

What are the benefits of receiving tax exemption as a government unit or affiliate?

Organizations exempt under 501(c)(3) have two primary tax benefits:

1. Exemption from income tax on earned income
2. A deduction available from income tax to donors who itemize

Income tax

When the entity is a government unit, it is exempt from income taxation under a doctrine known as the “doctrine of intergovernmental tax immunity.” The exemption from income tax for government units is spelled out in I.R.C. 115:

Income of States, municipalities, etc.

Gross income does not include:

- (1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia; or
- (2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

See also, Rev. Rul. 71-131 and 71-132.

The idea of “essential government function” is critical to exemption under this section. That rule was the basis, for instance, of a court holding that revenue from Iowa State University’s television station could not be exempt from income tax under section 115:

[C]ounsel for the University... argue that WOI-TV revenues are excluded from gross income by §115(a)(1) which states that gross income does not include:

income derived from any public utility or the exercise of any essential governmental function and accruing to a State * * *.

Referring... to the §115 argument, it will be noted that the section excludes only income derived from the exercise of any 'essential governmental function.' However strongly it might be urged that the operation of a purely educational television station would constitute an 'essential governmental function,' it certainly cannot be fairly argued that the operation of a commercial station could be so classified.

For 501(c)(3) entities, exemption from income tax for earned income is provided in I.R.C.501(a).

Taxation of “Unrelated” Income

The general rule for 501(c)(3) entities is that earned income unrelated to their exempt purposes is subject to income tax, a concept known in short as UBIT, “Unrelated Business Income Tax.” On the other hand, governmental entities exempt under the “inter-governmental tax immunity” doctrine are not subject to UBIT. However, schools and universities under the intergovernmental tax immunity doctrine have special rules about taxability of unrelated earned income. I.R.C. 511(a)(2)(b)

Iowa State University ran a television station, WOI, which ran both educational and commercial shows. Should any of that revenue be taxed? In 1974 a federal court held that it should be taxed.

It is not disputed that Iowa State University is itself an exempt organization and that the WOI complex of communications facilities is wholly owned and operated by that institution. The presence of an income tax exemption for the University, however, does not automatically exempt all activities in which it may participate. Income accruing to an educational institution exempt from taxation under Internal Revenue Code §501(c)(3) is taxable if the income is generated by the operation of an unrelated trade or business. To be taxable, the activity in question must be (1) a trade or business, (2) regularly carried on, and (3) not substantially related, other than through the production of income, to the purpose for which the institution was granted exemption under §501. Treas. Reg. §1.513--1(a)(2). 500 F.2d 508, 516.

Deductibility of contributions

It is clear in the tax code that contributions to government units and political subdivisions are deductible:

For purposes of this section, the term “charitable contribution” means a contribution or gift to or for the use of:

- (1) A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes. I.R.C. 170(c)(1)

It is also true that deductions can be taken by donors for contributions to government instrumentalities, affiliates, and to 501(c)(3) entities.

The critical issue is whether the cap on deductibility is 50 percent of AGI or 30 percent of AGI.

[A] charitable contribution, for purposes of section 170(c) of the Code, must satisfy two tests in order to qualify for a deduction. The contribution must be 'to or for the use of' a state or political subdivision and it must be made 'for exclusively public purposes.'

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Section 170(b)(1)(A)(v) of the Code provides, in part that in the case of an individual the deduction provided in section 170(a) shall be allowed for any charitable contribution to a governmental unit referred to in section 170(c)(1) to the extent that the aggregate of such contributions does not exceed 50 percent of the taxpayer's contribution base for the taxable year. However, section 170(b)(1)(B) provides, in part, that where there is a charitable contribution other than those specified in section 170(b)(1)(A), the deduction for such contributions is limited to 30 percent of the taxpayer's contribution base for the taxable year.

Section 170(c)(1) does not refer to instrumentalities of a state or instrumentalities of a political subdivision of a state; however, the long-standing position of the Service is that contributions or gifts to an instrumentality of a state or to an instrumentality of a political subdivision of a state are considered to be 'for the use of' a state rather than gifts 'to' a state or political subdivision. The significance of this distinction is that a gift 'for the use of' a state (or political subdivision) is subject to the 30 percent limitation of section 170(b)(1)(B).

See Rev. Rul. 75-359, 1975-2 C.B. 79.

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In the event the instrumentality also qualifies as an exempt organization within the meaning of section 501(c)(3) of the Code then the provisions of section 170(b)(1)(A) (i.e., 50 percent deductibility), rather than the 30 percent limitation set forth in section 170(b)(1)(B), may apply.

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Iowa state taxes – sales, property, etc.

There is also the benefit of exemption for government affiliates sometimes from Iowa state taxes. The Iowa Department of Revenue states:

A corporation can be considered a governmental unit for purposes of receiving a sales or use tax exemption on its purchases. A nonprofit corporation does not have any type of "blanket" sales or use tax exemption on its purchases solely because the organization is exempted from federal or state income taxes.

NOTE: A determination of whether a corporation is a government instrumentality is made on a case-by-case basis based on the facts of each case.

See: <https://tax.iowa.gov/iowa-tax-issues-nonprofit-entities#corpgovnt>

A recent decision by the Iowa Department of Revenue and Finance denied exemption from sales tax and hotel/motel tax for the National Governors Association (NGA) which has been classified as an “instrumentality of a governmental unit” by the Internal Revenue Service pursuant to Internal Revenue Code section 115(1). In part, the Department of Revenue and Finance letter of June 23, 2005 reads:

Iowa Code section **423.3(31)** provides an exemption from Iowa sales and use tax for purchases made by Iowa governmental entities. Department rule 701 IAC **18.5** which implements this statutory exemption also includes purchases by instrumentalities of Iowa government as also being exempt from Iowa sales and use tax. Based on *United States v. Joseph V. Orleans*, 425 U.S. 807, 814, 48 L. Ed. 390, 96 S. Ct. 1971 (1976), the primary factor used to determine whether a private nonprofit corporation is an instrumentality of government is whether the government body can control the detailed performance of the nonprofit corporation. However, in borderline cases in which it is not clear whether a corporation is an instrumentality of a government body or not, the case of *Unemployment Compensation of North Carolina v. Wachovia Bank and Trust Company*, 2 S.E.2d 592, 595, 215 No. Car. 491 (1939); 1976 O.A.G. 823, 827, 828 requires that all of the following factors be considered in making a determination

:

- Whether it is created by government.
- Whether it is wholly owned by government and upon dissolution of the organization, will assets of the organization revert to a governmental entity?
- Whether it is operated for profit.
- Whether it is primarily engaged in the performance of some essential governmental function.
- Whether the payment of tax will impose an economic burden upon the corporation, or that payment of tax serves to materially impair the usefulness or efficiency of the corporation or the payment of tax materially restricts the corporation in the performance of its duties.

Based on the information obtained from you in our telephone conversation of June 9, 2005, NGA is not an instrumentality of government and is therefore, not exempt from Iowa sales or use tax and also not exempt from local hotel/motel tax that is implemented by various jurisdictions in Iowa.

Helpful Sources

Guthry, Peter. Dealing with government related entities – A brave new world. ALI-ABA CLE (1991)

Aprill, Ellen P. The Integral, the essential and the instrumental: Federal Income tax treatment of governmental affiliates, 23 J. Corp. L. 803 (1998)

McCray, Richard A. Sr. and Marvin Fridlander, “Organizations closely affiliated with state or Indian tribal governments reference guide”, IRS Exempt Organizations CPE TIP FY 2004

Internal Revenue Service
Exempt Organizations Continuing Professional Education (CPE)
Technical Instruction Program FY 2004
**ORGANIZATIONS CLOSELY AFFILIATED
WITH STATE OR INDIAN TRIBAL
GOVERNMENTS REFERENCE GUIDE**
Richard A. McCray, Sr. and Marvin Friedlander

**GUIDE SHEET FOR SECTION 501(c)(3) ORGANIZATIONS CLOSELY
AFFILIATED WITH STATE OR INDIAN TRIBAL GOVERNMENTS**

INSTRUCTIONS: This guide sheet is designed to assist in the processing of an IRC 501(c)(3) exemption application submitted by an organization that is closely affiliated with state government (including federally recognized Indian tribal governments). See the Reference Guide for assistance in completing this guide sheet. Contact EO Technical for additional help.

Yes/ No

1. Is the applicant a corporation, association, or trust?
(A "Yes" response is favorable. A "No" response indicates that a problem exists.)
2. Does the organization meet the organizational test?
(A "Yes" response is favorable. A "No" response indicates that a problem exists.)
3. Is the organization a wholly owned integral part of a state or local government?
(A "Yes" response indicates that a problem exists. A "No" response is favorable.)
4. Is the organization a federally recognized Indian tribal government or a political subdivision of a federally recognized Indian tribal government?
(A "Yes" response indicates that a problem exists. A "No" response is favorable.)
5. Does the organization have substantial regulatory or enforcement powers (sovereign powers)?
(A "Yes" response indicates that a problem exists. A "No" response is favorable.) If "Yes," are they regulatory or enforcement powers that are specifically excepted from disqualifying an organization under IRC 501(c)(3)?
 - Determining a tax rate (Rev. Rul. 74-15)
 - Conducting campus policing (Rev. Rul. 177-165)(A "Yes" response is favorable. A "No" response indicates that a problem exists.)

6. Has the organization requested an exception from the Form 990 filing requirement under Rev. Proc. 98-45? If "Yes," continue.
7. Has the organization requested an exception from filing Form 990 because it is a governmental unit under Section 4.01 of Rev. Proc. 95-48 or because it is a governmental unit under Section 4.02(a) or Section 4.02(b) of Rev. Proc. 95-48?

(If "Yes," must meet a, b or c below.)

- a. Does the organization meet Section 4.01 because it is a governmental unit (1) as defined in Reg. 1.103-1(b), (2) an organization described in IRC 170(c)(1), or (3) an Indian tribal government or a political subdivision of an Indian tribal government under IRC 7701(a)(40) and 7871?
- b. Does the organization meet Section 4.02(a) because it possesses a ruling or determination from the Service that (1) its income is excluded from gross income under IRC 115, (2) it is entitled to receive deductible contributions under IRC 170(c)(1), or (3) it is a wholly owned instrumentality of a state for employment tax purposes under sections 3121(b)(7) and 3306(c)(7)?
- c. Does the organization meet Section 4.02(b) because (1) the organization is controlled by a governmental unit, (2) it satisfies at least two of the five affiliation factors listed in Section 4.03, and (3) its filing of Form 990 is not otherwise necessary for efficient tax administration.