



Montana Legislative Services Division

Legal Services Office

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TO: Members of the Children, Families, Health, and Human Services Interim Committee

From: Lee Heiman, Staff Attorney, Montana Legislative Services

Subject: Tax Treatment of Nonprofit Entities

Introduction

Reduced to its simplest terms, an income tax on a trade or business involves taxing an entity on any positive difference between its income and the costs of producing the income. The positive difference, profit, after taxes is either distributed to the owner of the trade or business or reinvested into the trade or business. The owners of the trade or business are the people who provided the capital of the business through the investment of money or work. A tax-exempt corporation conducts a trade or business, but the capital is donated to the corporation rather than invested and, under certain circumstances, the donor may deduct the amount of the donation for income tax purposes. The profit of a tax-exempt corporation may not be distributed to the benefit of individuals. If the tax-exempt corporation dissolves, the assets remaining after payment of debts must be paid either to another tax-exempt organization or to a government.

Because a tax-exempt corporation may not distribute money for the benefit of individuals, a great deal of attention is paid to the operations of a tax-exempt corporation to prevent corporate funds from being fraudulently funneled out of the corporation. The types of transactions usually involve board members, officers, or employees regarding excessive compensation, self-dealing, purchases, or sales for unreasonable amounts to for-profit entities and other transactions that allow individuals to surreptitiously syphon money from the corporation.

Federal Income Tax Treatment

Under federal law, qualifying charitable organizations are exempt from federal income taxation. The exemption for most purposes is granted under 26 U.S. Code section 501. The applicable provision for most charities, including hospitals, is the oft-quoted "501(c)(3)" that reads:

26 U.S.C. 501(c)(3) : "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no

part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.”

In order to qualify, the organization must be organized and operated for a particular purpose. A copy of Schedule C, IRS Form 1023 (Attachment A), is attached showing what the IRS looks for in an application for an organization that is a hospital.

A second requirement is that no part of the net earnings of the organization may benefit any private shareholder or individual. This is the nonprofit part. A large part of federal law and work of the IRS is concerned with preventing self-dealing or profiting by individuals or business using the nonprofit organization model. Pay to board members, officers, and employees has to be reasonable. Rules govern loans by a nonprofit, disposal of property, payment for services, and any number of other ways in which the assets of a nonprofit organization can be funneled off to benefit individuals.

The last requirement relates to political activities. An organization may be involved in activities to influence legislation as long as it is not a substantial part of the organization's activities. There are specific guidelines and dollar amounts that may be spent on lobbying, and an excise tax may be levied on the excess if the amount allowed is exceeded. For a charitable organization's involvement in the political campaign of a person running for public office, the organization's managers and officers may be personally and jointly subject to an excise tax for the violation and to second-tier increased excise taxes for continued violations.

A limited liability corporation is considered a corporation for the purposes of this law. The articles of organization should provide for the distribution of assets to an tax-exempt entity or government on termination of the limited liability corporation. A limited liability corporation that elects to become a disregarded entity would not qualify as a 501(c)(3) corporation because individuals and informal associations are prohibited from becoming tax-exempt, and a disregarded entity is not taxed as a corporation but the shareholders or members are taxed as individuals on their share of the limited liability corporation's profit or loss. A limited liability corporation could also be formed with a hospital as one of the partners.

Although a charitable organization may have a tax exemption under 501(c)(3), it is still liable for taxes on any business income not related to its exempt purpose.

26 U.S.C. 512 (a)(1): “... Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).”

26 U.S.C. 513 (a): “ ... The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 ... except that such term does not include any trade or business -

- (1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or
- (2) which is carried on, in the case of an organization described in section 501(c)(3) ... by the organization primarily for the convenience of its members, students, patients, officers, or employees, ...; or
- (3) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.”

Income from an unrelated trade or business is taxable even if the charitable organization operates the unrelated trade or business for the purpose of funding the organization’s charitable purpose. The unrelated income can be directly earned by the corporation when, for instance, a hospital operates a catering service or indirectly by the corporation when, for instance, the hospital owns a company that does catering. Obviously, the question is whether the trade or business is related to the organization’s charitable purpose. The relationship has to be looked at on a case-by-case basis.

Most business-type 501(c)(3) corporations that meet an income threshold must file an IRS Form 990 each year, and if they have unrelated taxable trade or business income over a certain threshold they must also file an IRS Form 990T. Attached is a copy of IRS Form 990 (Attachment B), the return of an organization exempt from taxes. The form is nine pages long, mostly concerned with the fiscal operation of the corporation.

Although not specified by statute, the underlying rationale for tax-exemption of charitable organizations is their benefit to the community. I have attached a copy of Schedule C of IRS Form 1023 (Attachment A). Form 1023 is the application for exemption under 26 U.S.C. 501(c)(3), and Schedule C relates specifically to hospitals. The IRS is also changing Form 990, the annual reporting form, by adopting a new Schedule H relating to hospitals. A draft of Schedule H is attached (Attachment C). One of the purposes for the change is to gather more information on the community

benefit claimed by a hospital. Completed IRS Form 990s are public documents. The IRS has recognized the need for public involvement; thus, some of the information it requires on the form goes beyond that needed just to monitor the organization's status.

State Tax Treatment

Corporate License Tax

For the purposes of the Montana corporate license tax, a corporation does not have to be a 501(c)(3) corporation but must meet a similar standard. Unrelated business income is also taxable in Montana.

15-31-102. Organizations exempt from tax -- unrelated business income not exempt. (1) Except as provided in subsection (3), there may not be taxed under this title any income received by any:

(d) corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual....

(3) Any unrelated business taxable income, as defined by section 512 of the Internal Revenue Code, 26 U.S.C. 512, as amended, earned by any exempt corporation resulting in a federal unrelated business income tax liability of more than \$100 must be taxed as other corporation income is taxed under this title. An exempt corporation subject to taxation on unrelated business income under this section shall file a copy of its federal exempt organization business income tax return on which it reports its unrelated business income with the department of revenue.

The Montana Department of Revenue requires an affidavit from a corporation stating that it meets the statutory requirements for tax exemption. The Administrative Rules of Montana provision reads:

42.23.103 EXEMPTIONS (1) A corporation is not exempt from this tax merely because it is not organized and operated for profit. A corporation seeking the benefits of exemption must prove strict compliance with all statutory conditions authorizing the classification claimed.

(2) In order to establish its exemption and thus be relieved of the duty of filing returns and paying the tax, each organization claiming exemption must file with the department an affidavit showing:

- (a) the character of the organization;
- (b) the purpose for which it was organized;
- (c) its actual activities;
- (d) the sources and the disposition of its income;

- (e) whether or not any of its income may inure to the benefit of any private shareholder or individual;
 - (f) a copy of the articles of incorporation;
 - (g) a copy of the by-laws; and
 - (h) copies of the latest financial statements showing the assets, liabilities, receipts, and disbursements must be submitted with the affidavit.
- (3) In addition, if the IRS has granted the organization exemption from the federal income tax, a certified copy of the exemption certificate or letter shall also be filed.

Property Tax

Under Montana law a 501(c)(3) organization is not exempt from property taxes. The charitable property tax exemption relates to the use of the property, not to the owner of the property. Different categories of property have different requirements, but as a general rule real property owned by a charitable entity that is used for its charitable purpose is exempt and that used for other purposes is not. A charity may be taxed on a parking lot it owns, any farmland it owns, and any other property it owns that is not directly used for its exempt charitable purpose. Like the distinction for unrelated taxable business income, the determination of whether property is used exclusively for the charitable purpose must be determined on a case-by-case basis.

15-6-201:" (1) The following categories of property are exempt from taxation: ...

(e) property used exclusively for nonprofit health care facilities, as defined in 50-5-101, licensed by the department of public health and human services and organized under Title 35, chapter 2 or 3. A health care facility that is not licensed by the department of public health and human services and organized under Title 35, chapter 2 or 3, is not exempt."