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# Preparation of Forms 990 and 990-T

John Myers

# PREPARATION OF FORMS 990 AND 990-T

**John Myers, Esquire**
**Williams, Myers & Quiggle**
**Washington, D.C.**

Thank you very much. It is a pleasure to be here. George has asked me to talk about the Forms 990 and 990-T. Since the 990-T may be the most pressing problem, I wanted to have someone with me who has an intimate working knowledge of it. For this reason, I have asked Andy Parker, who is a partner in Peat, Marwick, Mitchell and Co., to join me and discuss unrelated business after I go over with you briefly some of the problems with respect to the Forms 990 and 990-T.

I might say by way of introduction that, until recently, I would have never imagined that I would be here talking to a group such as this about filing tax returns. My father came to Washington in 1914 with Wilson. As a student at Princeton, he was an active supporter of the President in the campaign of the previous year. The President sent him to the Secretary of the Treasury, who assigned him the task of acting as secretary of the commission which wrote the regulations for the first income tax. This had just come into being as a 16-paragraph addition to a tariff act. After that, from about October of 1914 until March of 1915, my father sat in one room in the Old Treasury Building and answered all questions throughout the country orally on the Internal Revenue Code. As George suggested, it is a different world. I think probably the most significant thing about this story is that my father did not start law school until about three years later.

I am going to talk about the Form 990 and Form 990-T. I hope each of you has before you copies of the documents. The first document, and most important, is what is called the "Package 990." This includes the 990, 990-T and the Schedule A which goes with the 990. That "package" apparently is not available at local Internal Revenue Service offices. It is sent out to colleges, universities and other exempt organizations which have already filed a return. It is very convenient and, if you can get one, you should. It can be obtained from Philadelphia. It does include the whole kit—all the instructions with respect to both returns. The second document, which I think is equally important, is a so-called "Package 990 Supplement." That is a supplement the Service put out early this year for the first time and it includes two filled-out returns for 501(c)(3) organizations.

There are other aids available for those who eventually might be filing a college or hospital return. I think George is correct in believing that the Service eventually will insist that all colleges and hospitals file these returns, even those now excepted because of their church affiliation. The National Association of College and University Business Officers puts out every year specific instructions on how to fill out the 990 and the 990-T. Now the last one is a Special Report, 75-7, for the 1974 return. There is one coming out in June. This is issued in June because virtually all colleges file on a fiscal year ending June 30, so it is available just before they get ready to file their return. A detailed set of instructions for filing Form 990 and Form 990-T will be sent upon request by the Office of General Counsel, USCC.

Since the IRS has not yet defined the term "integrated auxiliary of the church," the instructions are not incorporated in this paper.

Now, the reason for both the 990 and 990-T being on this program is that they were both scheduled to be on your docket for this year. The 990-T is on your docket this year because, for the years beginning in 1976, that is, the calendar year, churches will be required to file an unrelated trade or buiness income tax return with respect to income from an unrelated trade or business carried on before May 27, 1969, IRC Section 512(b)(16). Previously excluded church-related entities, such as colleges and hospitals, were expected to be required to file the 990 for 1975. This, as you know, has been postponed because of the dispute with respect to the definition of "integrated auxiliary." (See Proposed Regulations, 41 *Federal Register* No. 29, 2/11/76, pp. 6073-6074.)

I might mention one other form which you may have to file. A Form 5500 was to have been filed with this return. This will be a return with respect to pensions and employee benefit programs. The filing of this form has been postponed until the tenth month of this year, and may be postponed even further. But if you were filing a return for this year, you would be required to complete this. An exempt institution may be required to file such a form whether or not it must file the 990.

I would like to make some preliminary remarks before I do turn to the return. I would note that the 990 does not have to be filed by any institution which normally receives less than $5,000 of gross receipts. The 990-T which is the unrelated trade or business return does not have to be filed for an entity which has an unrelated trade or business with gross receipts of less than $1,000 from the unrelated trade or business.

Now, to the forms. These are usually for a calendar year or for a fiscal year beginning in that year. The form that you have is for 1975 or for a fiscal year beginning in 1975. Now, should it happen that the decision of the Internal Revenue Service not to require a 1975 return does not extend over into institutions which begin their year in 1975, this would be the return for that year. In 1976, that is for the years beginning in 1976, including the calendar year 1976, an institution will have to file the 1976 return form.

All of the returns are filed, as the instructions show, in Philadelphia. That is, all exempt organizations file with the Philadelphia Internal Revenue Service Center. The 990, the basic return, is due the 15th day of the fifth month after the end of the taxable year. (May 15 for a calendar year and November 15 for a fiscal year ending June 30.) There is a little joker here when you are filing both the 990 and the 990-T because the unrelated trade or business return is due either one or two months before the 990. When the colleges first became subject to the filing of returns, they were in the same boat that you may be next year. Many of them did not notice the requirement of an earlier filing of the unrelated trade or business tax return and filed it late. If next year you do have an unrelated trade or business and you do have to file a return, say with respect to 1976, you would normally get an extension of time to file the 990-T. As the instructions indicate, you can get that extension automatically by filing a Form 7004. You can get an extension for the regular return (Form 990, the information return for exempt organizations) on another form which is also on the instructions, namely, Form 2758. For the 1975 calendar or fiscal year return, colleges and universities reporting on a fund accounting basis will be granted an automatic six-month extension to file their returns by filing the Form 2758. For institutions with a June 30 fiscal year, this would mean an extension from November 15, 1976, to May 15, 1977, to file the June 30, 1976, fiscal year return. Because you will not have the information concerning an unrelated trade or business until you have finished your books and your regular return, you should plan to automatically request the extension to file the 990-T before its due date.

There are penalties for failure to file both returns. If you are required to file a 990, there is a penalty of $10 per day, plus $10 a day for the person who is responsible. The penalty for failure to file the unrelated trade or business return is similar to the penalty with respect to failure to file an ordinary tax return, 5 percent of the taxes a month, up to a maximum of 25 percent. This penalty is, of course, in addition to interest.

I must assume for this purpose that most church-related colleges and hospitals will be filing returns for 1976 and later years. For that reason, those of you who represent such entities should be anticipating these requirements and keeping those records which are necessary to fill out this kind of return. These returns are going to have to be examined with considerable care to make sure that they do not require information which is unnecessary and, therefore, impinge upon the Church's own exemption from filing a return. I have not noted anything specifically in these returns which might do that, but I think they must be examined with this in mind. The 990-T, of course, is only for the unrelated trade or business. Therefore, that is the only thing that should be dealt with in the return and it should not involve anything else as far as the Church is concerned.

Basically, the 990-T will become applicable to churches in the calendar year 1976. I would note, however, that the prior exclusion was not absolute. It was limited to an unrelated trade or business which was being conducted by the Church prior to May 27, 1969.

One important aspect of these returns is what will cause the statute of limitations to run with respect to unrelated trade or business income. The unrelated business return is filed with respect to all unrelated trade or businesses. If an institution files an unrelated trade or business tax return, it will cause the three-year statute to run even though the organization may engage in an activity which an agent might later conclude is an unrelated trade or business. If your college or university or hospital is filing the tax return on 990, the statute will run if there is sufficient information included therein for the Commissioner to determine whether the activity is related, provided the gross receipts are disclosed. (Revenue Ruling 64-132, 1964-C.B. (Part 1), 501).

I would note that virtually all colleges and universities have all been subject to an audit during the last two years. A major problem, in terms of time and effort on the part of most agents, has related to whether or not certain activities which they carry on should be treated as an unrelated trade or business.

Now, I would like to switch to Form 990. I am sorry all of you do not have a copy before you. I cannot go over it item by item and tell you how to fill it out but perhaps I can make you feel a little more comfortable about it. The return is not as complicated as your individual income tax return although, after looking at it, you may dispute that contention. It is an information return because no tax is involved and it is just intended to describe the institution financially.

One comment about colleges and universities. The return is based on accounting procedures which are not followed by colleges and universities and many other charities. For years beginning before January 1, 1975, we have obtained from the Internal Revenue Service the right to file as the major part of the return (Part II) the HEGIS report which colleges have been filing with HEW. Similar permission was given upon request to hospitals and other agencies. That permission has been withdrawn, so in a sense colleges and universities are, for the first time, fully completing this return with respect to 1975 and fiscal years beginning therein. They have asked the Internal Revenue Service to provide a special return for colleges and universities which is based upon their fund accounting method of reporting. The Service has been giving serious consideration to this. We submitted a special form and we hope to hear within the next month or so whether they will accede to that request. So, I do put you on notice that, when you do come to filing a return, there may be a special return for colleges and universities. (*N.B.* The Service has since decided that it will not provide such a form.)

The return itself is made up of the instructions for the basic form and then the instructions for a Schedule A. I have already gone over a number of matters included in the instructions. I would mention a few additional points concerning the instructions themselves.

There is a provision for a group return. That group return is a group return based on a group ruling and on the parent organization, including all of the financial information with respect to subsidiaries.

There are certain parts of this return you might not want to be made public. Basically, the 501(c)(3) 990 return is going to be made available to the public. Anybody can inspect it. The instructions permit an institution to note that certain schedules are not subject to public inspection, provided the Service does not object. One such schedule may be the schedule of contributors which is required by the specific instructions on page 2. You have to list organizations and entities who make contributions in the year of more than $5,000. We tried hard to get this eliminated when the regulations first came out but such a schedule will have to be included. I also note, just for information, that there is a question which requires a dollar figure with respect to expenditures for political or legislative purposes.

The form previously required complete details of each sale transaction, including basis. The instructions have now deleted that and permit an institution to gross the sales transactions with respect to publicly traded securities. This is an important concession. One hospital group spent $35,000 a year completing just that schedule.

If you turn to the form 990 itself the first thing you note is that if the institution has $10,000 or less of income it fills out only the basic part of the form, that is, Part I on page 1 of the form. There follow a few questions which I do not think present any problem. Part II, which is the second page, is really a basic income and expense balance sheet.

There is a Schedule A and instructions for Schedule A and this may give you some problems. In Part I, you are supposed to report the compensation of directors, officers and trustees. In Part II, you are supposed to report compensation of over $30,000 per year paid to the five highest compensated employees, if you have not shown it in the first schedule. In Part III, you are supposed to report the payments of more than $35,000 to the five highest paid and compensated independent consultants ("professionals"). In the rest of the form and on the next page (page 2 of Schedule A), there are a number of questions which do not relate to taxes but to the Service's wish for additional information on which to base legislative recommendations. For example, these seek to determine whether there are dealings between the institution and its trustees or officers and the like, in other words, transactions which would be self-dealing if the institution were a private foundation. I might warn that judging from the information the Internal Revenue Service is collecting in this and other areas, the Service seems to be laying the groundwork for contending that some, if not all, of the burdensome private foundation rules be applied to public charities.

In Part V of Schedule A of the Form 990, you will just check that the institution is a college or a hospital. Colleges and hospitals normally will not complete the balance of Part V.

Shortly, Andy will be talking about unrelated trade or business and the Form 990-T, a subject which I know really concerns you. In this connection, I would note that in the January *Philanthropy Monthly,* Volume 9, No. 1, there is a short article on churches and the unrelated business income tax by a competitor of Andy's from Price Waterhouse. This is very brief, only two or three pages, and not at all technical, and I think very helpful if you want to get an introduction into what seems to be a difficult subject.

Now, I would like to turn to the Form 990-T. The 990-T looks a great deal more complicated and it is really difficult to advise how to fill this out because the institution must identify its unrelated trade or business before turning to it. As I mentioned earlier, if you are filing both the 990 and the 990-T, you will normally apply for extension for the latter because it is due before the 990.

Briefly, unrelated trade or business is rather well defined in the instructions. It is not too difficult to preach the concept of unrelated trade or business. Simply stated, it is income from a business activity (which is very broadly defined) which does not contribute importantly, as George said, to the carrying out of your exempt purposes (other than producing income). This rule is easier said than applied. There are certain exceptions. A business which is carried on by people who contribute their services entirely is not taxed. A business like a thrift shop where everything which is sold is contributed is not subject to the tax. For colleges and hospitals, there is a special exception for an activity that is carried on primarily for the convenience of, in the case of the college, the faculty, students, and the like, or in the case of the hospital, the patients. This normally takes care of a student bookstore.

There are a number of specific exceptions for "passive" income, such as dividends, interest, rent and royalties and sales from property which is not inventory and most rent from real property. As I think Andy will mention, the rent exception is a little bit tricky because the rent exception is for flat rent. If the institution operates the premises by providing services and the like, or shares profit, it may have not rental income but unrelated trade or business income.

The last item which is included in the return which in the long run may prove to be one of the greatest problems, is unrelated debt-financed income. If the institution has investment income which can be traced to borrowed funds, it may face a tax on the part of that investment income as the borrowing relates to the basis in the investment property. I just would warn that a number of institutions have found that they have unrelated debt-financed income when they sell a piece of property that has been contributed to them. This can happen if the contributed property is subject to a mortgage which was placed on the property within a certain number of years prior to the gift.

You should be aware that the Service now has authority for breaking out of a seemingly single activity a portion or "fragment" and treating it as taxable. An example is the advertising revenue of an exempt publication. You may be protected, particularly in your parish papers, by special legislative history in this regard. Because all unrelated trade or businesses are lumped together in determining whether an institution has taxable income, it may have losses from one unrelated trade or business which offset income from another.

The rest of the return is separate schedules with respect to separate kinds of income, such as rent, unrelated debt-financed income and the like. One final comment. If an institution receives rents, royalties, annuities or interest from a subsidiary, that income automatically may be unrelated trade or business income to the extent that that income would be unrelated if the parent exempt organization had received it directly.

With that, I would like to turn the podium over to Andy Parker.