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Instructions for Filling Out Form 990-T

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INSTRUCTIONS FOR FILLING OUT FORM 990—T

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I'm bringing a lot of papers up here with me, but I really don't have a prepared text, because I wasn't sure exactly what kind of role I was going to play this morning, and consequently what I have for you are several random comments which have some underlying relationship, but not necessarily a thread of continuity — so as I point out these things, don't feel like you're getting lost anywhere or if you doze off or your mind wanders, you can pick back up fairly quickly.

One thing I would like to echo is what Jack has told you about the potential trap that arises because the Form 990-T is due earlier than the Form 990. If you are a corporation required to file the Form 990-T, it's due 2 1/2 months after the end of your taxable year. That means March 15. If you're a trust, the Form 990-T is due 3 1/2 months after the end of your taxable year. We are all familiar with April 15, which is 3 1/2 months after the end of a calendar year. But the Form 990 for a calendar year is not due until May 15 for both corporations and trusts. Now, if you believe that you have unrelated business income, and it will be subject to filing, let me urge you, assuming the return is going to be prepared by an outside accounting firm, to make a special point to call this to their attention. Because if you don't, I can assure you what will happen, in most of the cases. The Form 990-T is not on the accountant's due list unless he has had the foresight to think that he may have some 990-T's that are going to be due this year for the first time. But I'm betting that they're not going to be on his agenda. Through March 15 he's going to be concerned with corporate returns that are due March 15 for his taxable corporations, or at least getting extensions out for them. Then, between March 15 and April 15, he's going to be thinking only about individual returns. And after he takes a few days off, following April 15, he will turn his attention to the 990. And that's when for the first time, he will discover, if you haven't advised him of it, that there is a delinquent 990-T. Now I think under the circumstances it will probably be possible to get the penalty for late filing waived, but I'm not going to bet on that and I think you can save yourselves a lot of potential grief to be aware of this problem beforehand.

And, one other thing to clarify what Jack was saying, with respect to churches that have not heretofore been subject to the 990-T filing: you become subject for years beginning after December 31, 1975. So your next one would generally be due March 15, 1977 or April 15, 1977.

Now, assuming you have not had to grapple with the problem before, let me point out some things to you that you should be doing now. In other words, don't sit back and say well, that's a problem I don't have to be concerned with till sometime early next year. What can you do now to be ready for next year? Well, I think it's going to be very important that the books be kept in such a fashion that the 990-T can be filed. I think there will be some organizations which will probably run into considerable difficulty in this area simply because they cannot easily and clearly segregate the expenses that are attributable to certain income on which they will be taxable. So it's very important that the accounts that you maintain on your books can be utilized in such a fashion that you can clearly determine how much of that unrelated business income is taxable. And, of course, the burden is on you, the taxpayer, to demonstrate to Uncle Sam what your income and deductions are. Uncle Sam doesn't have any obligation to help you out of your particular problem.

If you will be filing a return for the first time, important decisions will be involved, because in that return you're going to establish a pattern for doing certain things. Within certain parameters, it's generally more important to be consistent in what you do, than whether what you're doing is totally correct. The idea is consistency from year to year. In the first return you're going to be taking positions. For example, if you have depreciable assets, you're going to be adopting useful lives for those assets. If you have salaries that should be allocated in part to your unrelated business acitivity, you're going to be establishing an allocation formula. So the point I want to emphasize is that you do have some very important decisions to be made in that return. Don't wait until the last minute, thinking that the return can be put together fairly quickly, because if you do, you may hurriedly skim over some things that you should be looking at very carefully. Up until the present time, I think we've been fairly fortunate in that the examining agents who have come in to look at returns of exempt organizations have really not been that knowledgeable in what they're doing; at least that's been our experience. Now we are beginning to see what are called Taxpayer Compliance Measurement Program Audits. These are extremely meticulous and detailed audits. The auditor has a very voluminous audit program that he must work through and answer step by step. It forces him to think about a lot of things that may not be apparent from the return itself. So this in-depth audit is educating a number of agents who heretofore have come in and "waltzed around" the work papers and the return and walked out the door without really spotting some very large problems.

I'd like to mention one other thing that you will discover in the instructions to the Form 990, just to save you the trouble of reading this portion of the instructions. If you feel you're going to be liable for the tax, you should write to the Philadelphia Service Center of the Internal Revenue Service and ask for Form 503. When you pay your tax, you do not pay the money to the Internal Revenue Service. You pay it to a commercial depository bank or to a Federal Reserve bank and when you submit your payment you include Form 503 with it. Once you file your return, the Service will every year thereafter send you preprinted Forms 503. But again, having these forms in advance will minimize some of the last minute confusion that inevitably takes place when you're filing a tax return.

One of the interesting questions we're seeing arise relates to depreciable assets. Where you have had a business activity involving depreciable assets that has previously not been taxable, you are confronted with questions such as: "What is my basis now for depreciation? Can I go back and start with the original cost of that asset ten years ago? Do I start with the fair market value that that asset has today? What do I do when I sit down to prepare my depreciation schedule?" Well, the rules say that you have to treat the asset as though it had been involved in a taxable business since acquisition. In other words, you now have to go back and determine what depreciation you would have taken on the asset had you been involved in a taxable business up to the present time, and that's what you start with now. That is your remaining basis for depreciation purposes. As far as I know, this gives us some latitude in lengthening the useful life of assets to minimize the amount of depreciation that we have lost through this calculation of constructive depreciation. You know, normally we want to put as short a life on an asset as we can to recover the cost over the shortest possible period. But here, there's going to be an urge to utilize a little longer life. But be careful that you don't deliberately take a longer life in order to avoid losing a lot of this depreciation and then try to use a shorter life on similar assets currently purchased than what you were saying was the life of this asset that you already owned. You're going to have to be consistent in your depreciable lives for similar assets.

What about those situations in which you didn't bother to capitalize anything when you bought it? This happens quite a bit. Everything is expensed currently even though it involves the acquisition of a capital asset which would have been capitalized and depreciated by a taxable entity. Well, what do you do? If you've previously expensed it, are you now precluded from having any basis in that asset for purposes of computing depreciation as a taxable business? I don't have a definitive answer on that, but my opinion is that you do have a basis. I am relying on the regulation provision that says with respect to assets that you capitalize and have on your books, you have to reduce that basis by the depreciation which would have been allowable had you been a taxable entity. That's what the rule says and that's why you get to the point of having to lose, in effect, part of your original basis in those assets that you've held for several years. Well, utilizing the rationale of that regulation, if we had been a taxable business, we would not have been allowed to expense that asset in the current year. So I submit to you that with respect to previously expensed assets, we are entitled to the same consideration there in computing the basis that we now should have in those assets as we have with respect with those assets that we did capitalize and in which we now have to give up part of our basis.

I guess the trickiest part in preparing Form 990-T is simply to know what goes in there. When do you have a trade or business? That's something we could spend considerable time on. I understand that Father Whelan was on the program yesterday. I've met Father Whelan on occasions in the past and I know he does a very thorough and outstanding job in covering situations that could be unrelated business situations affecting the Church and I don't intend to delve into such a complex problem.

I'd like to mention a couple of areas that you as attorneys may be involved in without fully realizing that you have an opportunity to avoid a problem. These problems are especially acute in the debt-financed income area. To elaborate on a subject that Jack touched on, where property is acquired by the exempt organization by bequest, and there is a mortgage on the property, that property is temporarily exempt from the debt-financed property rules for ten years from date of acquisition, *provided* the Church does not *assume* the mortgage. If you simply take the property subject to the mortgage, that's okay. But if you assume the mortgage, then this exemption goes out the window. Where you acquire property by inter vivos gift, subject to a mortgage, that property is exempt from debt-financed property rules for ten years, *provided* the mortgage was placed on the property more than five years before the gift, and the property was held by the donor for more than five years. And again, you do not want to assume the mortgage here if you want to avoid debt-financed income. So when you're looking at a bequest or a gift, be very careful how it is going to be structured.

It may seem dangerous to have any debt at all for fear that you're going to be deemed by the Service to have debt-financed income. Let me mention a couple of situations that are specifically sanctioned in the Congressional Record, but which do not appear to be clearly reflected in the Regulations. One instance is where an exempt organization has a portfolio of investments with no debt, and it subsequently incurs a debt to acquire an asset to be used in the accomplishment of its exempt function, *i.e.*, a church has an investment portfolio and decides to go out and borrow money in order to build new church facilities, a new wing on the church, etc. The debt will not be considered acquisition indebtedness with respect to your investment portfolio. So, in that situation, the borrowing will not taint the investment income that you receive from the portfolio that you already had. Secondly, where an exempt organization uses property which has been acquired by a gift as collateral to borrow funds which it will use in its exempt purpose, the debt will not be considered acquisition indebtedness with respect to the property. There are some caveats on that, but that summarizes the general rule.

One final comment. It perhaps sounds as though the continued emphasis on unrelated business taxable income means that such income is inherently bad and you should forget about it because it's going to be taxable. Well, that's not true because even though you have to pay tax to the Internal Revenue Service on your net income, you've still got something left after you pay that tax. So you're still better off for having engaged in that business. Some of our individual clients don't necessarily feel that way; they feel like they are paying everything to the government and might as well quit working. But until we are confronted with a 100% confiscatory tax, you're still better off to have done it and pay the tax than not to have done it at all, with one major exception. If you get so carried away with engaging in business activities that those business activities overshadow your exempt function, then, of course, you can lose your tax exempt status because your principal purpose has become the operation of businesses rather than a charitable, religious or educational purpose.