 501(c)(1) is not subject to the tax on unrelated business income if the corporation is organized under an Act of Congress and, under the Act, is exempt from federal income taxes.

Colleges and universities. Colleges and universities that are agencies or instrumentalities of any government or any political subdivision of a government, or that are owned or operated by a government or political subdivision of a government, are subject to the tax on unrelated business income. As used here, the word government includes any foreign government (to the extent not contrary to a treaty) and all domestic governments (the United States and any of its possessions, any state, and the District of Columbia).

The tax is on the unrelated business income of both the universities and colleges themselves and on their wholly owned or controlled tax exempt subsidiary organizations. It is immaterial whether the business is conducted by the university or by a separately incorporated wholly owned or controlled subsidiary. If the business activity is unrelated, the income in both instances will be subject to the tax. If the primary purpose of a wholly owned or controlled subsidiary is to operate or conduct any unrelated trade or business (other than holding title to property and collecting income from it), the subsidiary is not an exempt organization, and this rule does not apply.

Title-holding corporations. When an exempt title-holding corporation, described in section 501(c)(2), pays any of its net income to an organization that itself is exempt from tax under section 501(a) (or would pay such an amount except that the expenses of collecting its income exceed the amount collected) and files a consolidated return with that organization, the title-holding corporation is treated, for unrelated business income tax purposes, as organized and operated for the same purposes as the exempt payee organization.

Thus, a title-holding corporation whose source of income is related to the exempt purposes of the payee organization is not subject to the unrelated business income tax if the holding corporation and the payee organization file a consolidated return. However, if the source of the income is not so related, the title-holding corporation is subject to unrelated business income tax.

Example. X, a title-holding corporation, is required to distribute its net income to A, an exempt organization. During the tax year, X realizes net income of $900,000 from source M, which is related to A's exempt function. X also receives $100,000 from source N, which is not related to A's exempt function. X and A file a consolidated return for the tax year. X has unrelated business income of $100,000.

2.

The Tax and Filing Requirements

All organizations subject to the tax on unrelated business income, except the exempt trusts described in section 511(b)(2), are taxable at corporate rates on that income. All exempt trusts subject to the tax on unrelated business income that, if not exempt, would be taxable as trusts are taxable at trust rates on that income. However, an exempt trust may not claim the deduction for a personal exemption that is normally allowed to a trust.

The tax is imposed on the organization's unrelated business taxable income (described in chapter 4). The tax is reduced by any applicable tax credits, including the general business credits (such as the investment credit) and the foreign tax credit.

Alternative minimum tax. Organizations liable for tax on unrelated business income may be liable for alternative minimum tax on certain adjustments and tax preference items.

Returns and Filing Requirements

An exempt organization subject to the tax on unrelated business income must file Form 990-T and attach any required supporting schedules and forms. The obligation to file Form 990-T is in addition to the obligation to file any other required returns.

Form 990-T is required if the organization's gross income from unrelated businesses is $1,000 or more. An exempt organization must report income from all its unrelated businesses on a single Form 990-T. Each organization must file a separate Form 990-T, except section 501(c)(2) title-holding corporations and organizations receiving their earnings that file a consolidated return under section 1501.

The various provisions of tax law relating to accounting periods, accounting methods, at-risk limits (described in section 465), assessments, and collection penalties that apply to tax returns generally also apply to Form 990-T.

When to file. The Form 990-T of an employees' trust described in section 401(a), an IRA (including a traditional, SEP, SIMPLE, Roth, or Coverdell IRA), or an MSA must be filed by the 15th day of the 4th month after the end of its tax year. The Form 990-T of any other exempt organization must be filed by the 15th day of the 5th month after the end of its tax year. If the due date falls on a Saturday, Sunday, or legal holiday, the return is due by the next business day.

Extension of time to file. A Form 990-T filer may request an automatic 3-month (6 months for corporation) extension of time to file a return by submitting Form 8868, Application for Extension of Time To File an Exempt Organization Return. The Form 990-T filer may also use Form 8868 to apply for an additional (not automatic) 3-month extension to file the return if the original 3-month extension was not enough time.

Public Inspection Requirements of Section 501(c)(3) Organizations. Under section 6104(d), a section 501(c)(3) organization that has gross income from an unrelated trade or business of $1,000 or more must make its annual exempt organization business income tax return (including amended returns) available for public inspection.

TIP *A section 501(c)(3) organization filing the Form 990-T only to request a credit for certain federal excise taxes paid does not have to make the Form 990-T available for public inspection.*

Payment of Tax

Estimated tax. A tax-exempt organization must make estimated tax payments if it expects its tax (unrelated business income tax after certain adjustments) to be $500 or more. Estimated tax payments are generally due by the 15th day of the 4th, 6th, 9th, and 12th months of the tax year. If any due date falls on a Saturday, Sunday, or legal holiday, the payment is due on the next business day.

Any organization that fails to pay the proper estimated tax when due may be charged an underpayment penalty for the period of underpayment. Generally, to avoid the estimated tax penalty, the organization must make estimated tax payments that total 100% of the organization's current tax year liability. However, an organization can base its required estimated tax payments on 100% of the tax shown on its return for the preceding year (unless no tax is shown) if its taxable income for each of the 3 preceding tax years was less than $1 million. If an organization's taxable income for any of those years was $1 million or more, it can base only its first required installment payment on its last year's tax.

All tax-exempt organizations should use Form 990-W (Worksheet), to figure their estimated tax.

Tax due with Form 990-T. Any tax due with Form 990-T must be paid in full when the return is filed, but no later than the date the return is due (determined without extensions).

Federal Tax Deposits Must be Made by Electronic Funds Transfer

You must use electronic funds transfer to make all federal deposits (such as deposits of estimated tax, employment tax, and excise tax). Generally, electronic fund transfers are made using the Electronic Federal Tax Payment System (EFTPS). If you do not want to use EFTPS, you can arrange for your tax professional, financial institution, payroll service, or other trusted third party to make deposits on your behalf. Also, you may arrange for your financial institution to submit a same-day wire payment on your behalf. For more information on paying your taxes using same-day payment, visit the IRS website at www.irs.gov/e-pay. EFTPS is a free service provided by the Department of Treasury. Services provided by your tax professional, financial institution, payroll service, or other third party may have a fee. To get more information about EFTPS or to enroll in EFTPS, visit www.eftps.gov or call 1-800-555-4477, 1-800-733-4829 (TDD), or 1-800-244-4829 (Spanish). Additional information about EFTPS is available in Publication 966, Electronic Federal Tax Payment System: A Guide To Getting Started.

Deposits on business days only. If a deposit is required to be made on a day that is not a business day, the deposit is considered timely if it is made by the close of the next business day. A business day is any day other than a Saturday, Sunday, or legal holiday. For example, if a deposit is required to be made on a Friday and Friday is a legal holiday, the deposit will be considered timely if it is made by the following Monday (if that Monday is a business day). The term "legal holiday" means any legal holiday in the District of Columbia.

3.

Unrelated Trade or Business

Unrelated business income. Unrelated business income is the income from a trade or business regularly conducted by an exempt organization and not substantially related to the performance by the organization of its exempt purpose or function, except that the organization uses the profits derived from this activity.

Certain trade or business activities are not treated as an unrelated trade or business. See *Excluded Trade or Business Activities*, later.

Trade or business. The term “trade or business” generally includes any activity conducted for the production of income from selling goods or performing services. An activity must be conducted with intent to profit to constitute a trade or business. An activity does not lose its identity as a trade or business merely because it is conducted within a larger group of similar activities that may or may not be related to the exempt purposes of the organization.

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, even though the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purpose. Similarly, soliciting, selling, and publishing commercial advertising is a trade or business even though the advertising is published in an exempt organization's periodical that contains editorial matter related to the organization's exempt purpose.

Regularly conducted. Business activities of an exempt organization ordinarily are considered regularly conducted if they show a frequency and continuity, and are pursued in a manner similar to comparable commercial activities of nonexempt organizations.

For example, a hospital auxiliary's operation of a sandwich stand for 2 weeks at a state fair

would not be the regular conduct of a trade or business. The stand would not compete with similar facilities that a nonexempt organization would ordinarily operate year-round. However, operating a commercial parking lot every Saturday, year-round, would be the regular conduct of a trade or business.

Not substantially related. A business activity is not substantially related to an organization's exempt purpose if it does not contribute importantly to accomplishing that purpose (other than through the production of funds). Whether an activity contributes importantly depends in each case on the facts involved.

In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function that they intend to serve. For example, to the extent an activity is conducted on a scale larger than is reasonably necessary to perform an exempt purpose, it does not contribute importantly to the accomplishment of the exempt purpose. The part of the activity that is more than needed to accomplish the exempt purpose is an unrelated trade or business.

Also in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the following principles apply.

Selling of products of exempt functions. Ordinarily, selling products that result from the performance of exempt functions is not an unrelated trade or business if the product is sold in substantially the same state it is in when the exempt functions are completed. Thus, for an exempt organization engaged in rehabilitating handicapped persons (its exempt function), selling articles made by these persons as part of their rehabilitation training is not an unrelated trade or business.

However, if a completed product resulting from an exempt function is used or exploited in further business activity beyond what is reasonably appropriate or necessary to dispose of it as is, the activity is an unrelated trade or business. For example, if an exempt organization maintains an experimental dairy herd for scientific purposes, the sale of milk and cream produced in the ordinary course of operation of the project is not an unrelated trade or business. But if the organization uses the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the sale of these products is an unrelated trade or business unless the manufacturing activities themselves contribute importantly to the accomplishment of an exempt purpose of the organization.

Dual use of assets or facilities. If an asset or facility necessary to the conduct of exempt functions is also used in commercial activities, its use for exempt functions does not, by itself, make the commercial activities a related trade or business. The test, as discussed earlier, is whether the activities contribute importantly to the accomplishment of exempt purposes.

For example, a museum has a theater auditorium designed for showing educational films in connection with its program of public education in the arts and sciences. The theater is a principal feature of the museum and operates continuously while the museum is open to the public. If the organization also operates the theater as a motion picture theater for the public when the museum is closed, the activity is an unrelated trade or business.

For information on allocating expenses for the dual use of assets or facilities, see *Deductions* in chapter 4.

Exploitation of exempt functions. Exempt activities sometimes create goodwill or other intangibles that can be exploited in a commercial way. When an organization exploits such an intangible in commercial activities, the fact that the income depends in part upon an exempt function of the organization does not make the commercial activities a related trade or business. Unless the commercial exploitation contributes importantly to the accomplishment of the exempt purpose, the commercial activities are an unrelated trade or business.

For the treatment of expenses attributable to the exploitation of exempt activities, see *Deductions* in chapter 4.

Examples

The following are examples of activities that were determined to be (or not to be) unrelated trades or businesses using the definitions and principles just discussed.

Artists' facilities. An organization whose exempt purpose is to stimulate and foster public interest in the fine arts by promoting art exhibits, sponsoring cultural events, and furnishing information about fine arts leases studio apartments to artist tenants and operates a dining hall primarily for these tenants. These two activities do not contribute importantly to accomplishing the organization's exempt purpose. Therefore, they are unrelated trades or businesses.

Broadcasting rights. An exempt collegiate athletic conference conducts an annual competitive athletic game between its conference champion and another collegiate team. Income is derived from admission charges and the sale of exclusive broadcasting rights to a national radio and television network. An athletic program is considered an integral part of the educational process of a university.

The educational purposes served by intercollegiate athletics are identical whether conducted directly by individual universities or by their regional athletic conference. Also, the educational purposes served by exhibiting a game before an audience that is physically present and exhibiting the game on television or radio before a much larger audience are substantially similar. Therefore, the sale of the broadcasting rights contributes importantly to the accomplishment of the organization's exempt purpose and is not an unrelated trade or business.

In a similar situation, an exempt organization was created as a national governing body for amateur athletes to foster interest in amateur sports and to encourage widespread public participation. The organization receives income each year from the sale of exclusive broadcasting rights to an independent producer, who contracts with a commercial network to broadcast many of the athletic events sponsored, supervised, and regulated by the organization.

The broadcasting of these events promotes the various amateur sports, fosters widespread public interest in the benefits of the organization's nationwide amateur program, and encourages public participation. The sale of the rights and the broadcasting of the events contribute importantly to the organization's exempt purpose. Therefore, the sale of the exclusive broadcasting rights is not an unrelated trade or business.

Business league's parking and bus services. A business league, whose purpose is to retain and stimulate trade in a downtown area that has inadequate parking facilities, operates a fringe parking lot and shuttle bus service. It also operates, as an insubstantial part of its activities, a park and shop plan.

The fringe parking lot and shuttle bus service operate in a manner that does not favor any individual or group of downtown merchants. The merchants cannot offer free or discount parking or bus fares to their customers.

The park and shop plan allows customers of particular merchants to park free at certain parking lots in the area. Merchants participating in this plan buy parking stamps, which they distribute to their customers to use to pay for parking.

Operating the fringe parking lot and shuttle bus service provides easy and convenient access to the downtown area and, therefore, stimulates and improves business conditions in the downtown area generally. That activity contributes importantly to the organization's accomplishing its exempt purpose and is not an unrelated trade or business.

The park and shop plan encourages customers to use a limited number of participating member merchants in order to obtain free parking. This provides a particular service to individual members of the organization and does not further its exempt purpose. Therefore, operating the park and shop plan is an unrelated trade or business.

Halfway house workshop. A halfway house organized to provide room, board, therapy, and counseling for persons discharged from alcoholic treatment centers also operates a furniture shop to provide full-time employment for its residents. The profits are applied to the operating costs of the halfway house. The income from this venture is not unrelated trade or business income because the furniture shop contributes importantly to the organization's purpose of aiding its residents' transition from treatment to a normal and productive life.

Health club program. An exempt charitable organization's purpose is to provide for the welfare of young people. The organization conducts charitable activities and maintains facilities that will contribute to the physical, social, mental, and spiritual health of young people at minimum or no cost to them. Nominal annual dues are charged for membership in the organization and use of the facilities.

In addition, the organization organized a health club program that its members could join for an annual fee in addition to the annual dues.

The annual fee is comparable to fees charged by similar local commercial health clubs and is sufficiently high to restrict participation in the program to a limited number of members of the community.

The health club program is in addition to the general physical fitness program of the organization. Operating this program does not contribute importantly to the organization's accomplishing its exempt purpose and, therefore, is an unrelated trade or business.

Hospital facilities. An exempt hospital leases its adjacent office building and furnishes certain office services to a hospital-based medical group for a fee. The group provides all diagnostic and therapeutic procedures to the hospital's patients and operates the hospital's emergency room on a 24-hour basis. The leasing activity is substantially related to the hospital's exempt purpose and is not an unrelated trade or business.

The hospital also operates a gift shop patronized by patients, visitors making purchases for patients, and employees; a cafeteria and coffee shop primarily for employees and medical staff; and a parking lot for patients and visitors only. These activities are also substantially related to the hospital's exempt purpose and do not constitute unrelated trades or businesses.

Insurance programs. An organization that acts as a group insurance policyholder for its members and collects a fee for performing administrative services is normally carrying on an unrelated trade or business.

Exceptions. Organizations whose exempt activities may include the provision of insurance benefits, such as fraternal beneficiary societies, voluntary employees beneficiary associations, and labor organizations, are generally exceptions to this rule.

Magazine publishing. An association of credit unions with tax-exempt status as a business league publishes a consumer-oriented magazine four times a year and makes it available to member credit unions for purchase.

By selling a magazine to its members as a promotional device, the organization furnishes its members with a regular commercial service they can use in their own operations. This service does not promote the improvement of business conditions of one or more lines of business, which is the exempt purpose of a business league.

Since the activity does not contribute importantly to the organization's exempt function, it is an unrelated trade or business.

Membership list sales. An exempt educational organization regularly sells membership mailing lists to business firms. This activity does not contribute importantly to the accomplishment of the organization's exempt purpose and therefore is an unrelated trade or business. Also see *Exchange or rental of member lists* under *Excluded Trade or Business Activities*, later.

Miniature golf course. An exempt youth welfare organization operates a miniature golf course that is open to the general public. The course, which is managed by salaried employees, is substantially similar to commercial courses. The admission fees charged are comparable to fees of commercial facilities and are designed to return a profit.

The operation of the miniature golf course in a commercial manner does not contribute importantly to the accomplishment of the organization's exempt purpose and, therefore, is an unrelated trade or business.

Museum eating facilities. An exempt art museum operates a dining room, a cafeteria, and a snack bar for use by the museum staff, employees, and visitors. Eating facilities in the museum help to attract visitors and allow them to spend more time viewing the museum's exhibits without having to seek outside restaurants at mealtime. The eating facilities also allow the museum staff and employees to remain in the museum throughout the day. Thus, the museum's operation of the eating facilities contributes importantly to the accomplishment of its exempt purposes and is not unrelated trade or business.

Museum greeting card sales. An art museum that exhibits modern art sells greeting cards that display printed reproductions of selected works from other art collections. Each card is imprinted with the name of the artist, the title or subject matter of the work, the date or period of its creation, if known, and the museum's name. The cards contain appropriate greetings and are personalized on request.

The organization sells the cards in the shop it operates in the museum and sells them at quantity discounts to retail stores. It also sells them by mail order through a catalog that is advertised in magazines and other publications throughout the year. As a result, a large number of cards are sold at a significant profit.

The museum is exempt as an educational organization on the basis of its ownership, maintenance, and exhibition for public viewing of works of art. The sale of greeting cards with printed reproductions of artworks contributes importantly to the achievement of the museum's exempt educational purposes by enhancing public awareness, interest, and appreciation of art. The cards may encourage more people to visit the museum itself to share in its educational programs. The fact that the cards are promoted and sold in a commercial manner at a profit and in competition with commercial greeting card publishers does not alter the fact that the activity is related to the museum's exempt purpose. Therefore, these sales activities are not an unrelated trade or business.

Museum shop. An art museum maintained and operated for the exhibition of American folk art operates a shop in the museum that sells:

1. Reproductions of works in the museum's own collection and reproductions of artistic works from the collections of other art museums (prints suitable for framing, postcards, greeting cards, and slides);
2. Metal, wood, and ceramic copies of American folk art objects from its own collection and similar copies of art objects from other collections of artworks;
3. Instructional literature and scientific books and souvenir items concerning the history and development of art and, in particular, of American folk art; and
4. Scientific books and souvenir items of the city in which the museum is located.

The shop also rents originals or reproductions of paintings contained in its collection. All of its reproductions are imprinted with the name of the artist, the title or subject matter of the work from which it is reproduced, and the museum's name.

Each line of merchandise must be considered separately to determine if sales are related to the exempt purpose.

The sale and rental of reproductions and copies of works from the museum's own collection and reproductions of artistic works not owned by the museum contribute importantly to the achievement of the museum's exempt educational purpose by making works of art familiar to a broader segment of the public, thereby enhancing the public's understanding and appreciation of art. The same is true for the sale of literature relating to art. Therefore, these sales activities are not an unrelated trade or business.

On the other hand, the sale of scientific books and souvenir items of the city where the museum is located has no causal relationship to art or to artistic endeavor and, therefore, does not contribute importantly to the accomplishment of the museum's exempt educational purposes. The fact that selling some of these items could, under different circumstances, be held related to the exempt educational purpose of some other exempt educational organization does not change this conclusion. Additionally, the sale of these items does not lose its identity as a trade or business merely because the museum also sells articles which do contribute importantly to the accomplishment of its exempt function. Therefore, these sales are an unrelated trade or business.

Nonpatient laboratory testing. Nonpatient laboratory testing performed by a tax-exempt teaching hospital on specimens needed for the conduct of its teaching activities is not an unrelated trade or business. However, laboratory testing performed by a tax-exempt non-teaching hospital on referred specimens from private office patients of staff physicians is an unrelated trade or business if these services are otherwise available in the community.

Pet boarding and grooming services. An exempt organization, organized and operated for the prevention of cruelty to animals, receives unrelated business income from providing pet boarding and grooming services for the general public. These activities do not contribute importantly to its purpose of preventing cruelty to animals.

Publishing legal notices. A bar association publishes a legal journal containing opinions of the county court, articles of professional interest to lawyers, advertisements for products and services used by the legal profession, and legal notices. The legal notices are published to satisfy state laws requiring publication of notices in connection with legal proceedings, such as the

administration of estates and actions to quiet title to real property. The state designated the bar association's journal as the place to publish the required notices.

The publication of ordinary commercial advertising does not advance the exempt purposes of the association even when published in a periodical that contains material related to exempt purposes. Although the advertising is directed specifically to members of the legal profession, it is still commercial in nature and does not contribute importantly to the exempt purposes of the association. Therefore, the advertising income is unrelated trade or business income.

On the other hand, the publication of legal notices is distinguishable from ordinary commercial advertising in that its purpose is to inform the general public of significant legal events rather than to stimulate demand for the products or services of an advertiser. This promotes the common interests of the legal profession and contributes importantly to the association's exempt purposes. Therefore, the publishing of legal notices does not constitute an unrelated trade or business.

Directory of members. A business league publishes an annual directory that contains a list of all its members, their addresses, and their area of expertise. Each member has the same amount of space in the directory, and its format does not emphasize the relative importance or reputation of any member. The directory contains no commercial advertisement and is sold only to the organization's members.

The directory facilitates communication among the members and encourages the exchange of ideas and expertise. Because the directory lists the members in a similar noncommercial format without advertising and is not distributed to the public, its sale does not confer private commercial benefits on the members. The sale of the directory does contribute importantly to the organization's exempt purpose and is not an unrelated trade or business. This directory differs from the publication discussed next because of its noncommercial characteristics.

Sales of advertising space. A national association of law enforcement officials publishes a monthly journal that contains articles and other editorial material of professional interest to its members. The journal is distributed without charge, mainly to the organization's members.

The organization sells advertising space in the journal either for conventional advertising or to merely identify the purchaser without a commercial message. Some of the noncommercial advertising identifies the purchaser in a separate space, and some consists of listings of 60 or more purchasers per page. A business firm identified in a separate space is further identified in an Index of Advertisers.

The organization solicits advertising by personal contacts. Advertising from large firms is solicited by contacting their chief executive officer or community relations officer rather than their advertising manager. The organization also solicits advertising in form letters appealing for corporate and personal contributions.

An exempt organization's sale of advertising placed for the purchaser's commercial benefit is a commercial activity. Goodwill derived by the purchaser from being identified as a patron of the organization is usually considered a form of commercial benefit. Therefore, advertising in an exempt organization's publication is generally presumed to be placed for the purchaser's commercial benefit, even if it has no commercial message. However, this presumption is not conclusive if the purchaser's patronage would be difficult to justify commercially in view of the facts and circumstances. In that case, other factors should also be considered in determining whether a commercial benefit can be expected. Those other factors include:

1. The normal manner in which the publication is circulated;
2. The territorial scope of the circulation;
3. The extent to which its readers, promoters, or the like could reasonably be expected to further, either directly or indirectly, the commercial interest of the advertisers;
4. The eligibility of the publishing organization to receive tax-deductible contributions; and
5. The commercial or noncommercial methods used to solicit the advertisers.

In this situation, the purchaser of a separate advertising space without a commercial message can nevertheless expect a commercial benefit from the goodwill derived from being identified in that manner as a patron of the organization. However, the purchaser of a listing cannot expect more than an inconsequential benefit. Therefore, the sale of separate spaces, but not the listings, is an unrelated trade or business.

Sales commissions. An agricultural organization, whose exempt purposes are to promote better conditions for cattle breeders and to improve the breed generally, engages in an unrelated trade or business when it regularly sells cattle for its members on a commission basis.

Sales of hearing aids. A tax-exempt hospital, whose primary activity is rehabilitation, sells hearing aids to patients. This activity is an essential part of the hospital's program to test and evaluate patients with hearing deficiencies and contributes importantly to its exempt purpose. It is not an unrelated trade or business.

School facilities. An exempt school has tennis courts and dressing rooms that it uses during the regular school year in its educational program. During the summer, the school operates a tennis club open to the general public. Employees of the school run the club, including collecting membership fees and scheduling court time.

Another exempt school leases the same type of facilities to an unrelated individual who runs a tennis club for the summer. The lease is for a fixed fee that does not depend on the income or profits derived from the leased property.

In both situations, the exempt purpose is the advancement of education. Furnishing tennis facilities in the manner described does not further that exempt purpose. These activities are unrelated trades or businesses. However, in the second situation the income derived from the leasing of the property is excluded from unrelated business taxable income as rent from real property. See *Rents* under *Exclusions* in chapter 4.

School handicraft shop. An exempt vocational school operates a handicraft shop that sells articles made by students in their regular courses of instruction. The students are paid a percentage of the sales price. In addition, the shop sells products made by local residents who make articles at home according to the shop's specifications. The shop manager periodically inspects the articles during their manufacture to ensure that they meet desired standards of style and quality. Although many local participants are former students of the school, any qualified person may participate in the program. The sale of articles made by students does not constitute an unrelated trade or business, but the sale of products made by local residents is an unrelated trade or business and is subject to unrelated business income tax.

Selling endorsements. An exempt scientific organization enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of laboratory equipment to manufacturers. Endorsing laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted to the organization. Accordingly, the sale of endorsements is an unrelated trade or business.

Services provided with lease. An exempt university leases its football stadium during several months of the year to a professional football team for a fixed fee. Under the lease agreement, the university furnishes heat, light, and water and is responsible for all ground maintenance. It also provides dressing room, linen, and stadium security services for the professional team.

Leasing of the stadium is an unrelated trade or business. In addition, the substantial services furnished for the convenience of the lessee go beyond those usually provided with the rental of space for occupancy only. Therefore, the income from this lease is rent from real property and unrelated business taxable income.

Sponsoring entertainment events. An exempt university has a regular faculty and a regularly enrolled student body. During the school year, the university sponsors the appearance of professional theater companies and symphony orchestras that present drama and musical performances for the students and faculty members. Members of the general public also are admitted. The university advertises these performances and supervises advance ticket sales at various places, including such university facilities as the cafeteria and the university bookstore. Although the presentation of the performances makes use of an intangible generated by the university's exempt educational functions—the presence of the student body and faculty—such drama and music events contribute importantly to the overall educational and

cultural functions of the university. Therefore, the activity is not an unrelated trade or business.

Travel tour programs. Travel tour activities that are a trade or business are an unrelated trade or business if the activities are not substantially related to the purpose for which tax exemption was granted to the organization.

Example 1. A tax-exempt university alumni association provides a travel tour program for its members and their families. The organization works with various travel agencies and schedules approximately ten tours a year to various places around the world. It mails out promotional material and accepts reservations for fees paid by the travel agencies on a per-person basis.

The organization provides an employee for each tour as a tour leader. There is no formal educational program conducted with these tours, and they do not differ from regular commercially operated tours.

By providing travel tours to its members, the organization is engaging in a regularly conducted trade or business. Even if the tours it offers support the university, financially and otherwise, and encourage alumni to do the same, they do not contribute importantly to the organization's exempt purpose of promoting education. Therefore, the sale of the travel tours is an unrelated trade or business.

Example 2. A tax-exempt organization formed for the purpose of educating individuals about the geography and the culture of the United States provides study tours to national parks and other locations within the United States. These tours are conducted by teachers and others certified by the state board of education. The tours are primarily designed for students enrolled in degree programs at state educational institutions but are open to all who agree to participate in the required study program associated with the tour taken. A tour's study program consists of instruction on subjects related to the location being visited on the tour. Each tour group brings along a library of material related to the subjects being studied on the tour. During the tour, 5 or 6 hours per day are devoted to organized study, preparation of reports, lectures, instruction, and recitation by the students. Examinations are given at the end of each tour. The state board of education awards academic credit for tour participation. Because these tours are substantially related to the organization's exempt purpose, they are not an unrelated trade or business.

Yearbook advertising. An exempt organization receives income from the sale of advertising in its annual yearbook. The organization hires an independent commercial firm, under a contract covering a full calendar year, to conduct an intensive advertising solicitation campaign in the organization's name. This firm is paid a percentage of the gross advertising receipts for selling the advertising, collecting from advertisers, and printing the yearbook. This advertising activity is an unrelated trade or business.

Youth residence. An exempt organization, whose purpose is to provide for the welfare of young people, rents rooms primarily to people under age 25. The residence units are operated on, and as a part of, the premises in which the organization carries on the social, recreational, and guidance programs for which it was recognized as exempt. The facilities are under the management and supervision of trained career professionals who provide residents with personal counseling, physical education programs, and group recreational activities. The rentals are not an unrelated trade or business because renting the rooms is substantially related to the organization's exempt purpose.

Excluded Trade or Business Activities

The following activities are specifically excluded from the definition of unrelated trade or business.

Bingo games. Certain bingo games are not included in the term "unrelated trade or business." To qualify for this exclusion, the bingo game must meet the following requirements.

1. It meets the legal definition of bingo.
2. It is legal where it is played.
3. It is played in a jurisdiction where bingo games are not regularly conducted by for-profit organizations.

Gambling activities other than bingo. Any game of chance conducted by an exempt organization in North Dakota is not an unrelated trade or business if conducting the game does not violate any state or local law.

Legal definition. For a game to meet the legal definition of bingo, wagers must be placed, winners must be determined, and prizes or other property must be distributed in the presence of all persons placing wagers in that game.

A wagering game that does not meet the legal definition of bingo does not qualify for the exclusion, regardless of its name. For example, "instant bingo," in which a player buys a prepackaged bingo card with pull-tabs that the player removes to determine if he or she is a winner, does not qualify.

Legal where played. This exclusion applies only if bingo is legal under the laws of the jurisdiction where it is conducted. The fact that a jurisdiction's law that prohibits bingo is rarely enforced or is widely disregarded does not make the conduct of bingo legal for this purpose.

No for-profit games where played. This exclusion applies only if for-profit organizations cannot regularly conduct bingo games in any part of the same jurisdiction. Jurisdiction is normally the entire state; however, in certain situations, local jurisdiction will control.

Example. Tax-exempt organizations X and Y are organized under the laws of state N, which has a law that permits exempt organizations to conduct bingo games. In addition, for-profit organizations are permitted to conduct bingo games in city S, a resort community located in county R. Several for-profit organizations conduct nightly games. Y conducts weekly bingo games in city S, while X conducts weekly games in county R. Since state law confines the for-profit organizations to city S, local jurisdiction controls. Y's bingo games conducted in city S are an unrelated trade or business. However, X's bingo games conducted in county R outside of city S are not an unrelated trade or business.

Convenience of members. A trade or business conducted by a 501(c)(3) organization or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees is not an unrelated trade or business. For example, a laundry operated by a college for the purpose of laundering dormitory linens and students' clothing is not an unrelated trade or business.

Convention or trade show activity. An unrelated trade or business does not include qualified convention or trade show activities conducted at a convention, annual meeting, or trade show.

A qualified convention or trade show activity is any activity of a kind traditionally conducted by a qualifying organization in conjunction with an international, national, state, regional, or local convention, annual meeting, or show if:

1. One of the purposes of the organization in sponsoring the activity is promoting and stimulating interest in, and demand for, the products and services of that industry or educating the persons in attendance regarding new products and services or new rules and regulations affecting the industry; and
2. The show is designed to achieve its purpose through the character of the exhibits and the extent of the industry products that are displayed.

For these purposes, a qualifying organization is one described in section 501(c)(3), 501(c)(4), 501(c)(5), or 501(c)(6). The organization must regularly conduct, as one of its substantial exempt purposes, a qualified convention or trade show activity.

The rental of display space to exhibitors (including exhibitors who are suppliers) at a qualified convention or trade show is not an unrelated trade or business even if the exhibitors who rent the space are permitted to sell or solicit orders. For this purpose, a supplier's exhibit is one in which the exhibitor displays goods or services that are supplied to, rather than by, members of the qualifying organization in the conduct of these members' own trades or businesses.

Certain Internet activities conducted by a trade association described in section 501(c)(6) will be considered qualified convention and trade show activity if conducted on a special supplementary section of the association's website in conjunction with a trade show conducted by the association. The trade show itself must be a qualified convention and trade show activity. The supplementary section of the website must be ancillary to, and serve to augment and enhance, the trade show, as when it makes

available the same information available at the trade show and is available only during a time period that coincides with the time period that the trade show is in operation. Conversely, Internet activities that are not conducted in conjunction with a qualified convention and trade show activity and that do not augment and enhance the trade show cannot themselves be qualified convention and trade show activity.

Distribution of low cost articles. The term unrelated trade or business does not include activities relating to the distribution of low cost articles incidental to soliciting charitable contributions. This applies to organizations described in section 501 that are eligible to receive charitable income tax deductible contributions.

A distribution is considered incidental to the solicitation of a charitable contribution if:

1. The recipient did not request the distribution,
2. The distribution is made without the express consent of the recipient, and
3. The article is accompanied by a request for a charitable contribution to the organization and a statement that the recipient may keep the low cost article regardless of whether a contribution is made.

An article is considered low cost if the cost of an item (or the aggregate costs if more than one item) distributed to a single recipient in a tax year is not more than $5, indexed annually for inflation. The maximum cost of a low cost article is $10.40 for 2014. The cost of an article is the cost to the organization that distributes the item or on whose behalf it is distributed.

Employee association sales. The sale of certain items by a local association of employees described in section 501(c)(4), organized before May 17, 1969, is not an unrelated trade or business if the items are sold for the convenience of the association's members at their usual place of employment. This exclusion applies only to the sale of work-related clothes and equipment and items normally sold through vending machines, food dispensing facilities, or by snack bars.

Exchange or rental of member lists. The exchange or rental of member or donor lists between organizations described in section 501 that are eligible to receive charitable contributions is not included in the term unrelated trade or business.

Hospital services. The providing of certain services at or below cost by an exempt hospital to other exempt hospitals that have facilities for 100 or fewer inpatients is not an unrelated trade or business. This exclusion applies only to services described in section 501(e)(1)(A).

Pole rentals. The term unrelated trade or business does not include qualified pole rentals by a mutual or cooperative telephone or electric company described in section 501(c)(12). A qualified pole rental is the rental of a pole (or other structure used to support wires) if the pole (or other structure) is used:

1. By the telephone or electric company to support one or more wires that the company uses in providing telephone or electric services to its members, and
2. According to the rental, to support one or more wires (in addition to the wires described in 1) for use in connection with the transmission by wire of electricity or of telephone or other communications.

For this purpose, the term rental includes any sale of the right to use the pole (or other structure).

Public entertainment activity. An unrelated trade or business does not include a qualified public entertainment activity. A public entertainment activity is one traditionally conducted at a fair or exposition promoting agriculture and education, including any activity whose purpose is designed to attract the public to fairs or expositions or to promote the breeding of animals or the development of products or equipment.

A qualified public entertainment activity is one conducted by a qualifying organization:

1. In conjunction with an international, national, state, regional, or local fair or exposition;
2. In accordance with state law that permits the activity to be operated or conducted solely by such an organization or by an agency, instrumentality, or political subdivision of the state; or
3. In accordance with state law that permits an organization to be granted a license to conduct an activity for not more than 20 days on paying the state a lower percentage of the revenue from the activity than the state charges nonqualifying organizations that hold similar activities.

For these purposes, a qualifying organization is an organization described in section 501(c)(3), 501(c)(4), or 501(c)(5) that regularly conducts an agricultural and educational fair or exposition as one of its substantial exempt purposes. Its conducting qualified public entertainment activities will not affect determination of its exempt status.

Qualified sponsorship activities. Soliciting and receiving qualified sponsorship payments is not an unrelated trade or business, and the payments are not subject to unrelated business income tax.

Qualified sponsorship payment. This is any payment made by a person engaged in a trade or business for which the person will receive no substantial benefit other than the use or acknowledgment of the business name, logo, or product lines in connection with the organization's activities. “Use or acknowledgment” does not include advertising the sponsor's products or services. The organization's activities include all its activities, whether or not related to its exempt purposes.

For example, if, in return for receiving a sponsorship payment, an organization promises to use the sponsor's name or logo in acknowledging the sponsor's support for an educational or fundraising event, the payment is a qualified sponsorship payment and is not subject to the unrelated business income tax.

Providing facilities, services, or other privileges (for example, complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) to a sponsor or the sponsor's designees in connection with a sponsorship payment does not affect whether the payment is a qualified sponsorship payment. Instead, providing these goods or services is treated as a separate transaction in determining whether the organization has unrelated business income from the event. Generally, if the services or facilities are not a substantial benefit or if providing them is a related business activity, the payments will not be subject to the unrelated business income tax.

Similarly, the sponsor's receipt of a license to use an intangible asset (for example, a trademark, logo, or designation) of the organization is treated as separate from the qualified sponsorship transaction in determining whether the organization has unrelated business taxable income.

If part of a payment would be a qualified sponsorship payment if paid separately, that part is treated as a separate payment. For example, if a sponsorship payment entitles the sponsor to both product advertising and the use or acknowledgment of the sponsor's name or logo by the organization, then the unrelated business income tax does not apply to the part of the payment that is more than the fair market value of the product advertising.

Advertising. A payment is not a qualified sponsorship payment if, in return, the organization advertises the sponsor's products or services. For information on the treatment of payments for advertising, see *Exploitation of Exempt Activity—Advertising Sales* in chapter 4.

Advertising includes:

1. Messages containing qualitative or comparative language, price information, or other indications of savings or value;
2. Endorsements; and
3. Inducements to purchase, sell, or use the products or services.

The use of promotional logos or slogans that are an established part of the sponsor's identity is not, by itself, advertising. In addition, mere distribution or display of a sponsor's product by the organization to the public at a sponsored event, whether for free or for remuneration, is considered use or acknowledgment of the product rather than advertising.

Exception for contingent payments. A payment is not a qualified sponsorship payment if its amount is contingent, by contract or otherwise, upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to one or more events. However, the fact that a sponsorship payment is contingent upon an event actually taking place or being broadcast does not, by itself, affect whether a payment qualifies.

Exception for conventions and trade shows. A payment is not a qualified sponsorship payment if it is made in connection with

any qualified convention or trade show activity. The exclusion of qualified convention or trade show activities from the definition of unrelated trade or business is explained later under *Convention or trade show activity*.

Exception for periodicals. A payment is not a qualified sponsorship payment if it entitles the payer to the use or acknowledgment of the business name, logo, or product lines in the organization's periodical. For this purpose, a periodical is any regularly scheduled and printed material (for example, a monthly journal) published by or on behalf of the organization. It does not include material that is related to and primarily distributed in connection with a specific event conducted by the organization (for example, a program or brochure distributed at a sponsored event).

The treatment of payments that entitle the payer to the depiction of the payer's name, logo, or product lines in an organization's periodical is determined under the rules that apply to advertising activities. See *Sales of advertising space* under *Examples,* earlier in this chapter. Also see *Exploitation of Exempt Activity—Advertising Sales* in chapter 4.

Selling donated merchandise. A trade or business that consists of selling merchandise, substantially all of which the organization received as gifts or contributions, is not an unrelated trade or business. For example, a thrift shop operated by a tax-exempt organization that sells donated clothes and books to the general public, with the proceeds going to the exempt organization, is not an unrelated trade or business.

Volunteer workforce. Any trade or business in which substantially all the work is performed for the organization without compensation is not an unrelated trade or business.

Example 1. A retail store operated by an exempt orphanage where unpaid volunteers perform substantially all the work in carrying on the business is not an unrelated trade or business.

Example 2. A volunteer fire company conducts weekly public dances. Holding public dances and charging admission on a regular basis may, given the facts and circumstances of a particular case, be considered an unrelated trade or business. However, because the work at the dances is performed by unpaid volunteers, the activity is not an unrelated trade or business.

4. Unrelated Business Taxable Income

The term "unrelated business taxable income" generally means the gross income derived from any unrelated trade or business regularly conducted by the exempt organization, less the deductions directly connected with carrying on the trade or business. If an organization regularly carries on two or more unrelated business activities, its unrelated business taxable income is the total of gross income from all such activities less the total allowable deductions attributable to all the activities.

In computing unrelated business taxable income, gross income and deductions are subject to the modifications and special rules explained in this chapter. Whether a particular item of income or expense falls within any of these modifications or special rules must be determined by all the facts and circumstances in each specific case. For example, if the organization received a payment termed rent that is in fact a return of profits by a person operating the property for the benefit of the organization, or that is a share of the profits retained by the organization as a partner or joint venturer, the payment is not within the income exclusion for rents, discussed later under *Exclusions.*

Income

Generally, unrelated business income is taxable, but there are exclusions and special rules that must be considered when figuring the income.

Exclusions

The following types of income (and deductions directly connected with the income) are generally excluded when figuring unrelated business taxable income.

Dividends, interest, annuities and other investment income. All dividends, interest, annuities, payments with respect to securities loans, income from notional principal contracts, and other income from an exempt organization's ordinary and routine investments that the IRS determines are substantially similar to these types of income are excluded in computing unrelated business taxable income.

Exception for insurance activity income of a controlled foreign corporation. This exclusion does not apply to income from certain insurance activities of an exempt organization's controlled foreign corporation. The income is not excludable dividend income, but instead is unrelated business taxable income to the extent it would be so treated if the exempt organization had earned it directly. Certain exceptions to this rule apply. For more information, see section 512(b)(17).

Other exceptions. This exclusion does not apply to unrelated debt-financed income (discussed under *Income From Debt-Financed Property,* later), or to certain rents, royalties, interest or annuities received from a controlled corporation (discussed under *Income From Controlled Organizations*, later).

Income from lending securities. Payments received with respect to a security loan are excluded in computing unrelated business taxable income only if the loan is made under an agreement that:

1. Provides for the return to the exempt organization of securities identical to the securities loaned,
2. Requires payments to the organization of amounts equivalent to all interest, dividends, and other distributions that the owner of the securities is entitled to receive during the period of the loan,
3. Does not reduce the organization's risk of loss or opportunity for gain on the securities,
4. Contains reasonable procedures to implement the obligation of the borrower to furnish collateral to the organization with a fair market value each business day during the period of the loan in an amount not less than the fair market value of the securities at the close of the preceding business day, and
5. Permits the organization to terminate the loan upon notice of not more than 5 business days.

Payments with respect to securities loans include:

1. Amounts in respect of dividends, interest, and other distributions,
2. Fees based on the period of time the loan is in effect and the fair market value of the security during that period,
3. Income from collateral security for the loan, and
4. Income from the investment of collateral security.

The payments are considered to be from the securities loaned and not from collateral security or the investment of collateral security from the loans. Any deductions that are directly connected with collateral security for the loan, or with the investment of collateral security, are considered deductions that are directly connected with the securities loaned.

Royalties. Royalties, including overriding royalties, are excluded in computing unrelated business taxable income.

To be considered a royalty, a payment must relate to the use of a valuable right. Payments for trademarks, trade names, or copyrights are ordinarily considered royalties. Similarly, payments for the use of a professional athlete's

name, photograph, likeness, or facsimile signature are ordinarily considered royalties. However, royalties do not include payments for personal services. Therefore, payments for personal appearances and interviews are not excluded as royalties and must be included in figuring unrelated business taxable income.

Unrelated business taxable income does not include royalty income received from licensees by an exempt organization that is the legal and beneficial owner of patents assigned to it by inventors for specified percentages of future royalties.

Mineral royalties are excluded whether measured by production or by gross or taxable income from the mineral property. However, the exclusion does not apply to royalties that stem from an arrangement whereby the organization owns a working interest in a mineral property and is liable for its share of the development and operating costs under the terms of its agreement with the operator of the property. To the extent they are not treated as loans under section 636 (relating to income tax treatment of mineral production payments), payments for mineral production are treated in the same manner as royalty payments for the purpose of computing unrelated business taxable income. To the extent they are treated as loans, any payments for production that are the equivalent of interest are treated as interest and are excluded.

Exceptions. This exclusion does not apply to debt-financed income (discussed under *Income From Debt-Financed Property,* later) or to royalties received from a controlled corporation (discussed under *Income From Controlled Organizations,* later).

Rents. Rents from real property, including elevators and escalators, are excluded in computing unrelated business taxable income. Rents from personal property are not excluded. However, special rules apply to "mixed leases" of both real and personal property.

Mixed leases. In a mixed lease, all of the rents are excluded if the rents attributable to the personal property are not more than 10% of the total rents under the lease, as determined when the personal property is first placed in service by the lessee. If the rents attributable to personal property are more than 10% but not more than 50% of the total rents, only the rents attributable to the real property are excluded. If the rents attributable to the personal property are more than 50% of the total rents, none of the rents are excludable.

Property is placed in service when the lessee first may use it under the terms of a lease. For example, property subject to a lease entered into on November 1, for a term starting on January 1 of the next year, is considered placed in service on January 1, regardless of when the lessee first actually uses it.

If separate leases are entered into for real and personal property and the properties have an integrated use (for example, one or more leases for real property and another lease or leases for personal property to be used on the real property), all the leases will be considered as one lease.

The rent attributable to the personal property must be recomputed, and the treatment of the rents must be redetermined, if:

1. The rent attributable to all the leased personal property increases by 100% or more because additional or substitute personal property is placed in service, or
2. The lease is modified to change the rent charged (whether or not the amount of rented personal property changes).

Any change in the treatment of rents resulting from the recomputation is effective only for the period beginning with the event that caused the recomputation.

Exception for rents based on net profit. The exclusion for rents does not apply if the amount of the rent depends on the income or profits derived by any person from the leased property, other than an amount based on a fixed percentage of the gross receipts or sales.

Exception for income from personal services. Payment for occupying space when personal services are also rendered to the occupant does not constitute rent from real property. Therefore, the exclusion does not apply to transactions such as renting hotel rooms, rooms in boarding houses or tourist homes, and space in parking lots or warehouses.

Other exceptions. This exclusion does not apply to unrelated debt-financed income (discussed under *Income From Debt-Financed Property,* later), or to interest, annuities, royalties and rents received from a controlled corporation (discussed under *Income From Controlled Organizations,* later), or investment income (dividends, interest, rents, etc.) received by organizations described in sections 501(c)(7), 501(c)(9), 501(c)(17), and 501(c)(20). See *Special Rules for Social Clubs, VEBAs, SUBs, and GLSOs,* discussed later for more information.

Income from research. A tax-exempt organization may exclude income from research grants or contracts from unrelated business taxable income. However, the extent of the exclusion depends on the nature of the organization and the type of research.

Income from research for the United States, any of its agencies or instrumentalities, or a state or any of its political subdivisions is excluded when computing unrelated business taxable income.

For a college, university, or hospital, all income from research, whether fundamental or applied, is excluded in computing unrelated business taxable income.

When an organization is operated primarily to conduct fundamental research (as distinguished from applied research) and the results are freely available to the general public, all income from research performed for any person is excluded in computing unrelated business taxable income.

The term research, for this purpose, does not include activities of a type normally conducted as an incident to commercial or industrial operations, such as testing or inspecting materials or products, or designing or constructing equipment, buildings, etc. In addition, the term fundamental research does not include research conducted for the primary purpose of commercial or industrial application.

Gains and losses from disposition of property. Also excluded from unrelated business taxable income are gains or losses from the sale, exchange, or other disposition of property other than:

1. Stock in trade or other property of a kind that would properly be includable in inventory if on hand at the close of the tax year,
2. Property held primarily for sale to customers in the ordinary course of a trade or business, or
3. Cutting of timber that an organization has elected to consider as a sale or exchange of the timber.

It should be noted that the last exception relates only to cut timber. The sale, exchange, or other disposition of standing timber is excluded from the computation of unrelated business income, unless it constitutes property held for sale to customers in the ordinary course of business.

Lapse or termination of options. Any gain from the lapse or termination of options to buy or sell securities is excluded from unrelated business taxable income. The exclusion applies only if the option is written in connection with the exempt organization's investment activities. Therefore, this exclusion is not available if the organization is engaged in the trade or business of writing options or the options are held by the organization as inventory or for sale to customers in the ordinary course of a trade or business.

Exception. This exclusion does not apply to unrelated debt-financed income, discussed later under *Income From Debt-Financed Property*.

Gain or loss on disposition of certain brownfield property. Gain or loss from the qualifying sale, exchange, or other disposition of a qualifying brownfield property (as defined in section 512(b)(19)(C)), which was acquired by the organization after December 31, 2005 and before January 1, 2011, is excluded from unrelated business taxable income and is excepted from the debt-financed rules. See sections 512(b)(19) and 514(b)(1)(E).

Income from services provided under federal license. There is a further exclusion from unrelated business taxable income of income from a trade or business conducted by a religious order or by an educational organization maintained by the order.

This exclusion applies only if the following requirements are met.

1. The trade or business must have been operated by the order or by the institution before May 27, 1959.
2. The trade or business must provide services under a license issued by a federal regulatory agency.
3. More than 90% of the net income from the business for the tax year must be devoted

to religious, charitable, or educational purposes that constitute the basis for the religious order's exemption.

4. The rates or other charges for these services must be fully competitive with the rates or other charges of similar taxable businesses. Rates or other charges for these services will be considered as fully competitive if they are neither materially higher nor materially lower than the rates charged by similar businesses operating in the same general area.

Exception. This exclusion does not apply to unrelated debt-financed income (discussed under *Income From Debt-Financed Property*, later).

Member income of mutual or cooperative electric companies. Income of a mutual or cooperative electric company described in section 501(c)(12) which is treated as member income under subparagraph (H) of that section is excluded from unrelated business taxable income.

Dues of Agricultural Organizations and Business Leagues

Dues received from associate members by organizations exempt under section 501(c)(5) or section 501(c)(6) may be treated as gross income from an unrelated trade or business if the associate member category exists for the principal purpose of producing unrelated business income. For example, if an organization creates an associate member category solely to allow associate members to purchase insurance through the organization, the associate member dues may be unrelated business income.

Exception. Associate member dues received by an agricultural or horticultural organization are not treated as gross income from an unrelated trade or business, regardless of their purpose, if they are not more than the annual limit. The limit on dues paid by an associate member is $158 for 2014.

If the required annual dues are more than the limit, the entire amount is treated as income from an unrelated business unless the associate member category was formed or availed of for the principal purpose of furthering the organization's exempt purposes.

Deductions

To qualify as allowable deductions in computing unrelated business taxable income, the expenses, depreciation, and similar items generally must be allowable income tax deductions that are directly connected with carrying on an unrelated trade or business. They cannot be directly connected with excluded income.

For an exception to the “directly connected” requirement, see *Charitable contributions deduction,* under *Modifications,* later.

Directly Connected

To be directly connected with the conduct of an unrelated business, deductions must have a proximate and primary relationship to carrying on that business. For an exception, see *Expenses attributable to exploitation of exempt activities*, later.

Expenses attributable solely to unrelated business. Expenses, depreciation, and similar items attributable solely to the conduct of an unrelated business are proximately and primarily related to that business and qualify for deduction to the extent that they are otherwise allowable income tax deductions.

For example, salaries of personnel employed full-time to conduct the unrelated business and depreciation of a building used entirely in the conduct of that business are deductible to the extent otherwise allowable.

Expenses attributable to dual use of facilities or personnel. When facilities or personnel are used both to conduct exempt functions and to conduct an unrelated trade or business, expenses, depreciation, and similar items attributable to the facilities or personnel must be allocated between the two uses on a reasonable basis. The part of an item allocated to the unrelated trade or business is proximately and primarily related to that business and is allowable as a deduction in computing unrelated business taxable income if the expense is otherwise an allowable income tax deduction.

Example 1. A school recognized as a tax-exempt organization contracts with an individual to conduct a summer tennis camp. The school provides the individual with tennis courts, housing, and dining facilities, and personnel to maintain and operate them. The contracted individual hires the instructors, recruits campers, and provides supervision of the tennis camp. The income the school receives from the individual under the contract from this activity for the use of its facilities and personnel is from a dual use of the facilities and personnel, not from conducting an educational activity. The school, in computing its unrelated business taxable income, may deduct an allocable part of the expenses attributable to the facilities and personnel it makes available under the contract.

Example 2. An exempt organization with gross income from an unrelated trade or business pays its president $90,000 a year. The president devotes approximately 10% of his time to the unrelated business. To figure the organization's unrelated business taxable income, a deduction of $9,000 ($90,000 × 10%) is allowed for the salary paid to its president.

Expenses attributable to exploitation of exempt activities. Generally, expenses, depreciation, and similar items attributable to the conduct of an exempt activity are not deductible in computing unrelated business taxable income from an unrelated trade or business that exploits the exempt activity. (See *Exploitation of exempt functions* under *Not substantially related* in chapter 3.) This is because they do not have a proximate and primary relationship to the unrelated trade or business, and therefore, they do not qualify as directly connected with that business.

Exception. Expenses, depreciation, and similar items may be treated as directly connected with the conduct of the unrelated business if all the following statements are true.

1. The unrelated business exploits the exempt activity.
2. The unrelated business is a type normally conducted for profit by taxable organizations.
3. The exempt activity is a type normally conducted by taxable organizations in carrying on that type of business.

The amount treated as directly connected is the smaller of:

1. The excess of these expenses, depreciation, and similar items over the income from, or attributable to, the exempt activity; or
2. The gross unrelated business income reduced by all other expenses, depreciation, and other items that are actually directly connected.

The application of these rules to an advertising activity that exploits an exempt publishing activity is explained next.

Exploitation of Exempt Activity—Advertising Sales

The sale of advertising in a periodical of an exempt organization that contains editorial material related to the accomplishment of the organization's exempt purpose is an unrelated business that exploits an exempt activity, the circulation and readership of the periodical. Therefore, in addition to direct advertising costs, exempt activity costs (expenses, depreciation, and similar expenses attributable to the production and distribution of the editorial or readership content) can be treated as directly connected with the conduct of the advertising activity. (See *Expenses attributable to exploitation of exempt activities* under *Directly Connected*, earlier.)

Figuring unrelated business taxable income (UBTI). The UBTI of an advertising activity is the amount shown in the following chart.

IF gross advertising income is . . .	THEN UBTI is . . .
More than direct advertising costs	The excess advertising income, reduced (but not below zero) by the excess, if any, of readership costs over circulation income.
Equal to or less than direct advertising costs	Zero. • Circulation income and readership costs are not taken into account. • Any excess advertising costs reduce (but not below zero) UBTI from any other unrelated business activity.

The terms used in the chart are explained in the following discussions.

Periodical Income

Gross advertising income. This is all the income from the unrelated advertising activities of an exempt organization periodical.

Circulation income. This is all the income from the production, distribution, or circulation of an exempt organization's periodical (other than gross advertising income). It includes all amounts from the sale or distribution of the readership content of the periodical, such as income from subscriptions. It also includes allocable membership receipts if the right to receive the periodical is associated with a membership or similar status in the organization.

Allocable membership receipts. This is the part of membership receipts (dues, fees, or other charges associated with membership) equal to the amount that would have been charged and paid for the periodical if:

1. The periodical was published by a taxable organization,
2. The periodical was published for profit, and
3. The member was an unrelated party dealing with the taxable organization at arm's length.

The amount used to allocate membership receipts is the amount shown in the following chart.

For this purpose, the total periodical costs are the sum of the direct advertising costs and the readership costs, explained under *Periodical Costs*, later. The cost of other exempt activities means the total expenses incurred by the organization in connection with its other exempt activities, not offset by any income earned by the organization from those activities.

IF . . .	THEN the amount used to allocate membership receipts is . . .
20% or more of the total circulation consists of sales to nonmembers	The subscription price charged nonmembers.
The above condition does not apply, **and** 20% or more of the members pay reduced dues because they do not receive the periodical	The reduction in dues for a member not receiving the periodical.
Neither of the above conditions applies	The membership receipts multiplied by this fraction: Total periodical costs / (Total periodical costs Plus Cost of other exempt activities)

Example 1. U is an exempt scientific organization with 10,000 members who pay annual dues of $15. One of U's activities is publishing a monthly periodical distributed to all of its members. U also distributes 5,000 additional copies of its periodical to nonmembers, who subscribe for $10 a year. Since the nonmember circulation of U's periodical represents one-third (more than 20%) of its total circulation, the subscription price charged to nonmembers is used to determine the part of U's membership receipts allocable to the periodical. Thus, U's allocable membership receipts are $100,000 ($10 times 10,000 members), and U's total circulation income for the periodical is $150,000 ($100,000 from members plus $50,000 from sales to nonmembers).

Example 2. Assume the same facts except that U sells only 500 copies of its periodical to nonmembers, at a price of $10 a year. Assume also that U's members may elect not to receive the periodical, in which case their dues are reduced from $15 a year to $6 a year, and that only 3,000 members elect to receive the periodical and pay the full dues of $15 a year. U's stated subscription price of $9 to members consistently results in an excess of total income (including gross advertising income) attributable to the periodical over total costs of the periodical. Since the 500 copies of the periodical distributed to nonmembers represent only 14% of the 3,500 copies distributed, the $10 subscription price charged to nonmembers is not used to determine the part of membership receipts allocable to the periodical. Instead, since 70% of the members elect not to receive the periodical and pay $9 less per year in dues, the $9 price is used to determine the subscription price charged to members. Thus, the allocable membership receipts will be $9 a member, or $27,000 ($9 times 3,000 copies). U's total circulation income is $32,000 ($27,000 plus the $5,000 from nonmember subscriptions).

Periodical Costs

Direct advertising costs. These are expenses, depreciation, and similar items of deduction directly connected with selling and publishing advertising in the periodical.

Examples of allowable deductions under this classification include agency commissions and other direct selling costs, such as transportation and travel expenses, office salaries, promotion and research expenses, and office overhead directly connected with the sale of advertising lineage in the periodical. Also included are other deductions commonly classified as advertising costs under standard account classifications, such as artwork and copy preparation, telephone, telegraph, postage, and similar costs directly connected with advertising.

In addition, direct advertising costs include the part of mechanical and distribution costs attributable to advertising lineage. For this purpose, the general account classifications of items includable in mechanical and distribution costs ordinarily employed in business-paper and consumer-publication accounting provide a guide for the computation. Accordingly, the mechanical and distribution costs include the part of the costs and other expenses of composition, press work, binding, mailing (including paper and wrappers used for mailing), and bulk postage attributable to the advertising lineage of the publication.

In the absence of specific and detailed records, the part of mechanical and distribution costs attributable to the periodical's advertising lineage can be based on the ratio of advertising lineage to total lineage in the periodical, if this allocation is reasonable.

Readership costs. These are all expenses, depreciation, and similar items that are directly connected with the production and distribution of the readership content of the periodical.

Costs partly attributable to other activities. Deductions properly attributable to exempt activities other than publishing the periodical may not be allocated to the periodical. When expenses are attributable both to the periodical and to the organization's other activities, an allocation must be made on a reasonable basis. The method of allocation will vary with the nature of the item, but once adopted, should be used consistently. Allocations based on dollar receipts from various exempt activities generally are not reasonable since receipts usually do not accurately reflect the costs associated with specific activities that an exempt organization conducts.

Consolidated Periodicals

If an exempt organization publishes more than one periodical to produce income, it may treat all of them (but not less than all) as one in determining unrelated business taxable income from selling advertising. It treats the gross income from all the periodicals, and the deductions directly connected with them, on a consolidated basis. Consolidated treatment, once adopted, must be followed consistently and is binding. This treatment can be changed only with the consent of the Internal Revenue Service.

An exempt organization's periodical is published to produce income if:

1. The periodical generates gross advertising income to the organization equal to at least 25% of its readership costs, and
2. Publishing the periodical is an activity engaged in for profit.

Whether the publication of a periodical is an activity engaged in for profit can be determined only by all the facts and circumstances in each case. The facts and circumstances must show that the organization carries on the activity for economic profit, although there may not be a profit in a particular year. For example, if an organization begins publishing a new periodical whose total costs exceed total income in the start-up years because of lack of advertising sales, that does not mean that the organization did not have as its objective an economic profit. The organization may establish that it had this objective by showing it can reasonably expect advertising sales to increase, so that total income will exceed costs within a reasonable time.

Example. Y, an exempt trade association, publishes three periodicals that it distributes to its members: a weekly newsletter, a monthly magazine, and a quarterly journal. Both the monthly magazine and the quarterly journal contain advertising that accounts for gross advertising income equal to more than 25% of

their respective readership costs. Similarly, the total income attributable to each periodical has exceeded the total deductions attributable to each periodical for substantially all the years they have been published. The newsletter carries no advertising and its annual subscription price is not intended to cover the cost of publication. The newsletter is a service that Y distributes to all of its members in an effort to keep them informed of changes occurring in the business world. It is not engaged in for profit.

Under these circumstances, Y may consolidate the income and deductions from the monthly and quarterly journals in computing its unrelated business taxable income. It may not consolidate the income and deductions from the newsletter with the income and deductions of its other periodicals, since the newsletter is not published for the production of income.

Modifications

Net operating loss deduction. The net operating loss (NOL) deduction (as provided in section 172) is allowed in computing unrelated business taxable income. However, the NOL for any tax year, the carrybacks and carryovers of NOLs, and the NOL deduction are determined without taking into account any amount of income or deduction that has been specifically excluded in computing unrelated business taxable income. For example, a loss from an unrelated trade or business is not diminished because dividend income was received.

If this were not done, organizations would, in effect, be taxed on their exempt income, since unrelated business losses then would be offset by dividends, interest, and other excluded income. This would reduce the loss that could be applied against unrelated business income of prior or future tax years. Therefore, to preserve the immunity of exempt income, all NOL computations are limited to those items of income and deductions that affect the unrelated business taxable income.

In line with this concept, an NOL carryback or carryover is allowed only from a tax year for which the organization is subject to tax on unrelated business income.

For example, if an organization just became subject to the tax last year, its NOL for that year is not a carryback to a prior year when it had no unrelated business taxable income, nor is its NOL carryover to succeeding years reduced by the related income of those prior years.

However, in determining the span of years for which an NOL may be carried back or forward, the tax years for which the organization is not subject to the tax on unrelated business income are counted. For example, if an organization was subject to the tax for 2012 and had an NOL for that year, the last tax year to which any part of that loss may be carried over is 2032, regardless of whether the organization was subject to the unrelated business income tax in any of the intervening years.

For more details on the NOL deduction, including property eligible for an extended carryback period, see sections 172 and 1400N, Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts, and Publication 4492-B, Information for Affected Taxpayers in the Midwestern Disaster Areas.

Charitable contributions deduction. An exempt organization is allowed to deduct its charitable contributions in computing its unrelated business taxable income whether or not the contributions are directly connected with the unrelated business.

To be deductible, the contribution must be paid to another qualified organization. For example, an exempt university that operates an unrelated business may deduct a contribution made to another university for educational work, but may not claim a deduction for contributions of amounts spent for carrying out its own educational program.

For purposes of the deduction, a distribution by a trust made under the trust instrument to a beneficiary, which itself is a qualified organization, is treated the same as a contribution.

Deduction limits. An exempt organization that is subject to the unrelated business income tax at corporate rates is allowed a deduction for charitable contributions up to 10% of its unrelated business taxable income computed without regard to the deduction for contributions. See the Instructions for Form 990-T for more information.

An exempt trust that is subject to the unrelated business income tax at trust rates generally is allowed a deduction for charitable contributions in the same amounts as allowed for individuals. However, the limit on the deduction is determined in relation to the trust's unrelated business taxable income computed without regard to the deduction, rather than in relation to adjusted gross income.

Contributions in excess of the limits just described may be carried over to the next 5 tax years. A contribution carryover is not allowed, however, to the extent that it increases an NOL carryover.

Suspension of deduction limits for farmers and ranchers. The limitations discussed above are temporarily suspended for certain qualified conservation contributions of property used in agriculture or livestock production. See the Instructions for Form 990-T for details.

Specific deduction. In computing unrelated business taxable income, a specific deduction of $1,000 is allowed. However, the specific deduction is not allowed in computing an NOL or the NOL deduction.

Generally, the deduction is limited to $1,000 regardless of the number of unrelated businesses in which the organization is engaged.

Exception. An exception is provided in the case of a diocese, province of a religious order, or a convention or association of churches that may claim a specific deduction for each parish, individual church, district, or other local unit. In these cases, the specific deduction for each local unit is limited to the lower of:

- $1,000, or
- Gross income derived from an unrelated trade or business regularly conducted by the local unit.

This exception applies only to parishes, districts, or other local units that are not separate legal entities, but are components of a larger entity (diocese, province, convention, or association) filing Form 990-T. The parent organization must file a return reporting the unrelated business gross income and related deductions of all units that are not separate legal entities. The local units cannot file separate returns. However, each local unit that is separately incorporated must file its own return and cannot include, or be included with, any other entity. See *Title-holding corporations* in chapter 1 for a discussion of the only situation in which more than one legal entity may be included on the same Form 990-T.

Example. X is an association of churches and is divided into local units A, B, C, and D. Last year, A, B, C, and D derived gross income of, respectively, $1,200, $800, $1,500, and $700 from unrelated businesses that they regularly conduct. X may claim a specific deduction of $1,000 with respect to A, $800 with respect to B, $1,000 with respect to C, and $700 with respect to D.

Partnership Income or Loss

An organization may have unrelated business income or loss as a member of a partnership, rather than through direct business dealings with the public. If so, it must treat its share of the partnership income or loss as if it had conducted the business activity in its own capacity as a corporation or trust. No distinction is made between limited and general partners. The organization is required to notify the partnership of its tax-exempt status.

Thus, if an organization is a member of a partnership regularly engaged in a trade or business that is an unrelated trade or business with respect to the organization, the organization must include in its unrelated business taxable income its share of the partnership's gross income from the unrelated trade or business (whether or not distributed), and the deductions attributable to it. The partnership income and deductions to be included in the organization's unrelated business taxable income are figured the same way as any income and deductions from an unrelated trade or business conducted directly by the organization. The partnership is required to provide the organization this information on Schedule K-1.

Example. An exempt educational organization is a partner in a partnership that operates a factory. The partnership also holds stock in a corporation. The exempt organization must include its share of the gross income from operating the factory in its unrelated business taxable income but may exclude its share of any dividends the partnership received from the corporation.

Different tax years. If the exempt organization and the partnership of which it is a member have different tax years, the partnership items that enter into the computation of the organization's unrelated business taxable income must

be based on the income and deductions of the partnership for the partnership's tax year that ends within the organization's tax year.

S Corporation Income or Loss

An organization that owns S corporation stock must take into account its share of the S corporation's income, deductions, or losses in figuring unrelated business taxable income, regardless of the actual source or nature of the income, deductions, and losses. For example, the organization's share of the S corporation's interest and dividend income will be taxable, even though interest and dividends are normally excluded from unrelated business taxable income. The organization must also take into account its gain or loss on the sale or other disposition of the S corporation stock in figuring unrelated business taxable income.

Special Rules for Foreign Organizations

The unrelated business taxable income of a foreign organization exempt from tax under section 501(a) consists of the organization's:

1. Unrelated business taxable income derived from sources within the United States but not effectively connected with the conduct of a trade or business within the United States, and
2. Unrelated business taxable income effectively connected with the conduct of a trade or business within the United States, whether or not this income is derived from sources within the United States.

To determine whether income realized by a foreign organization is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States, see sections 861 through 865 and the related regulations.

Special Rules for Social Clubs, VEBAs, SUBs, and GLSOs

The following discussion applies to:

- ***Social clubs*** described in section 501(c)(7),
- ***Voluntary employees' beneficiary associations (VEBAs)*** described in section 501(c)(9),
- ***Supplemental unemployment compensation benefit trusts (SUBs)*** described in section 501(c)(17), and
- ***Group legal services organizations (GLSOs)*** described in section 501(c)(20).

These organizations must figure unrelated business taxable income under special rules. Unlike other exempt organizations, they cannot exclude their investment income (dividends, interest, rents, etc.). (See *Exclusions* under *Income,* earlier.) Therefore, they are generally subject to unrelated business income tax on this income.

The unrelated business taxable income of these organizations includes all gross income, less deductions directly connected with the production of that income, except that gross income for this purpose does not include exempt function income. The deduction for dividends received by a corporation is not allowed in computing unrelated business taxable income because it is not an expense incurred in the production of income.

Losses from nonexempt activities. Losses from nonexempt activities of these organizations cannot be used to offset investment income unless the activities were undertaken with the intent to make a profit.

Example. A private golf and country club that is a qualified tax-exempt social club has nonexempt function income from interest and from the sale of food and beverages to nonmembers. The club sells food and beverages as a service to members and their guests rather than for the purpose of making a profit. Therefore, any loss resulting from sales to nonmembers cannot be used to offset the club's interest income.

Modifications. The unrelated business taxable income is modified by any NOL or charitable contributions deduction and by the specific deduction (described earlier under *Deductions*).

Exempt function income. This is gross income from dues, fees, charges or similar items paid by members for goods, facilities, or services to the members or their dependents or guests, to further the organization's exempt purposes. Exempt function income also includes income set aside for qualified purposes.

Income that is set aside. This is income set aside to be used for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals. In addition, for a VEBA, SUB, or GLSO, it is income set aside to provide for the payment of life, sick, accident, or other benefits.

However, any amounts set aside by a VEBA or SUB that exceed the organization's qualified asset account limit (determined under section 419A) are unrelated business income. Special rules apply to the treatment of existing reserves for post-retirement medical or life insurance benefits. These rules are explained in section 512(a)(3)(E)(ii).

Income derived from an unrelated trade or business may not be set aside and therefore cannot be exempt function income. In addition, any income set aside and later spent for other purposes must be included in unrelated business taxable income.

Set-aside income is generally excluded from gross income only if it is set aside in the tax year in which it is otherwise includible in gross income. However, income set aside on or before the date for filing Form 990-T, including extensions of time, may, at the election of the organization, be treated as having been set aside in the tax year for which the return was filed. The income set aside must have been includible in gross income for that earlier year.

Nonrecognition of gain. If the organization sells property used directly in performing an exempt function and purchases other property used directly in performing an exempt function, any gain on the sale is recognized only to the extent that the sales price of the old property exceeds the cost of the new property. The purchase of the new property must be made within 1 year before the date of sale of the old property or within 3 years after the date of sale.

This rule also applies to gain from an involuntary conversion of the property resulting from its destruction in whole or in part, theft, seizure, requisition, or condemnation.

Special Rules for Veterans' Organizations

Unrelated business taxable income of a veterans' organization that is exempt under section 501(c)(19) does not include the net income from insurance business that is properly set aside. The organization may set aside income from payments received for life, sick, accident, or health insurance for the organization's members or their dependents for the payment of insurance benefits or reasonable costs of insurance administration, or for use exclusively for religious, charitable, scientific, literary, or educational purposes, or the prevention of cruelty to children or animals. For details, see section 512(a)(4) and the regulations under that section.

Income From Controlled Organizations

The exclusions for interest, annuities, royalties, and rents, explained earlier in this chapter under *Income*, may not apply to a payment of these items received by a controlling organization from its controlled organization. The payment is included in the controlling organization's unrelated business taxable income to the extent it reduced the net unrelated income (or increased the net unrelated loss) of the controlled organization. All deductions of the controlling organization directly connected with the amount included in its unrelated business taxable income are allowed.

Excess qualifying specified payments. Excess qualifying specified payments received or accrued from a controlled entity are included in a controlling exempt organization's unrelated business taxable income only to the extent of the amount that exceeds that which would have been paid or accrued if the payments had been determined under section 482. Qualifying specified payments means any payments of interest, annuities, royalties, or rents received or accrued from the controlled organization pursuant to a binding written contract in effect on August 17, 2006, or to a contract which is a renewal, under substantially similar terms of a binding written contract in effect on August 17, 2006, and the payments are received or accrued before January 1, 2015.

If a controlled participant is not required to file a United States income tax return, the

participant must ensure that the copy or copies of the Regulations section 1.482-7 Cost Sharing Arrangement Statement and any updates are attached to Schedule M of any Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, any Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business, or any Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, filed for that participant.

Addition to tax for valuation misstatements. Under section 512(b)(13)(E)(ii), the tax imposed on a controlling organization will be increased by 20 percent of the excess qualifying specified payments that are determined with or without any amendments or supplements to a return of tax, whichever is larger. See section 512(b)(13)(E)(ii) for more information.

Net unrelated income. This is:

- For an exempt organization, its unrelated business taxable income, or
- For a nonexempt organization, the part of its taxable income that would be unrelated business taxable income if it were exempt and had the same exempt purposes as the controlling organization.

Net unrelated loss. This is:

- For an exempt organization, its NOL, or
- For a nonexempt organization, the part of its NOL that would be its NOL if it were exempt and had the same exempt purposes as the controlling organization.

Control. An organization is controlled if:

- For a corporation, the controlling organization owns (by vote or value) more than 50% of the stock,
- For a partnership, the controlling organization owns more than 50% of the profits or capital interests, or
- For any other organization, the controlling organization owns more than 50% of the beneficial interest.

For this purpose, constructive ownership of stock (determined under section 318) or other interests is taken into account.

As a result, an exempt parent organization is treated as controlling any subsidiary in which it holds more than 50% of the voting power or value, whether directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Income from property financed with qualified 501(c)(3) bonds.

If any part of a 501(c)(3) organization's property financed with qualified 501(c)(3) bonds is used in a trade or business of any person other than a section 501(c)(3) organization or a governmental unit, and such use is not consistent with the requirements for qualified 501(c)(3) bonds under section 145, the section 501(c)(3) organization is considered to have received unrelated business income in the amount of the greater of the actual rental income or the fair rental value of the property for the period it is used. No deduction is allowed for interest on the private activity bond. See sections 150(b)(3) and (c) for more information.

Disposition of property received from taxable subsidiary and used in unrelated business.

A taxable 80%-owned subsidiary corporation of one or more tax-exempt entities is generally subject to tax on a distribution in liquidation of its assets to its exempt parent (or parents). The assets are treated as if sold at fair market value.

Tax-exempt entities include organizations described in sections 501(a), 529, and 115, charitable remainder trusts, U.S. and foreign governments, Indian tribal governments, international organizations, and similar non-taxable organizations.

A taxable corporation that transfers substantially all of its assets to a tax-exempt entity in a transaction that otherwise qualifies for nonrecognition treatment must recognize gain on the transaction as if it sold the assets at fair market value. However, such a transfer is not taxable if it qualifies as a like-kind exchange under section 1031 or an involuntary conversion under section 1033. In such a case the built-in appreciation is preserved in the replacement property received in the transaction.

A corporation that changes status from taxable to tax-exempt is treated generally as if it transferred all of its assets to a tax-exempt entity immediately before the change in status (thus subjecting it to the tax on a deemed sale for fair market value). This rule does not apply where the taxable corporation becomes exempt within 3 years of formation, or had previously been exempt and within several years (generally a period of 3 years) regains exemption, unless the principal purpose of the transactions is to avoid the tax on the change in status.

In the transactions described above, the taxable event is deferred for property that the tax-exempt entity immediately uses in an unrelated business. If the parent later disposes of the property, then any gain (not in excess of the amount not recognized) is included in the parent's unrelated business taxable income. If there is partial use of the assets in unrelated business, then there is partial recognition of gain or loss. Property is treated as disposed if the tax-exempt entity no longer uses it in an unrelated business.

Losses on the transfer of assets to a tax-exempt entity are disallowed if part of a plan with a principal purpose of recognizing losses.

Income From Debt-Financed Property

Investment income that would otherwise be excluded from an exempt organization's unrelated business taxable income (see *Exclusions* under *Income*, earlier) must be included to the extent it is derived from debt-financed property. The amount of income included is proportionate to the debt on the property.

Debt-Financed Property

In general, the term "debt-financed property" means any property held to produce income (including gain from its disposition) for which there is an acquisition indebtedness at any time during the tax year (or during the 12-month period before the date of the property's disposal, if it was disposed of during the tax year). It includes rental real estate, tangible personal property, and corporate stock.

Acquisition Indebtedness

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

The facts and circumstances of each situation determine whether incurring a debt was reasonably foreseeable. That an organization may not have foreseen the need to incur a debt before acquiring or improving the property does not necessarily mean that incurring the debt later was not reasonably foreseeable.

Example 1. Y, an exempt scientific organization, mortgages its laboratory to replace working capital used in remodeling an office building that Y rents to an insurance company for nonexempt purposes. The debt is acquisition indebtedness since the debt, though incurred after the improvement of the office building, would not have been incurred without the improvement, and the debt was reasonably foreseeable when, to make the improvement, Y reduced its working capital below the amount necessary to continue current operations.

Example 2. X, an exempt organization, forms a partnership with A and B. The partnership agreement provides that all three partners will share equally in the profits of the partnership, each will invest $3 million, and X will be a limited partner. X invests $1 million of its own funds in the partnership and $2 million of borrowed funds.

The partnership buys as its sole asset an office building that it leases to the public for nonexempt purposes. The office building costs the partnership $24 million, of which $15 million is borrowed from Y bank. The loan is secured by a mortgage on the entire office building. By

agreement with Y bank, X is not personally liable for payment of the mortgage.

X has acquisition indebtedness of $7 million. This amount is the $2 million debt X incurred in acquiring the partnership interest, plus the $5 million that is X's allocable part of the partnership's debt incurred to buy the office building (one-third of $15 million).

Example 3. A labor union advanced funds, from existing resources and without any borrowing, to its tax-exempt subsidiary title-holding company. The subsidiary used the funds to pay a debt owed to a third party that was previously incurred in acquiring two income-producing office buildings. Neither the union nor the subsidiary has incurred any further debt in acquiring or improving the property. The union has no outstanding debt on the property. The subsidiary's debt to the union is represented by a demand note on which the subsidiary makes payments whenever it has the available cash. The books of the union and the subsidiary list the outstanding debt as inter-organizational indebtedness.

Although the subsidiary's books show a debt to the union, it is not the type subject to the debt-financed property rules. In this situation, the very nature of the title-holding company and the parent-subsidiary relationship shows this debt to be merely a matter of accounting between the two organizations. Accordingly, the debt is not acquisition indebtedness.

Change in use of property. If an organization converts property that is not debt-financed property to a use that results in its treatment as debt-financed property, the outstanding principal debt on the property is thereafter treated as acquisition indebtedness.

Example. Four years ago a university borrowed funds to acquire an apartment building as housing for married students. Last year, the university rented the apartment building to the public for nonexempt purposes. The outstanding principal debt becomes acquisition indebtedness as of the time the building was first rented to the public.

Continued debt. If an organization sells property and, without paying off debt that would be acquisition indebtedness if the property were debt-financed property, buys property that is otherwise debt-financed property, the unpaid debt is acquisition indebtedness for the new property. This is true even if the original property was not debt-financed property.

Example. To house its administration offices, an exempt organization bought a building using $600,000 of its own funds and $400,000 of borrowed funds secured by a pledge of its securities. The office building was not debt-financed property. The organization later sold the building for $1 million without repaying the $400,000 loan. It used the sale proceeds to buy an apartment building it rents to the general public. The unpaid debt of $400,000 is acquisition indebtedness with respect to the apartment building.

Property acquired subject to mortgage or lien. If property (other than certain gifts, bequests, and devises) is acquired subject to a mortgage, the outstanding principal debt secured by that mortgage is treated as acquisition indebtedness even if the organization did not assume or agree to pay the debt.

Example. An exempt organization paid $50,000 for real property valued at $150,000 and subject to a $100,000 mortgage. The $100,000 of outstanding principal debt is acquisition indebtedness, as though the organization had borrowed $100,000 to buy the property.

Liens similar to a mortgage. In determining acquisition indebtedness, a lien similar to a mortgage is treated as a mortgage. A lien is similar to a mortgage if title to property is encumbered by the lien for a creditor's benefit. However, when state law provides that a lien for taxes or assessments attaches to property before the taxes or assessments become due and payable, the lien is not treated as a mortgage until after the taxes or assessments have become due and payable and the organization has had an opportunity to eliminate the lien by paying the amount it secured in accordance with state law. Liens similar to mortgages include (but are not limited to):

1. Deeds of trust,
2. Conditional sales contracts,
3. Chattel mortgages,
4. Security interests under the Uniform Commercial Code,
5. Pledges,
6. Agreements to hold title in escrow, and
7. Liens for taxes or assessments (other than those discussed earlier in this paragraph).

Exception for property acquired by gift, bequest, or devise. If property subject to a mortgage is acquired by gift, bequest, or devise, the outstanding principal debt secured by the mortgage is not treated as acquisition indebtedness during the 10-year period following the date the organization receives the property. However, this applies to a gift of property only if:

1. The mortgage was placed on the property more than 5 years before the date the organization received it, and
2. The donor held the property for more than 5 years before the date the organization received it.

This exception does not apply if an organization assumes and agrees to pay all or part of the debt secured by the mortgage or makes any payment for the equity in the property owned by the donor or decedent (other than a payment under an annuity obligation excluded from the definition of acquisition indebtedness, discussed under *Debt That Is Not Acquisition Indebtedness*, later).

Whether an organization has assumed and agreed to pay all or part of a debt in order to acquire the property is determined by the facts and circumstances of each situation.

Modifying existing debt. Extending, renewing, or refinancing an existing debt is considered a continuation of that debt to the extent its outstanding principal does not increase. When the principal of the modified debt is more than the outstanding principal of the old debt, the excess is treated as a separate debt.

Extension or renewal. In general, any modification or substitution of the terms of a debt by an organization is considered an extension or renewal of the original debt, rather than the start of a new one, to the extent that the outstanding principal of the debt does not increase.

The following are examples of acts resulting in the extension or renewal of a debt:

1. Substituting liens to secure the debt,
2. Substituting obligees whether or not with the organization's consent,
3. Renewing, extending, or accelerating the payment terms of the debt, and
4. Adding, deleting, or substituting sureties or other primary or secondary obligors.

Debt increase. If the outstanding principal of a modified debt is more than that of the unmodified debt, and only part of the refinanced debt is acquisition indebtedness, the payments on the refinanced debt must be allocated between the old debt and the excess.

Example. An organization has an outstanding principal debt of $500,000 that is treated as acquisition indebtedness. The organization borrows another $100,000, which is not acquisition indebtedness, from the same lender, resulting in a $600,000 note for the total obligation. A payment of $60,000 on the total obligation would reduce the acquisition indebtedness by $50,000 ($60,000 x $500,000/$600,000) and the excess debt by $10,000.

Debt That Is Not Acquisition Indebtedness

Certain debt and obligations are not acquisition indebtedness. These include the following.

- Debts incurred in performing an exempt purpose.
- Annuity obligations.
- Securities loans.
- Real property debts of qualified organizations.
- Certain Federal financing.

Debt incurred in performing exempt purpose. A debt incurred in performing an exempt purpose is not acquisition indebtedness. For example, acquisition indebtedness does not include the debt an exempt credit union incurs in accepting deposits from its members or the debt an exempt organization incurs in accepting payments from its members to provide them with insurance, retirement, or other benefits.

Annuity obligation. The organization's obligation to pay an annuity is not acquisition indebtedness if the annuity meets all the following requirements.

1. It must be the sole consideration (other than a mortgage on property acquired by gift, bequest, or devise that meets the exception discussed under *Property*

acquired subject to mortgage or lien, earlier in this chapter) issued in exchange for the property received.

2. Its present value, at the time of exchange, must be less than 90% of the value of the prior owner's equity in the property received.
3. It must be payable over the lives of either one or two individuals living when issued.
4. It must be payable under a contract that:
   a. Does not guarantee a minimum nor specify a maximum number of payments, and
   b. Does not provide for any adjustment of the amount of the annuity payments based on the income received from the transferred property or any other property.

Example. X, an exempt organization, receives property valued at $100,000 from donor A, a male age 60. In return X promises to pay A $6,000 a year for the rest of A's life, with neither a minimum nor maximum number of payments specified. The amounts paid under the annuity are not dependent on the income derived from the property transferred to X. The present value of this annuity is $81,156, determined from IRS valuation tables. Since the value of the annuity is less than 90 percent of A's $100,000 equity in the property transferred and the annuity meets all the other requirements just discussed, the obligation to make annuity payments is not acquisition indebtedness.

Securities loans. Acquisition indebtedness does not include an obligation of the exempt organization to return collateral security provided by the borrower of the exempt organization's securities under a securities loan agreement (discussed under *Exclusions* earlier in this chapter). This transaction is not treated as the borrowing by the exempt organization of the collateral furnished by the borrower (usually a broker) of the securities.

However, if the exempt organization incurred debt to buy the loaned securities, any income from the securities (including income from lending the securities) would be debt-financed income. For this purpose, any payments because of the securities are considered to be from the securities loaned and not from collateral security or the investment of collateral security from the loans. Any deductions that are directly connected with collateral security for the loan, or with the investment of collateral security, are considered deductions that are directly connected with the securities loaned.

Short sales. Acquisition indebtedness does not include the "borrowing" of stock from a broker to sell the stock short. Although a short sale creates an obligation, it does not create debt.

Real property debts of qualified organizations. In general, acquisition indebtedness does not include debt incurred by a qualified organization in acquiring or improving any real property. A qualified organization is:

1. A qualified retirement plan under section 401(a),
2. An educational organization described in section 170(b)(1)(A)(ii) and certain of its affiliated support organizations,
3. A title-holding company described in section 501(c)(25), or
4. A retirement income account described in section 403(b)(9) in acquiring or improving real property in tax years beginning on or after August 17, 2006.

This exception from acquisition indebtedness does not apply in the following six situations.

1. The acquisition price is not a fixed amount determined as of the date of the acquisition or the completion of the improvement. However, the terms of a sales contract may provide for price adjustments due to customary closing adjustments such as prorating property taxes. The contract also may provide for a price adjustment if it is for a fixed amount dependent upon subsequent resolution of limited, external contingencies such as zoning approvals, title clearances, and the removal of easements. These conditions in the contract will not cause the price to be treated as an undetermined amount. However, see *Note 1* at the end of this list.
2. Any debt or other amount payable for the debt, or the time for making any payment, depends, in whole or in part, upon any revenue, income, or profits derived from the real property. However, see *Note 1* at the end of this list.
3. The real property is leased back to the seller of the property or to a person related to the seller as described in section 267(b) or section 707(b). However, see *Note 2* at the end of this list.
4. The real property is acquired by a qualified retirement plan from, or after its acquisition is leased by a qualified retirement plan to, a related person. However, see *Note 2* at the end of this list. For this purpose, a related person is:
   a. An employer who has employees covered by the plan,
   b. An owner with at least a 50% interest in an employer described in (a),
   c. A member of the family of any individual described in (a) or (b),
   d. A corporation, partnership, trust, or estate in which a person described in (a), (b), or (c) has at least a 50% interest, or
   e. An officer, director, 10% or more shareholder, or highly compensated employee of a person described in (a), (b), or (d).
5. The seller, a person related to the seller (under section 267(b) or section 707(b)), or a person related to a qualified retirement plan (as described in (4)) provides financing for the transaction on other than commercially reasonable terms.
6. The real property is held by a partnership in which an exempt organization is a partner (along with taxable entities), and the principal purpose of any allocation to an exempt organization is to avoid tax. This generally applies to property placed in service after 1986. For more information, see section 514(c)(9)(B)(vi) and section 514(c)(9)(E).

Note 1. Qualifying sales by financial institutions of foreclosure property or certain conservatorship or receivership property are not included in (1) or (2) and, therefore, do not give rise to acquisition indebtedness. For more information, see section 514(c)(9)(H).

Note 2. For purposes of (3) and (4), small leases are disregarded. A small lease is one that covers no more than 25% of the leasable floor space in the property and has commercially reasonable terms.

Certain federal financing. Acquisition indebtedness does not include an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low or moderate income people.

In addition, acquisition indebtedness does not include indebtedness incurred by a small business investment company licensed under the Small Business Investment Act of 1958 after October 22, 2004, if such indebtedness is evidenced by a debenture issued by such company and held or guaranteed by the Small Business Administration. However, this provision does not apply to any small business investment company during any period that any organization which is exempt from tax (other than a governmental unit) owns more than 25% of the capital or profits interest in such company, or organizations which are exempt from tax (including governmental agencies other than any agency or instrumentality of the United States) own, in the aggregate, 50% or more of the capital or profits interest in such company.

Exceptions to Debt-Financed Property

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

Property related to exempt purposes. If substantially all (85% or more) of the use of any property is substantially related to an 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 its use of the profits. The extent to which property is used for a particular purpose is determined on the basis of all the facts. They may include:

1. A comparison of the time the property is used for exempt purposes with the total time the property is used,
2. A comparison of the part of the property that is used for exempt purposes with the part used for all purposes, or
3. Both of these comparisons.

If less than 85% of the use of any property is devoted to an organization's exempt purposes, only that part of the property used to further the organization's exempt purposes is not treated as debt-financed property.

Property used in an unrelated trade or business. To the extent that the gross income from any property is treated as income from the conduct of an unrelated trade or business, the property is not treated as debt-financed property. However, any gain on the disposition of the property not included in income from an unrelated trade or business is includible as gross income derived from, or on account of, debt-financed property.

The rules for debt-financed property do not apply to rents from personal property, certain passive income from controlled organizations, and other amounts that are required by other rules to be included in computing unrelated business taxable income.

Property used in research activities. Property is not treated as debt-financed property when it produces gross income derived from research activities otherwise excluded from the unrelated trade or business tax. See *Income from research* under *Exclusions,* earlier in this chapter.

Property used in certain excluded activities. 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:

1. It has a volunteer workforce,
2. It is conducted for the convenience of its members, or
3. It consists of selling donated merchandise.

See *Excluded Trade or Business Activities* in chapter 3.

Related exempt uses. Property owned by an exempt organization and used by a related exempt organization, or by an exempt organization related to that related exempt organization, is not treated as debt-financed property when the property is used by either organization to further its exempt purpose. Furthermore, property is not treated as debt-financed property when a related exempt organization uses it for research activities or certain excluded activities, as described above.

Related organizations. An exempt organization is related to another exempt organization only if:

1. One organization is an exempt holding company and the other receives profits derived by the exempt holding company,
2. One organization controls the other as discussed under *Income From Controlled Organizations* earlier in this chapter,
3. More than 50% of the members of one organization are members of the other, or
4. Each organization is a local organization directly affiliated with a common state, national, or international organization that also is exempt.

Medical clinics. Real property is not debt-financed property if it is leased to a medical clinic and the lease is entered into primarily for purposes related to the lessor's exercise or performance of its exempt purpose.

Example. An exempt hospital leases all of its clinic space to an unincorporated association of physicians and surgeons. They, under the lease, agree to provide all of the hospital's outpatient medical and surgical services and to train all of the hospital's residents and interns. In this case the rents received are not unrelated debt-financed income.

Life income contract. If an individual transfers property to a trust or a fund with the income payable to that individual or other individuals for a period not to exceed the life of the individual or individuals, and with the remainder payable to an exempt charitable organization, the property is not treated as debt-financed property. This exception applies only where the payments to the individual are not the proceeds of a sale or exchange of the property transferred.

Neighborhood land rule. If an organization acquires real property with the intention of using the land for exempt purposes within 10 years, it will not be treated as debt-financed property if it is in the neighborhood of other property that the organization uses for exempt purposes. This rule applies only if the intent to demolish any existing structures and use the land for exempt purposes within 10 years is not abandoned.

Property is considered in the neighborhood of property that an organization owns and uses for its exempt purposes if it is contiguous with the exempt purpose property or would be contiguous except for an intervening road, street, railroad, stream, or similar property. If it is not contiguous with the exempt purpose property, it still may be in the same neighborhood if it is within 1 mile of the exempt purpose property and if the facts and circumstances make it unreasonable to acquire the contiguous property.

Some issues to consider in determining whether acquiring contiguous property is unreasonable include the availability of land and the intended future use of the land.

Example. A university tries to buy land contiguous to its present campus, but cannot do so because the owners either refuse to sell or ask unreasonable prices. The nearest land of sufficient size and utility is a block away from the campus. The university buys this land. Under these circumstances, the contiguity requirement is unreasonable and not applicable. The land bought would be considered neighborhood land.

Exceptions. For all organizations other than churches and conventions or associations of churches, discussed later under *Churches,* the neighborhood land rule does not apply to property after the 10 years following its acquisition. Further, the rule applies after the first 5 years only if the organization satisfies the IRS that use of the land for exempt purposes is reasonably certain before the 10-year period expires. The organization need not show binding contracts to satisfy this requirement; but it must have a definite plan detailing a specific improvement and a completion date, and it must show some affirmative action toward the fulfillment of the plan. This information should be forwarded to the IRS for a ruling at least 90 days before the end of the 5th year after acquisition of the land. Send information to:

Internal Revenue Service
Commissioner, TE/GE
Attention: T:EO:RA
P.O. Box 120, Ben Franklin Station
Washington, DC 20044

The IRS may grant a reasonable extension of time for requesting the ruling if the organization can show good cause. For more information, contact the IRS.

For any updates to the address go to IRS.gov/pub598.

Actual use. If the neighborhood land rule does not apply because the acquired land is not in the neighborhood of other land used for an organization's exempt purposes, or because the organization fails to establish after the first 5 years of the 10-year period that the property will be used for exempt purposes, but the land is used eventually by the organization for its exempt purposes within the 10-year period, the property is not treated as debt-financed property for any period before the conversion.

Limits. The neighborhood land rule or actual use rule applies to any structure on the land when acquired, or to the land occupied by the structure, only so long as the intended future use of the land in furtherance of the organization's exempt purpose requires that the structure be demolished or removed in order to use the land in this manner. Thus, during the first 5 years after acquisition (and for later years if there is a favorable ruling), improved property is not debt financed so long as the organization does not abandon its intent to demolish the existing structures and use the land in furtherance of its exempt purpose. If an actual demolition of these structures occurs, the use made of the land need not be the one originally intended as long as its use furthers the organization's exempt purpose.

In addition to this limit, the neighborhood land rule and the actual use rule do not apply to structures erected on land after its acquisition. They do not apply to property subject to a business lease (as defined in section 1.514(f)-1 of the regulations) whether an organization acquired the property subject to the lease, or whether it executed the lease after acquisition. A business lease is any lease, with certain exceptions, of real property for a term of more than 5 years by an exempt organization if at the close of the lessor's tax year there is a business lease (acquisition) indebtedness on that property.

Refund of taxes. When the neighborhood land rule does not initially apply, but the land is used eventually for exempt purposes, a refund or credit of any overpaid taxes will be allowed for a prior tax year as a result of the satisfaction of the actual use rule. A claim must be filed within 1 year after the close of the tax year in which the actual use rule is satisfied. Interest

rates on any overpayment are governed by the regulations.

Example. In January 2004, Y, a calendar year exempt organization, acquired real property contiguous to other property that Y uses in furtherance of its exempt purpose. Assume that without the neighborhood land rule, the property would be debt-financed property. Y did not satisfy the IRS by January 2009 that the existing structure would be demolished and the land would be used in furtherance of its exempt purpose. From 2009 until the property is converted to an exempt use, the income from the property is subject to the tax on unrelated business income. During July 2013, Y will demolish the existing structure on the land and begin using the land in furtherance of its exempt purpose. At that time, Y can file claims for refund for the open years 2010 through 2012.

Further, Y also can file a claim for refund for 2009, even though a claim for that tax year may be barred by the statute of limitations, provided the claim is filed before the close of 2014.

Churches. The neighborhood land rule as described here also applies to churches, or a convention or association of churches, but with two differences:

1. The period during which the organization must demonstrate the intent to use acquired property for exempt purposes is increased from 10 to 15 years, and
2. Acquired property does not have to be in the neighborhood of other property used by the organization for exempt purposes.

Thus, if a church or association or convention of churches acquires real property for the primary purpose of using the land in the exercise or performance of its exempt purpose, within 15 years after the time of acquisition, the property is not treated as debt-financed property as long as the organization does not abandon its intent to use the land in this manner within the 15-year period.

This exception for a church or association or convention of churches does not apply to any property after the 15-year period expires. Further, this rule will apply after the first 5 years of the 15-year period only if the church or association or convention of churches establishes to the satisfaction of the IRS that use of the acquired land in furtherance of the organization's exempt purpose is reasonably certain before the 15-year period expires.

If a church or association or convention of churches cannot establish after the first 5 years of the 15-year period that use of acquired land for its exempt purpose is reasonably certain within the 15-year period, but the land is in fact converted to an exempt use within the 15-year period, the land is not treated as debt-financed property for any period before the conversion.

The same rule for demolition or removal of structures as discussed earlier in this chapter under *Limits* applies to a church or an association or a convention of churches.

Computation of Debt-Financed Income

For each debt-financed property, the unrelated debt-financed income is a percentage (not over 100%) of the total gross income derived during a tax year from the property. This percentage is the same percentage as the average acquisition indebtedness with respect to the property for the tax year of the property's average adjusted basis for the year (the debt/basis percentage). Thus, the formula for deriving unrelated debt-financed income is:

$$\frac{\text{average acquisition indebtedness}}{\text{average adjusted basis}} \times \text{gross income from debt-financed property}$$

Example. X, an exempt trade association, owns an office building that is debt-financed property. The building produced $10,000 of gross rental income last year. The average adjusted basis of the building during that year was $100,000, and the average acquisition indebtedness with respect to the building was $50,000. Accordingly, the debt/basis percentage was 50% (the ratio of $50,000 to $100,000). Therefore, the unrelated debt-financed income with respect to the building was $5,000 (50% of $10,000).

Gain or loss from sale or other disposition of property. If an organization sells or otherwise disposes of debt-financed property, it must include, in computing unrelated business taxable income, a percentage (not over 100%) of any gain or loss. The percentage is that of the highest acquisition indebtedness with respect to the property during the 12-month period preceding the date of disposition, in relation to the property's average adjusted basis.

The tax on this percentage of gain or loss is determined according to the usual rules for capital gains and losses. These amounts may be subject to the alternative minimum tax. (See *Alternative minimum tax* at the beginning of chapter 2.)

Debt-financed property exchanged for subsidiary's stock. A transfer of debt-financed property by a tax-exempt organization to its wholly owned taxable subsidiary, in exchange for additional stock in the subsidiary, is not considered a gain subject to the tax on unrelated business income.

Example. A tax-exempt hospital wants to build a new hospital complex to replace its present old and obsolete facility. The most desirable location for the new hospital complex is a site occupied by an apartment complex. Several years ago the hospital bought the land and apartment complex, taking title subject to a first mortgage already on the premises.

For valid business reasons, the hospital proposed to exchange the land and apartment complex, subject to the mortgage on the property, for additional stock in its wholly owned subsidiary. The exchange satisfied all the requirements of section 351(a).

The transfer of appreciated debt-financed property from the tax-exempt hospital to its wholly owned subsidiary in exchange for stock did not result in a gain subject to the tax on unrelated business income.

Gain or loss on disposition of certain brownfield property. Gain or loss from the qualifying sale, exchange, or other disposition of a qualifying brownfield property (as defined in section 512(b)(19)(C)), which was acquired by the organization after December 31, 2004, is excluded from unrelated business taxable income and is excepted from the debt-financed rules for such property. See sections 512(b)(19) and 514(b)(1)(E).

Average acquisition indebtedness. This is the average amount of outstanding principal debt during the part of the tax year that the organization holds the property.

Average acquisition indebtedness is computed by determining how much principal debt is outstanding on the first day in each calendar month during the tax year that the organization holds the property, adding these amounts, and dividing the sum by the number of months during the year that the organization held the property. Part of a month is treated as a full month in computing average acquisition indebtedness.

Indeterminate price. If an organization acquires or improves property for an indeterminate price (that is, neither the price nor the debt is certain), the unadjusted basis and the initial acquisition indebtedness are determined as follows, unless the organization obtains the IRS's consent to use another method. The unadjusted basis is the fair market value of the property or improvement on the date of acquisition or completion of the improvement. The initial acquisition indebtedness is the fair market value of the property or improvement on the date of acquisition or completion of the improvement, less any down payment or other initial payment applied to the principal debt.

Average adjusted basis. The average adjusted basis of debt-financed property is the average of the adjusted basis of the property as of the first day and as of the last day that the organization holds the property during the tax year.

Determining the average adjusted basis of the debt-financed property is not affected if the organization was exempt from tax for prior tax years. The basis of the property must be adjusted properly for the entire period after the property was acquired. As an example, adjustment must be made for depreciation during all prior tax years whether or not the organization was tax-exempt. If only part of the depreciation allowance may be taken into account in computing the percentage of deductions allowable for each debt-financed property, that does not affect the amount of the depreciation adjustment to use in determining average adjusted basis.

Basis for debt-financed property acquired in corporate liquidation. If an exempt organization acquires debt-financed property in a complete or partial liquidation of a corporation in exchange for its stock, the organization's basis in the property is the same as it would be in the hands of the transferor corporation. This basis is increased by the gain recognized to the transferor corporation upon the distribution and

by the amount of any gain that, because of the distribution, is includible in the organization's gross income as unrelated debt-financed income.

Computation of debt/basis percentage. The following example shows how to compute the debt/basis percentage by first determining the average acquisition indebtedness and average adjusted basis.

Example. On July 7, an exempt organization buys an office building for $510,000 using $300,000 of borrowed funds. The organization files its return on a calendar year basis. During the year the only adjustment to basis is $20,000 for depreciation. Starting July 28, the organization pays $20,000 each month on the mortgage principal plus interest. The debt/basis percentage for the year is calculated as follows:

Month	Debt on first day of each month property is held
July	$ 300,000
August	280,000
September	260,000
October	240,000
November	220,000
December	200,000
Total	$1,500,000
Average acquisition indebtedness: $1,500,000 ÷ 6 months	$ 250,000
	Basis
As of July 7	$ 510,000
As of December 31	490,000
Total	$1,000,000
Average adjusted basis: $1,000,000 ÷ 2	$ 500,000
Debt/basis percentage	
$250,000 ÷ $500,000	= 50%

Deductions for Debt-Financed Property

The deductions allowed for each debt-financed property are determined by applying the debt/basis percentage to the sum of allowable deductions.

The allowable deductions are those directly connected with the debt-financed property or with the income from it (including the dividends-received deduction), except that:

1. The allowable deductions are subject to the modifications for computation of the unrelated business taxable income (discussed earlier in this chapter), and
2. The depreciation deduction, if allowable, is computed only by use of the straight-line method.

To be directly connected with debt-financed property or with the income from it, a deductible item must have proximate and primary relationship to the property or income. Expenses, depreciation, and similar items attributable solely to the property qualify for deduction, to the extent they meet the requirements of an allowable deduction.

For example, if the straight-line depreciation allowance for an office building is $10,000 a year, an organization can deduct depreciation of $10,000 if the entire building is debt-financed property. However, if only half of the building is debt-financed property, the depreciation allowed as a deduction is $5,000.

Capital losses. If a sale or exchange of debt-financed property results in a capital loss, the loss taken into account in the tax year in which the loss arises is computed as provided earlier. See *Gain or loss from sale or other disposition of property* under *Computation of Debt-Financed Income,* earlier.

If any part of the allowable capital loss is not taken into account in the current tax year, it may be carried back or carried over to another tax year without application of the debt/basis percentage for that year.

Example. X, an exempt educational organization, owned debt-financed securities that were capital assets. Last year, X sold the securities at a loss of $20,000. The debt/basis percentage for computing the loss from the sale of the securities is 40%. Thus, X sustained a capital loss of $8,000 (40% of $20,000) on the sale of the securities. Last year and the preceding 3 tax years, X had no other capital transactions. Under these circumstances, the $8,000 of capital loss may be carried over to succeeding years without further application of the debt/basis percentage.

Net operating loss. If, after applying the debt/basis percentage to the income from debt-financed property and the deductions directly connected with this income, the deductions exceed the income, an organization has an NOL for the tax year. This amount may be carried back or carried over to other tax years in the same manner as any other NOL of an organization with unrelated business taxable income. (For a discussion of the NOL deduction, see *Modifications* under *Deductions* earlier in this chapter.) However, the debt/basis percentage is not applied in those other tax years to determine the deductions that may be taken in those years.

Example. Last year, Y, an exempt organization, received $20,000 of rent from a debt-financed building that it owns. Y had no other unrelated business taxable income for the year. The deductions directly connected with this building were property taxes of $5,000, interest of $5,000 on the acquisition indebtedness, and salary of $15,000 to the building manager. The debt/basis percentage with respect to the building was 50%. Under these circumstances, Y must take into account, in computing its unrelated business taxable income, $10,000 (50% of $20,000) of income and $12,500 (50% of $25,000) of the deductions directly connected with that income.

Thus, Y sustained an NOL of $2,500 ($10,000 of income less $12,500 of deductions), which may be carried back or carried over to other tax years without further application of the debt/basis percentage.

Allocation Rules

When only part of the property is debt-financed property, proper allocation of the basis, debt, income, and deductions with respect to the property must be made to determine how much income or gain derived from the property to treat as unrelated debt-financed income.

Example. X, an exempt college, owns a four-story office building that it bought with borrowed funds (assumed to be acquisition indebtedness). During the year, the lower two stories of the building were used to house computers that X uses for administrative purposes. The two upper stories were rented to the public and used for nonexempt purposes.

The gross income X derived from the building was $6,000, all of which was attributable to the rents paid by tenants. The expenses were $2,000 and were equally allocable to each use of the building. The average adjusted basis of the building for the year was $100,000 and the average acquisition indebtedness for the year was $60,000.

Since the two lower stories were used for exempt purposes, only the upper half of the building is debt-financed property. Consequently, only the rental income and the deductions directly connected with this income are taken into account in computing unrelated business taxable income. The part taken into account is determined by multiplying the $6,000 of rental income and $1,000 of deductions directly connected with the rental income by the debt/basis percentage.

The debt/basis percentage is the ratio of the allocable part of the average acquisition indebtedness to the allocable part of the property's average adjusted basis: that is, in this case, the ratio of $30,000 (one-half of $60,000) to $50,000 (one-half of $100,000). Thus, the debt/basis percentage for the year is 60% (the ratio of $30,000 to $50,000).

Under these circumstances, X must include net rental income of $3,000 in its unrelated business taxable income for the year, computed as follows:

Rental income treated as gross income from an unrelated trade or business (60% of $6,000)	$3,600
Less the allowable portion of deductions directly connected with that income (60% of $1,000)	600
Net rental income included by X in computing its unrelated business taxable income from debt-financed property.	$3,000

How to Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. The Taxpayer Advocate Service (TAS) is an independent organization within the IRS. TAS helps taxpayers who are experiencing economic harm, such as not being able to provide necessities like housing, transportation, or food; taxpayers who are seeking help in resolving tax problems with the IRS; and those who believe that an IRS system or procedure is not working as it should. Here are seven things every taxpayer should know about TAS:

- The Taxpayer Advocate Service is your voice at the IRS.
- TAS services are free, confidential, and tailored to meet your needs.
- You may be eligible for help from TAS if you have tried to resolve your tax problem through normal IRS channels and have gotten nowhere, or you believe an IRS procedure just isn't working as it should.
- TAS helps taxpayers whose problems are causing financial difficulty or significant cost, including the cost of professional representation. This includes businesses as well as individuals.
- TAS employees know the IRS and how to navigate it. If you qualify for help, TAS will assign your case to an advocate who will listen to your problem, help you understand what needs to be done to resolve it, and stay with you every step of the way until your problem is resolved.
- TAS has at least one local taxpayer advocate in every state, the District of Columbia, and Puerto Rico. You can call your local advocate, whose number is in your phone book, in Pub. 1546, Taxpayer Advocate Service—Your Voice at the IRS, and on our website at *www.irs.gov/Advocate*. You can also call our toll-free line at 1-877-777-4778 or TTY/TDD 1-800-829-4059.
- You can learn about your rights and responsibilities as a taxpayer by visiting our Taxpayer Bill of Rights web page at *www.irs.gov/Taxpayer-Bill-of-Rights*. You can get updates on hot tax topics by visiting our YouTube channel at *www.youtube.com/tasnta* and our Facebook page at *www.facebook.com/YourVoiceAtIRS*, or by following our tweets at *www.twitter.com/YourVoiceAtIRS*.

Internet.
You can access the IRS website at IRS.gov 24 hours a day, 7 days a week to:

- Download forms, including talking tax forms, instructions and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- Use the online Internal Revenue Code, Regulations, or other official guidance.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Sign up to receive local and national tax news by email.

Phone.
Many services are available by phone.

- Ordering forms, instructions, and publications. Call 1-800-TAX-FORM (1-800-829-3676) to order current-year forms, instructions, and publications, and prior-year forms and instructions. You should receive your order within 10 days.
- TTY/TDD equipment. If you have access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.

Mail.
You can send your order for forms, instructions, and publications to the address below. You should receive a response within 10 days after your request is received.

Internal Revenue Service
1201 N. Mitsubishi Motorway
Bloomington, IL 61705-6613

DVD for tax products.
You can order Publication 1796, IRS Tax Products DVD, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.
- Tax Map: An electronic research tool and finding aid.
- Tax law frequently asked questions.
- Tax Topics from the IRS telephone response system.
- Internal Revenue Code—Title 26 of the U.S. Code.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.
- Two releases during the year.

-The first release will ship the beginning of January 2015.
-The final release will ship the beginning of March 2015.

The IRS can provide copies of exempt organization returns on DVD. Requesters can order the complete set (for example, all Forms 990 and 990-EZ or all Forms 990-PF filed for a year) or a partial set by state or by month. If you are ordering a partial set on DVD, indicate the format (Alchemy or raw), state(s), and month(s) you are ordering. Sample DVD requests are not available for individual states. DVDs and sample DVDs are not available for individual exempt organizations. Complete information, including the cost, is available on the IRS website. Search "Copies of Scanned EO Returns Available" at *www.irs.gov/Charities* and search "DVD", or go to *www.irs.gov*.

Index

To help us develop a more useful index, please let us know if you have ideas for index entries. See "Comments and Suggestions" in the "Introduction" for the ways you can reach us.

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July 29, 2010

TAX INFORMATION RELEASE NO. 2010-05

Re: Act 155, Session Laws of Hawaii 2010, Relating to General Excise Tax; The General Excise Tax Protection Act

On June 1, 2010, Governor Linda Lingle signed into law House Bill 2595 HD 1 SD 2 CD 1, which became law as Act 155, Session Laws of Hawaii 2010 (also referred to as the "GET Protection Act").

Act 155 amends Chapter 237, Hawaii Revised Statutes (HRS), by adding two new sections. The first new section statutorily denies certain general excise tax benefits to taxpayers that fail to comply with administrative procedures. The second new section creates trust fund liability, or personal liability, for certain amounts where a responsible person willfully fails to pay over those amounts to the government.

The purpose of this Tax Information Release is to provide guidance on the Department's interpretation of Act 155, in addition to providing examples and safe harbors for certain of its provisions.

DENIAL OF GENERAL EXCISE TAX BENEFITS

Section 2 of Act 155 creates a new obligation for all persons doing business in Hawaii with gross income or gross receipts as defined by HRS § 237-3, to comply with two administrative requirements. Failure to comply with the administrative requirements will result in the taxpayer's loss of any benefit available under the general excise tax law, including exemption from the law.

A. Administrative Requirements

In order to maintain entitlement to any general excise tax benefit, the person claiming the benefit must:

1) File for and obtain a general excise tax license, available on Form BB-1, *State of Hawaii Basic Business Application*; and
2) File an annual general excise tax reconciliation tax return on Form G-49, *Annual Return & Reconciliation of General Excise/Use Tax Return*, within 12 months from the due date for the return.

Taxpayers with gross income or gross receipts who are engaging in business within the meaning of Chapter 237, HRS, were always required to comply with both of these requirements. *See* HRS §§ 237-9, 237-33.

The GET Protection Act simply requires taxpayers to obtain a general excise tax license and file the annual reconciliation return. Failure to claim the general excise tax benefit on the annual return will not automatically preclude the taxpayer from claiming the general excise tax benefit on an amended return filed within the statute of limitations for assessment or refund, or from receiving the general excise tax benefit by adjustment upon audit.

B. General Excise Tax Benefits

A general excise tax benefit that could be jeopardized for failure to comply with the statutory administrative requirements of the GET Protection Act includes any of the following:

1) Exemption amount, including exemption from application of Chapter 237;
2) Exempt taxpayer or entity, including exemption from application of Chapter 237;
3) Any exclusion, including the exclusion for exporting tangible personal property, contracting, or services;
4) Reduction from the measure of general excise tax;
5) Deduction, including the subcontractor's deduction;
6) Tax credit, including an offsetting credit for taxes paid to another state;
7) Lower rate of tax, including the 0.15% rate for insurance producers or the 0.5% rate for certain manufacturing or wholesaling; or
8) Segregation or splitting of a gross income or gross receipts, including commission splitting or segregation involving agency relationships, reimbursements, or tourism activities.

Please note that the foregoing list is not exhaustive.

C. Reasonable Cause; Safe Harbor Protection

The GET Protection Act authorizes the Director of Taxation to waive the denial of general excise tax benefits in certain situations where the failure to obtain a general excise tax license or file an annual reconciliation return is due to reasonable cause and not willful neglect.

The following circumstances are deemed to have reasonable cause within the meaning of Act 155 and the Department will not utilize Act 155 to deny a general excise tax benefit in the following situations:

1) The provisions of the United States Constitution or laws of the United States prohibit the Department from imposing the tax;

2) The person is not "engaging" in "business" within the meaning of HRS § 237-2;

3) The amounts involved are not "gross income" or "gross proceeds of sale" as defined in HRS § 237-3(b);

4) The person is a Public Service Company and the gross income or gross proceeds are included in the measure of the tax imposed by Chapter 239, HRS;

5) Amounts received by persons exempt under HRS § 237-23(a)(3) through (6); provided that such person is exempt from filing federal Form 990, *Return of Organization Exempt from Income Tax*, or Form 990-EZ, *Short Form—Return of Organization Exempt from Income Tax*;

6) Amounts received that are exempt under HRS §§ 237-24(1) through (7) (with respect to certain insurance proceeds, gifts, bequests, compensatory tort damages, salaries or wages, and alimony);

7) Amounts received that are exempt under HRS § 237-24.8(a) (with respect to certain amounts not taxable for financial institutions);

8) Amounts received that are exempt under HRS § 237-29.7 (with respect to certain amounts not taxable for insurance companies);

9) Credit unions chartered under Chapter 412, HRS, and exempt from tax as provided in HRS § 412:10-122;

10) Any other amounts, persons, or transactions as determined by the Director to be made by subsequent Announcement or Tax Information Release.

The safe harbors set forth above are illustrated by the following examples:

EXAMPLE 1—ABC Corp. is headquartered and conducts primarily all of its business outside Hawaii. ABC Corp.'s business activity is the wholesaling of tangible personal property for resale at retail. ABC Corp. sells a small amount of tangible personal property in Hawaii and takes the position that it has no nexus with Hawaii. ABC Corp. therefore has not obtained a general excise tax license nor filed any general excise tax annual returns. The Department opens an audit of ABC Corp.'s nexus to determine whether ABC Corp. should have been filing Hawaii general excise tax returns. The Department determines that, because ABC Corp. was found to have a sales agent in Hawaii, ABC Corp. is responsible for the Hawaii general excise tax and should have obtained a general excise tax license and further should have filed general excise tax returns. ABC Corp. appeals the Department's assessment, exhausting its appeals. Ultimately, it is determined that ABC Corp. has nexus with Hawaii for general excise tax purposes. Under Act 155, ABC Corp. will lose its general excise tax benefit of the lower 0.5% wholesale rate because it failed to obtain a general excise tax license and file a general excise tax annual return. ABC Corp. is not entitled to the safe harbor protection because Hawaii was not without the authority to assert the general excise tax against ABC Corp. based upon the United States Constitution's Commerce Clause. *See Safe Harbor 1, above. [ABC Corp. would have maintained its general excise tax benefit (i.e., the lower 0.5% general excise tax rate for wholesaling, assuming ABC Corp. does in fact qualify for the lower 0.5% rate) if, prior to being audited, ABC Corp. would have obtained a general excise tax license and filed an annual general*

excise tax return claiming it had no nexus with Hawaii, even if the position was ultimately found to be in error.]

EXAMPLE 2—Assume the same facts as in Example 1, except that ABC Corp. is successful upon final appeal and is found not to have nexus with Hawaii and that Hawaii is without the power to tax ABC Corp. under the Commerce Clause. ABC Corp. falls within the safe harbor protection because Hawaii is without the power under the US Constitution to tax ABC Corp. *See Safe Harbor 1, above.*

EXAMPLE 3—Larry Landowner sold land that he owned in fee simple. Amounts received from the sale of land in fee simple are not considered "gross income" under the general excise tax. Larry Landowner will not lose his exemption from the sale of land in fee simple if he does not obtain a general excise tax license or file an annual general excise tax return because amounts received from the sale of land in fee simple is within the safe harbor protection for amounts not considered "gross income" under HRS § 237-3(b). *See Safe Harbor 3, above.*

EXAMPLE 4—John Doe is a salaried employee for Bonanza Corp. Salary and wages are exempt from general excise tax. John Doe will not lose his exemption for his salary if he does not obtain a general excise tax license or file an annual general excise tax return because employees who receive salary or wages are within the safe harbor protection for amounts received under HRS § 237-24(6). *See Safe Harbor 6, above.*

EXAMPLE 5—XYZ Organization, a nonprofit organization that provides social services to the low-income, holds a general excise tax exemption certificate from the Department. XYZ Organization's gross receipts are less than $15,000 per year, which are comprised of both donations and small fees charged for services that would be exempt under HRS § 237-23(a)(4). XYZ Organization is exempt from filing federal Forms 990 and 990-EZ because its gross receipts are less than the federal threshold amount (*i.e.*, normally $25,000 or less in gross receipts per year). The Department will not utilize Act 155 to deny XYZ Organization its general excise tax exemption because XYZ Organization is within the safe harbor protection for certain organizations exempt from filing federal Forms 990 and 990-EZ. *See Safe Harbor 5, above.*

EXAMPLE 6—Assume the same facts as in Example 5, except that XYZ Organization's $15,000 in gross receipts per year is comprised of fees charged in furtherance of its exempt purpose that are exempt from general excise tax under HRS § 237-23(a)(4) and fundraising activities taxable under the general excise tax. Under this scenario, the Department will not utilize Act 155 to deny XYZ Organization its general excise tax exemption because XYZ Organization falls within the safe harbor protection for certain organizations exempt from filing federal Forms 990 and 990-EZ; however, upon audit, XYZ Organization will be required to obtain a general excise tax license and file general excise tax returns for the taxable receipts from fundraising activity. XYZ Organization's tax exemption for the fees under HRS § 237-23(a)(4) will be preserved under the safe harbor protection. *See Safe Harbor 5, above. The safe harbor protection from Act 155 in this TIR does not relieve a taxpayer from general excise tax responsibility for taxable activities.*

EXAMPLE 7—Assume the same facts as in Example 5, except that XYZ Organization has gross receipts of $100,000 per year and is required by federal law to file a federal 990 series form. Assume further that $50,000 of XYZ Organization's receipts constitute gifts and donations, $30,000 of the receipts constitute fees charged in furtherance of its exempt purpose that are exempt from general excise tax under HRS § 237-23(a)(4), and $20,000 is from taxable fundraising. Assume further that XYZ Organization has obtained a general excise tax license; however has failed to file an annual general excise tax return within the time required by Act 155. When audited, XYZ Organization will have the following adjustments due to the application of Act 155: (1) All of the $50,000 constituting gifts or donations will continue to be exempt from general excise tax and will not have Act 155 utilized to deny the exemption for these amounts because gifts and donations are protected under a separate safe harbor. *See Safe Harbor 6 for amounts received as gifts.* (2) XYZ Organization is not entitled to the safe harbor protection for certain tax-exempt organizations under HRS § 237-23(a)(4) because its gross receipts require filing a federal 990 series form. XYZ Organization will lose the general excise tax exemption for the fees charged in furtherance of its tax exempt purpose that were otherwise tax exempt under HRS § 237-23(a)(4) by operation of Act 155. (3) XYZ Organization will owe any unpaid general excise tax for the fundraising because there is no general excise tax benefit for this amount. The conclusions in this example assume that XYZ Organization had no reasonable cause outside the safe harbors in this TIR.

EXAMPLE 8—Assume the same facts as in Example 7; however XYZ Organization demonstrated to the Director of Taxation that it had reasonable cause for failing to file its annual general excise tax return. Under these facts, XYZ Organization will be entitled to maintain the exempt character of its fees charged in furtherance of its tax exempt purpose that are exempt under HRS § 237-23(a)(4). The gifts always remained protected. XYZ Organization will owe any unpaid general excise tax for the fundraising.

TRUST FUND LIABILITY

Section 2 of Act 155 also creates liability for certain key individuals involved in the financial management of taxpayers.

A. Amounts Held in Trust

Under the new amendment, certain key individuals will be personally liable for unpaid general excise tax involving the following amounts:

1) Any amount separately stated as a tax. This amount includes any separately stated amount on a receipt, invoice, contract or other evidence of the business activity where the amount is designated as a tax; or

2) An imputed tax liability equal to the general excise tax owed on a transaction where the amount of tax is not separately stated. The imputed liability amount is the gross income multiplied by the proper tax rate. For example, assume ABC Corp. sold an automobile for $20,000 cash with no tax separately stated. Under Act 155, the

amount of imputed tax subject to trust fund liability is $800 of the $20,000 received (*i.e.*, $20,000 x 4% GET (assuming no county surcharge)).

The foregoing amounts are statutorily held in trust for the benefit of the State and for payment to the State as general excise tax liability. A key individual will be held personally liable for these amounts. Liability under Act 155 remains notwithstanding dissolution of the taxpayer's business.

B. Key Individuals

Persons subject to personal liability under Act 155 are the following persons typically involved in the financial management of taxpayers: any officer, member, manager, or other person having control or supervision over amounts of gross proceeds or gross income to be held in trust; as well as any person who is charged with the responsibility of filing or paying general excise taxes.

The liability of these key individuals is limited to the extent the person was in control or in a capacity of supervision, responsibility, or duty to act for the taxpayer.

C. Willful Failure

A person is personally liable under the GET Protection Act only where the Department proves that the person acted willfully. To prove that a person acted willfully, the Department must show that the person voluntarily and intentionally violated a known legal duty.

Act 155 authorizes the interpretation of trust fund liability to be construed in accordance with case law and regulations interpreting similar provisions of the Internal Revenue Code. The Department will utilize case law and regulations interpreting Sections 6672 and 7202 of the Internal Revenue Code (with respect to civil and criminal penalties for willful failure to pay over taxes held in trust) in construing the willful standard contained in Act 155.

D. Good Cause

The Director is authorized to relieve key individuals from liability for good cause. The burden of proof and persuasion to demonstrate good cause is upon the person seeking relief from liability.

E. Personal Liability is Prospective Only

Act 155 is effective on July 1, 2010. Personal liability under Act 155 for certain key individuals only applies to gross income or gross proceeds received by a taxpayer on or after that date. Personal liability is prospective only and does not extend to gross income or gross proceeds received prior to July 1, 2010.

EFFECTIVE DATE

Act 155 is effective on July 1, 2010, and applies to gross income or gross proceeds received on or after its effective date.

For more information, contact the Technical Section at 587-1577.

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TAX INFORMATION RELEASE NO. 2011-04

RE: General Excise Tax Reporting Requirements for Nonprofit Organizations

The purpose of this Tax Information Release (TIR) is to announce that most nonprofit organizations are not required to file Schedule GE-1[1], "Survey of General Excise/Use Tax Exemptions and Deductions" and to clarify the general excise tax licensing and reporting requirements for nonprofit organizations generally and for purposes of Hawaii Revised Statutes ("HRS") section 237-9.3.

I. Information Reporting Required by Act 105 on Schedule GE-1

This TIR serves as the official pronouncement that Schedule GE-1 will not be required for most nonprofit organizations who have filed a Form G-6, "Application for Exemption from the General Excise Tax," or Form G-6S, "Application for Exemption from the General Excise Tax (Short Form)," and have been granted an exemption from the general excise tax from the Department of Taxation (the "Department").[1]

Section 2 of Act 105, Session Laws of Hawaii ("SLH") 2011, ("Act 105") directed the Department of Taxation to

> require information reporting on all exclusions or exemptions of all amounts, persons, or transactions from this chapter, except for the following:
>
> (1) Amounts received that are exempt under section 237-24(1) through (7); and
>
> (2) Any other amounts, persons, or transactions as determined by the director to be in the best interest of tax administration and made by official pronouncement.

[1] A small group of nonprofit organizations with unrelated trade or business income who have claimed general excise tax exemptions or deductions will be required to file the Schedule GE-1.

See Department of Taxation Announcement 2011-26 for a discussion of these information reporting requirements.

A. Nonprofit Organizations Not Required to file Schedule GE-1

The director has determined that, in the best interest of tax administration, nonprofit organizations, who have filed a Form G-6 or Form G-6S and received a letter from the Department that the nonprofit organization qualifies for exemption from general excise tax, will not be required to provide Act 105 information reporting on general excise and use tax exemptions and deductions actually claimed, unless the nonprofit organization has unrelated trade or business income and claimed general excise tax exemptions or deductions. Therefore, most nonprofit organizations, who have been granted an exemption from general excise taxation from the Department after filing Form G-6 or Form G-6S, will not be required to file the Schedule GE-1.

B. Nonprofit Organizations Required to File Schedule GE-1

Nonprofit organizations will be required to file the Schedule GE-1, if the nonprofit organization has unrelated trade or business income and claims general excise tax exemptions or deductions with respect to that income.

II. Denial of General Excise Tax Benefits

Under section 237-9.3, HRS, any nonprofit organization who is required to obtain a general excise tax license and fails to do so or who has a license and fails to file Form G-49 within 12 months of the prescribed due date may be denied general excise tax benefits, such as exemptions, deductions, or lower rates, unless the organization qualifies for the safe harbor protection provided in TIR No. 2010-05, as discussed below.[2] Section 237-9.3, HRS, applies to gross income or gross proceeds received on or after July 1, 2010.

III. Who Must Obtain a General Excise Tax License

Any nonprofit organization, who has income that is subject to the general excise tax, including fundraising income, must obtain a general excise tax license. A general excise tax license is obtained by filing a Form BB-1, "State of Hawaii Basic Business Application." If a nonprofit organization filed a Form G-6 or Form G-6S and was assigned a Hawaii tax identification number, the nonprofit organization still needs to file a Form BB-1 to obtain a general excise tax license if the organization has income that is subject to the general excise tax, including fundraising income.

Nonprofit organizations that file federal Form 990-N and whose only source of income is donations (see part IV(A) below) and/or exempt function or exempt purpose income (see part IV(C)(1) below), are not required to obtain a general excise tax license.

[2] In addition, the director may waive the denial of the general excise tax benefit, if the failure to comply is due to reasonable cause and not the willful neglect of the taxpayer. HRS Section 237-9.3(c).

Nonprofit organizations that file federal Form 990 or Form 990-EZ are required to obtain a general excise tax license. Any nonprofit organization that is required to obtain a general excise tax license and fails to do so may be penalized under section 237-9.3, HRS, unless the organization qualifies for safe harbor protection provided in Tax TIR 2010-05, as discussed below. [2]

IV. Form G-45 and G-49 Reporting and Filing for Nonprofit Organizations

Nonprofit organizations have many different types of income. How to report these different types of income and associated exemptions on the Form G-45, "Periodic General Excise/Use Tax Return," and Form G-49, "Annual Return and Reconciliation of General Excise/Use Tax Return," may not be clear to many nonprofit organizations. In addition, any nonprofit organization that fails to file Form G-49 within 12 months of the prescribed due date may be penalized under section 237-9.3, HRS, unless the organization qualifies for safe harbor protection provided in TIR 2010-05, as discussed below. Therefore, nonprofit organizations must carefully consider their reporting requirements.

In general, the main types of income received by a nonprofit organization are (1) contributions, donations, gifts, and bequests; (2) dues; (3) income resulting from the nonprofit organization's exempt function or purpose; and (4) fundraising income. The following discusses how each of these types of income are to be reported on Form G-45 and Form G-49.

A. Contributions, Donations, Gifts and Bequests

Section 237-24(4), HRS exempts from the general excise tax amounts received as gifts or bequests. Contributions and donations to a nonprofit organization would generally fall into this category. Please see Tax Facts 99-4, "Parent-Teacher Organizations and Other School-Related Organizations," and Tax Facts 98-3, "Tax Issues for Nonprofit Organizations," for a discussion of what constitutes a donation that is not subject to general excise tax.

The general excise tax exemption for contributions, donations, gifts, and bequests under section 237-24(4) will not be denied under HRS section 237-9.3 (see safe harbor #6 in TIR 2010-05). Do not report contributions, donations, gifts, or bequests on Form G-45 or Form G-49. See "General Instructions for Filing the General/Excise/Use Tax Returns" page 20.

B. Dues

In general, membership dues are not subject to general excise tax and will be treated like contributions, donations, gifts, and bequests. See Tax Facts 99-4, Q&A 35. Therefore, do not report membership dues on Form G-45 or Form G-49.

C. Exempt Function or Exempt Purpose Income

Section 237-23(a)(3) through (6) of the HRS, exempts from general excise tax certain nonprofit organizations provided that (1) the organization has filed Form G-6 or Form G-6S with

the Department and been granted an exemption from general excise tax; (2) no private inurement to any private stockholder or individual exists; and (3) the exemption only applies to income from the exempt activities of the organization and "not to any activity the primary purpose of which is to produce income even though the income is to be used for or in furtherance of the exempt activities of …" the organization. HRS Section 237-23(b).

1. Nonprofits Who Are Exempt From Filing Federal Form 990 & 990-EZ

For purposes of HRS section 237-9.3, only certain nonprofit organizations will be in jeopardy of losing the tax exemption provided in HRS section 237-23(a)(3) through (6), if the nonprofit organization fails to obtain a general excise tax license or fails to file Form G-49 within 12 months of the prescribed due date. Pursuant to TIR 2010-05, a nonprofit organization that is exempt from filing federal Form 990, "Return of Organization Exempt from Income Tax," or Form 990-EZ, "Short Form – Return of Organization Exempt from Income Tax," will not be subject to HRS section 237-9.3. Therefore, nonprofit organizations that are only required to file the Form 990-N, "Electronic Notice (*e*-Postcard) for Tax-Exempt Organizations not Required to File Form 990 or 990-EZ," are not subject to section 237-9.3.[3] Accordingly, a nonprofit organization that does not file a Form 990 or Form 990-EZ, is an organization described under HRS section 237-23(a)(3) through (5), and only has income that meets the requirements under HRS section 237-23(b)(1) through (3) for exemption ("exempt function income"), or donations exempt under section 237-24(4), or a combination of exempt function income and donations, does not have to obtain a general excise tax license or file a Form G-45 or Form G-49.[4] Any nonprofit organization that does not have to file Form 990 or Form 990-EZ but has income that is subject to general excise tax, in addition to income that is exempt under section 237-23(b), is required to obtain a general excise tax license and must file a Form G-45 and Form G-49.

2. Nonprofits Who Are Required to File Federal Form 990 or 990-EZ

However, a nonprofit organization that must file a Form 990 or Form 990-EZ and qualifies for the exemption under HRS section 237-23(a)(3) through (5) must obtain a general excise tax license and file Form G-45 and Form G-49. Gross receipts that qualify for the exemption provided in section 237-23(a)(3) through (5) and 237-23(b)(1) through (3) are reported as gross income in column (a) of Form G-45 and Form G-49 and the exemption is claimed in column (b) of Form G-45 and Form G-49. In addition, Schedule GE must be completed.

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[3] For the 2010 tax year, nonprofit organizations with gross receipts of $200,000 or more or total assets of $500,000 or more must file Form 990. Nonprofit organizations with gross receipts of less than $200,000 and total assets of less than $500,000 are required to file Form 990 or Form 990-EZ. Nonprofit organizations with gross receipts normally less than $50,000 are required to file Form 990-N. In addition, certain types of organizations are not required to file Form 990 or Form 990-EZ, such as churches and section 501(c)(1) organizations. Please see the instructions to Form 990 and Form 990-EZ for a more detailed explanation of who must file Form 990 and Form 990-EZ.

[4] However, if no Form G-49 is filed for the taxable year, then the statute of limitations prohibiting the Department from assessing tax on unreported or underreported income does not commence. See HRS section 237-40.

D. Fundraising Income

All nonprofit organizations that receive fundraising income are subject to general excise tax on that income and are required to obtain a general excise tax license and must file a Form G-45 and Form G-49 to report that income. See Tax Facts 99-4 and 98-3 for a discussion of what constitutes taxable fundraising income. For example, a little league baseball team with annual gross receipts of $5,000 and no assets submitted a Form G-6 and received a letter from the Department approving the team's exemption under section 237-23(a)(4). The team holds a car wash to raise funds for a trip to attend a baseball tournament in California. The car wash generates $750.00 in gross receipts. The team must obtain a general excise tax license and file a Form G-45 and Form G-49 and pay general excise tax on the $750.00 of gross receipts from the car wash.

V. Conclusion

In general, nonprofit organizations, who have filed Form G-6 or Form G-6S and received a letter from the Department that the nonprofit organization qualifies for exemption from general excise tax, are excluded from the Act 105 information reporting requirements and are not required to file Schedule GE-1. However, any nonprofit organization with unrelated trade or business income who has claimed general excise tax exemptions or deductions will be required to file the Schedule GE-1. Nonprofit organizations must analyze the types of income received to determine their general excise tax reporting requirements for Forms G-45 and Form G-49.

The chart below summarizes the conclusions set forth in this tax information release.

Federal Form Filed	Type of income	Can GET exemption be denied under HRS §237-9.3?	GET license required?	Reportable for GET purposes?	Sch GE-1 Survey required?
990-N	Donations only	No (SH 5, 6)*	No	No	No
	Exempt function income	No (SH 5)*	No	No	No
	Fundraising	Taxable activity	Yes	Yes	No
	Unrelated trade or business income	Taxable activity with exemption under another HRS section	Yes	Yes	Yes
990 or 990-EZ	Donations only	No (SH 6)*	Yes	No	No
	Exempt function income	Yes	Yes	Yes	No[1]
	Fundraising	Taxable activity	Yes	Yes	No[1]
	Unrelated trade or business income	Taxable activity with exemption under another HRS section	Yes	Yes	Yes

* See safe harbor protection in section C of Tax Information Release No. 2010-05.

VI. Additional Considerations

In addition, businesses are reminded that the general excise tax exemption provided to nonprofit organizations applies to the nonprofit organization's gross receipts. In general, businesses may pass on the general excise tax to nonprofit organizations and the nonprofit organization should be treated like any other purchaser. For example, if a nonprofit organization purchases office supplies at an office supply store, the office supply store is liable for the general excise tax on the sale of the office supplies to the nonprofit organization and the office supply store may pass on the general excise tax on the sale of the office supplies to the nonprofit organization.

For more information contact the Technical Section at (808)587-1577 or e-mail at Tax.Technical.Section@hawaii.gov.

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HRS Sections Explained: Sections 237-9.3 and 237-23
New Section under Chapter 237 created by Act 105, SLH 2011

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TAX ADVISORY ON THE APPLICATION OF THE GENERAL EXCISE TAX TO TOURIST WEDDING ACTIVITIES OF CHURCHES

Recently, questions have been raised regarding the application of the general excise tax to the income received from tourist "wedding" activities on church premises. This advisory provides information about the general excise tax exemption for churches and, in particular, their tourist wedding activities.

Section 237-23(a), Hawaii Revised Statutes (HRS), provides that the general excise tax shall not apply to corporations, associations, trusts, or societies organized and operated exclusively for religious, charitable, scientific, or educational purposes.

Section 237-23(b), HRS, further provides that the exemption shall apply only to the fraternal, religious, charitable, scientific, educational, communal, or social welfare activities of such persons, and not to any activity the primary purpose of which is to produce income even though the income is to be used for or in furtherance of the exempt activities of such persons.

Section 237-23(c), HRS, provides that in order to obtain an exemption from the general excise taxes, the organization must file Form G-6, Application for Exemption from the Payment of General Excise Taxes, with the Hawaii Department of Taxation for approval.

The following discussion assumes that the church in question is organized and operated for a religious purpose, and has applied and received approval for exemption from the general excise tax.

In performing traditional wedding ceremonies, a church is conducting an activity that is religious in nature. Accordingly, income received from the conduct of these ceremonies are generally considered exempt from the general excise tax. With the recent introduction of tourist "wedding" activities on church premises on a wholesale basis, questions have arisen as to whether the income derived from this activity qualifies for exemption from the general excise tax.

The test is whether the primary purpose of the tourist "wedding" activity is religious or fundraising in nature. If fundraising, the income received from the activity will be subject to the 4 percent general excise tax. This determination is made on a case-by-case basis taking into account all of the facts involved.

For example, if the ceremony performed is in fact a wedding (as opposed to, say, a reenactment of one) conducted on church premises by the church minister, priest, or other officiator, then the activity will be considered religious and not income-producing. On the other hand, if the weddings are arranged, packaged and conducted through a commercial entity without church involvement other than making available the use of church premises, the "wedding" activity will be considered fundraising in nature. Even though the wedding activity may be conducted by the church minister, priest, or other officiator, the activity can take on a commercial hue that is so predominant as to render it fundraising in nature (considering the size and frequency of the activity, how the activity is marketed, the amount of time and resources expended, and the amount of revenues derived from the activity).

We recognize that there maybe other factual circumstances not detailed in the preceding paragraph. In order to ensure that the correct reporting position is being taken on these activities, a church may ask the department for a ruling on its specific circumstances. A ruling is requested by submitting a Form A-7 to the department. Please call 587-7572, our forms line, and ask for the Form A-7 with instructions.

In general, the honoraria or fee that the minister, priest, or other officiator receives for performing the wedding ceremony is subject to the 4 percent general excise tax. However, where the honoraria or fee is turned over intact to the church and the wedding ceremony is not viewed as primarily fundraising, then the gross income will not be taxable under the general excise tax.

Aside from tourist wedding activities, many church facilities are made available for use by other organizations, individuals, or community groups. Amounts charged for this use will be considered rental income subject to the 4 percent general excise tax. Whether it is called "rental," "user donation," "donation," or by some other designation, the charge for the use of church facilities will as a general rule be considered fundraising in nature.

What Is the Difference Between a Compilation, a Review and an Audit?

Comparative Overview

The level of service is determined by your needs as the client, and what your creditors and/or investors require. The higher the level of service required, the more time the CPA needs to complete the engagement and therefore the more costly the engagement. While privately held companies opt for compiled or reviewed statements, credit agreements with lenders often require audited statements.

Compilation

- Compiled financial statements represent the **most basic level of service** CPAs provide with respect to financial statements.
- In a compilation engagement, the accountant assists management in presenting financial information in the form of financial statements **without undertaking to obtain or provide any assurance** that there are no material modifications that should be made to the financial statements.
- In a compilation, the CPA **must comply with Statements on Standards for Accounting and Review Services (SSARSs),** which require the accountant to have an understanding of the industry in which the client operates, obtain knowledge about the client, and read the financial statements and consider whether such financial statements appear appropriate in form and free from obvious material errors.
- A compilation **does not contemplate performing inquiry, analytical procedures, or other procedures ordinarily performed in a review;** or obtaining an understanding of the entity's internal control; assessing fraud risk; or testing of accounting records; or other procedures ordinarily performed in an audit.
- The CPA issues a report stating the compilation was performed in accordance with Statements on Standards for Accounting and Review Services; and that **the accountant has not audited or reviewed the financial statements** and accordingly does not express an opinion or provide any assurance about whether the financial statements are in accordance with the applicable financial reporting framework.

Review

- Reviewed financial statements provide the user with comfort that, based on the accountant's review, **the accountant is not aware of any material modifications** that should be made to the financial statements for the statements to be in conformity with the applicable financial reporting framework.
- A review engagement involves the CPA performing procedures (primarily analytical procedures and inquiries) that will provide a **reasonable basis for obtaining limited assurance** that there are no material modifications that should be made to the financial statements for them to be in conformity with the applicable financial reporting framework.
- In a review, the CPA designs and performs analytical procedures, inquiries and other procedures, as appropriate, based on the accountant's understanding of the industry, knowledge of the client, and awareness of the risk that he or she may unknowingly fail to modify the accountant's review report on financial statements that are materially misstated. **A review does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records; or other procedures ordinarily performed in an audit.**
- The CPA issues a report stating the review was performed in accordance with Statements on Standards for Accounting and Review Services; that management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and for designing, implementing and maintaining internal control relevant to the preparation

Compilation vs. Review vs. Audit

Comparative Snapshot			
	Compilation	**Review**	**Audit**
Level of Assurance Obtained by the Accountant/Auditor that the Financial Statements Are Not Materially Misstated	Accountant **does not obtain or provide any assurance** that there are no material modifications that should be made to the financial statements	Accountant **obtains limited assurance** that there are no material modifications that should be made to the financial statements	The auditor **obtains a high, but not absolute, level of assurance** about whether the financial statements are free of material misstatement
Objective	To assist management in presenting financial information in the form of financial statements **without undertaking to provide any assurance** that there are no material modifications that should be made to the financial statements	To obtain **limited assurance** that there are no material modifications that should be made to the financial statements	To obtain a **high level of assurance** about whether the financial statements as a whole are free of material misstatement thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects
Assurance Provided to the User of the Financial Statements	None – the report states that **no assurance is provided**	None – the report provides a statement that **the accountant is not aware of any material modifications** that should be made to the financial statements	None – **the auditor provides an opinion** as to whether the financial statements present fairly, in all material respects, the company's financial position, results of operations and cash flows
The accountant is required to obtain an understanding of the entity's internal control and assess fraud risk			✓
The accountant is required to perform inquiry and analytical procedures		✓	✓
The accountant is required to perform verification and substantiation procedures			✓
Situations requiring different levels of service	Generally appropriate for privately held companies and are **often prepared for simple situations** (e.g., a lender needs GAAP financial statements instead of the statements the internal accounting system produces or the lender needs the comfort provided by knowing that an accountant read the financial statements)	**Often prepared for privately held companies because of requirements of outside third parties** (such as banks, creditors and potential purchasers) that are looking for comfort that the financial statements are not materially misstated	**Often prepared for companies because outside third parties** (such as banks, creditors, potential purchasers and outside investors) **require an auditor's opinion** on the financial statements
Differences in costs for each level of service	Involves the **lowest amount of work** and as a result is **far less costly** than a review or audit	**More costly** than a compilation but **substantially lower in cost** than an audit	**Involves the most work** and therefore the **cost is substantially higher** than a review or compilation

and fair presentation of the financial statements; that a review includes primarily applying analytical procedures to management's financial data and making inquiries of management; that a review is **substantially less in scope than an audit** and that the CPA is not aware of any material modifications that should be made to the financial statements for them to be in conformity with the applicable financial reporting framework.

Audit

- Audited financial statements **provide the user with the auditor's opinion** that the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.
- In an audit, **the auditor is required** by auditing standards generally accepted in the United States of America (GAAS) **to obtain an understanding of the entity's internal control and assess fraud risk.** The auditor also is required to corroborate the amounts and disclosures included in the financial statements by obtaining audit evidence through inquiry, physical inspection, observation, third-party confirmations, examination, analytical procedures and other procedures.
- The auditor issues a report that states the audit was conducted in accordance with GAAS, the financial statements are the responsibility of management, provides an opinion that the financial statements present fairly in all material respects the financial position of the company and the results of operations are in conformity with the applicable financial reporting framework (or issues a qualified opinion if the financial statements are not in conformity with the applicable financial reporting framework. **The auditor may also issue a disclaimer of opinion or an adverse opinion if appropriate**).

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