



10 Common Errors to Avoid In Completing A Private Foundation's Form 990-PF

A Guide for Tax Preparers

Prepared by

PricewaterhouseCoopers LLP

for the

Forum of Regional Associations of Grantmakers

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Foreword

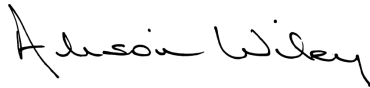
In this era of increased public interest and accessibility, submission of the 990-PF foundation tax return to the IRS has taken on new meaning and importance. Reporters, researchers, grant seekers – and others – look at the 990-PF for information about your organization. According to the Urban Institute, it is the most commonly used data source about nonprofits.

Based on the recommendation of its National Task Force on Accountability, the Forum of Regional Association of Grantmakers and its 32 member regional associations have teamed with PricewaterhouseCoopers to prepare two documents: *What You Should Know Before Signing Your Organization's Form 990-PF* and *10 Common Errors to Avoid In Completing A Private Foundation's Form 990-PF*. Designed for the 990-PF foundation signer and tax preparer respectively, both documents focus on the clear and accurate completion of that form, with tips to avoid common mistakes and potentially misleading entries.

The Forum appreciates the work of the primary author, John Edie, former general counsel of the Council on Foundations and current director at PricewaterhouseCoopers, and grant support from the Charles Stewart Mott Foundation for these two documents.

Regional associations of grantmakers collectively represent more than 4,000 grantmakers and the majority of private foundation assets in the country. Organized around states or key metropolitan areas, these associations are widely respected for accurate, unbiased information about the practice of philanthropy. The association serving your own region is identified on the cover of this document and additional information can be found at www.givingforum.org

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The information in this document is not providing legal, accounting or tax advice. Facts in each case can vary widely. Each foundation is encouraged to consult its accountant or legal counsel for appropriate advice.

I. Introduction: A New Environment for the Form 990-PF

Purpose of the Publication. The purpose of this publication is to provide information that may be useful in connection with preparation of the Form 990-PF tax return for a private foundation, whether by a foundation employee, volunteer, or professional preparer. It is not intended to be a comprehensive, step-by-step guide to the complete return. In fact, the instructions provided by the IRS for the Form 990-PF are quite thorough and helpful in this regard. Rather, the intent here is to highlight only the most common errors – particularly those that can lead to an incorrect and often negative interpretation of a foundation’s activities by the media, government officials, and other persons who may examine the return.

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Intended Audience. The primary audience for this publication is the person who has limited or no prior experience in completing this complicated return. Attorneys or certified public accountants with significant experience preparing this return may also find the information useful

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Public Nature of the Form 990-PF. With the growing speed of the Internet and the availability of this Form online, full copies of a private foundation’s tax return normally can be brought to a computer screen in less than a minute. Federal tax law also requires a private foundation to permit public inspection of its return during normal business hours and to provide a printed copy of its return upon request. In short, a private foundation’s Form 990-PF has become an increasingly *public* document. The media, critics, researchers, donors, state and Federal regulators, and elected officials all have ready access to this return and the information it provides. Completed incorrectly or without careful attention, the information in this return can be misconstrued and publicized in a misleading manner, leading to a negative public image of the foundation – even where not deserved. Hopefully, the information provided in this publication should contribute to a more accurate return that reflects the true status of the foundation.

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New Environment. Disturbed by ongoing stories in the media of “excessive compensation” and other misdeeds, Congressional committees and state attorneys general are focusing increased attention on the oversight of private foundations. In the for-profit world, the Sarbanes-Oxley legislation that passed Congress in the summer of 2002 now establishes the principle that corporate executives can be held responsible for the accuracy of their company’s reports. While this legislation for the most part does not apply to private foundations, the publicity around it has created a renewed atmosphere of accountability in the nonprofit field calling for a more “hands on” approach.

At the same time as foundation executives are becoming more diligent in reviewing this return before signing, it is increasingly important that the return not only be free of mistakes but also be completed in a way that helps portray the foundation accurately.

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Penalties for Failing to File Timely, Completely, or Correctly. An incomplete or incorrect Form 990-PF filed before the due date has *not* been filed on time. For most private foundations, the penalty for failing to file a timely return is \$20 per day up to a maximum of \$10,000 or 5 percent of gross receipts (whichever is less). For larger foundations (gross receipts exceeding \$1 million), the penalty is \$100 per day up to a

maximum of \$50,000 or 5 percent of gross receipts (whichever is less). There also is a potential penalty on the foundation manager responsible for filing the return.

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Limitation on This Checklist. The Form 990-PF has earned a well-deserved reputation for its length and complexity. Reasonable practitioners may disagree as to what required information is most commonly entered incorrectly. Foundations with circumstances more complicated than the norm are encouraged to refine this checklist with the assistance of their professional advisors.

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How to Use This Checklist. As noted above, the checklist provided below is not comprehensive. Instead, it attempts to focus attention on those errors that are most common and that most easily can lead to a negative misinterpretation of the foundation's programs and activities. Preparers are encouraged to read this checklist early in the process so that foundation staff or other persons responsible for providing the relevant data to the preparer can be briefed about any required changes in the procedures for tracking the necessary information. A checklist similar to this one is available for the signer. Finally, to encourage a more thorough review by the foundation officer responsible for signing the return, it would be helpful for the preparer to schedule a meeting with him or her to review a draft leaving sufficient time for any corrections that need to be made.

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II. Checklist of 10 Common Errors in Preparing the Return

#1 – All Parts and Lines Require an Entry. The IRS requires some kind of entry for each line in each part of the return; otherwise, the IRS considers the return incomplete. The instructions for Form 990-PF make this point clear in a section entitled "How to avoid filing an incomplete return" that states:

- Complete all applicable line items,
- Answer "Yes," "No," or "N/A" (not applicable) to each question on the return,
- Make an entry (including a zero when appropriate) on all total lines, and
- Enter "None" or "N/A" if an entire part does not apply.

As noted above, an incomplete return is not considered to be filed on time.

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#2 – Important Schedules Must Be Attached. Depending on the complexity of the activities, expenditures, and investments of a private foundation, many schedules may need to be attached to the return. For any foundation that makes grants and has investments, three (usually quite long) schedules must be included. It is important that the required level of detail is provided for each of the following schedules:

- Complete Lists of Investments [Part II, lines 7,10,11,13 and 14]. As tedious as it may seem to prepare, the return requires detailed (end of the year) lists containing each individual stock, bond, government obligation, land holding, building, and equipment, plus other types of investment assets that do not fall into these categories. For larger foundations, the lists of investments can total hundreds of pages. The temptation is to aggregate by type of investment (corporate stocks, corporate bonds, etc.) and not list every investment separately. In 2006, the instructions changed slightly allowing certain debt securities to be combined for the purpose of listing investment assets. In these cases only, totals can be used instead of separately listed investments. A return that only provides aggregated categories is incomplete. These investment schedules for Part II require specific detail about each individual asset.

- Complete List of Capital Gains and Losses [Part IV]. Similarly, every capital gain or loss recorded during the tax year must be described in detail to satisfy the requirements for this part. The rules were also updated in this area allowing publicly-held securities sold through a broker to be listed in summary rather than attaching all of the gain/loss detail. The results from these calculations help determine the amount of investment income that is subject to excise tax. Here again the temptation may be to aggregate and summarize, which will result in an incomplete return.

Part IV states “List and describe the kind(s) of property sold (e.g., real estate, 2-story brick warehouse; or common stock, 200 shs. MLC Co.)” Using the answer “various” is not acceptable. It is important that the schedule for Part IV includes all the specific information for each sale individually that results in a capital gain or loss. For assets acquired since 1969, eight pieces of information are required for each capital gain or loss: description of the property sold (see above); how acquired; date acquired; date sold; gross sales price; depreciation allowed; cost or other basis; and resulting gain or loss.

- Complete List of Grants Paid and Approved [Part XV, line 3(a) and 3(b)]. This list is one of the most important parts of the private foundation return. Unfortunately, the IRS reports that more than half of all private foundation tax returns are received with this schedule prepared incorrectly, thus making any such return incomplete. Many grantseekers turn to it for information about the types of grants and types of grantees favored by the foundation. The minimum information requirements for all grants made during the year (or approved for future payment) are:

1. The name and address of each grantee;
2. The amount of each grant;
3. The foundation status of each recipient such as public charity, private foundation, or non-charity [such as a Chamber of Commerce] – it is not sufficient to describe the status as “501(c)(3)” because all private foundations are classified under that section and grants to private foundations must be separately identified¹; and
4. The purpose of the grant. The instructions are quite particular about purpose. For example, they state that the following types of descriptions are insufficient and unacceptable: “charitable, educational, religious, or scientific activities.” Describing the purpose as “grant” or “contribution” is also unacceptable. Favorable examples for describing “purpose” are: payments for nursing service, fellowships, or assistance to indigent families.

Some foundations already have recognized the value of giving special attention to this list of grants. In addition to providing all the required information, they also group the grants by subject matter (e.g., health care grants, environmental grants, scientific research grants, etc.) to make it easier for the reader to understand the foundation’s grant priorities.

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¹ Part VII-B, line 5a(4) asks if the foundation provided a grant to “an organization other than a charitable, etc., organization described in section 509(a)(1), (2), or (3), or section 4940(d)(2)?” Many returns answer “No” to this question and then list several grants in Part XV, lines 3(a) and 3(b) that are NOT described in these sections, such as grants to a private foundation or a fraternal order. Be aware of the interconnection between these two parts of the return.

#3 – Presenting Operating and Administrative Expenses Correctly in Part I.

Recently, the administrative costs of private foundations have been the target of attention from the media and government officials. In some cases, the criticism derives from either a misreading of the tax return or poor completion of the return. At the same time, more research is underway to analyze the true costs of running a foundation. Data from the Form 990-PF is the most valuable source for this research. If foundations are not consistent in how they report certain expenses, the research will be less reliable.

The administrative and operating expenses of the foundation must be reported on page one of the return. Here are several areas where mistakes commonly are made in Part I:

- Are amounts entered in column (a) consistent with the foundation's financial statements? Whenever possible, it is strongly recommended that the numbers inserted to complete the return conform to the financial statements prepared for the foundation, particularly in Part I, column (a). But see the next paragraph.
- Column (d) must be completed using the cash method of accounting. All of the amounts entered on Part I, column (d) are counted in meeting the foundation's 5-percent minimum distribution requirement, and all these expenditures must be paid out before the end of the year (cash method of accounting). Amounts approved for future payment (accrual method of accounting) cannot be included in column (d). Thus, if the foundation's books are kept using the accrual method, then that method is recommended for column (a), but it cannot be used for column (d).
- Column (d) must not include any amounts from column (b). Only expenses incurred in managing the foundation's investment assets are included in column (b); none of these expenses count in meeting the 5-percent minimum distribution requirement. Therefore, column (b) expenses cannot be included in column (d). In the rare case that a foundation must complete column (c) – see bullet farther down on this page – no expenses from column (c) may be included in column (d) either.
- Is the allocation between column (b) and column (d) proper? All expenses for managing the foundation's investments are entered in column (b) of Part I. Examples of investment expenses are investment manager fees, custodial bank fees, and the costs of a board meeting dedicated to investment issues. As noted above, no investment expenses can count in satisfying the 5-percent minimum distribution requirement; therefore, no amounts in column (b) can be included in column (d). However, some expenses are incurred for both investment and charitable purposes. For example, the chief executive officer may spend a percentage of time on investment matters and a percentage of time on grantmaking and other charitable activities. Thus, there must be a reasonable allocation of the compensation costs for the CEO. The full compensation amount is entered in column (a), a proportional amount for investment activities is entered in column (b) and a proportional amount is entered in column (d). It is important that a reasonable procedure is adopted for such allocation and used consistently.
- In most cases, use zeros in column (c). For most foundations, column (c) will simply be filled with zeros. There are two circumstances when column (c) must

be completed: 1) The foundation is an operating foundation,² or 2) The foundation derives income from its charitable activities (sales of publications, fees for services, etc.).

- Are taxes paid reported on the correct line and in the correct column? Mistakes often occur through incorrect reporting of tax amounts required in Part I.
 1. The taxes on investment income (Section 4940) and unrelated business taxable income (Section 511) belong on line 18. These taxes do *not* belong in column (b) since they are not expenses incurred in the management of investments, and they do *not* belong in column (d) since they are not charitable expenditures. They only belong in column (a). [Note that a private foundation must make *estimated* tax payments for the Section 4940 excise tax based on investment income if it can expect its estimated tax to be \$500 or more (see Part VI of the return). Investment income for the year of \$25,000 would generate a tax of \$500 at the 2-percent rate].
 2. The employer's share of Federal, state, and local payroll taxes belong on line 15, not on line 18. Such taxes include the employer's share of social security, Medicare, FUTA, and state unemployment compensation. Taxes withheld from employee's salaries are not included in Form 990-PF.
- Are professional fee expenses reported on the correct line? All professional fees belong on line 16. Legal fees go on line 16a; accounting fees go on line 16b; and all other professional fees (such as investment manager fees and independent consulting fees) go on line 16c.
- Other Expenses (Line 23). Use the line for "other expenses" *only* for disbursements that do not belong in other lines. Compensation of officers, directors, or other employee salaries and professional fees do *not* belong on line 23, yet they are often placed there in error.

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#4 – Administrative Expenses v. Grants and Direct Charitable Activities. Fairly or unfairly, some private foundations have been criticized for the amount of their administrative expenses, and this subject has become highly sensitive. The ratio of administrative costs to grants can be misconstrued by the media and others. This issue is complicated by the fact that there is no clear definition of administrative costs. The attention to these costs has intensified in recent years, including efforts in Congress to propose legislation to limit or cap them. Therefore, it is important to complete the return in a manner that clearly distinguishes grants, direct charitable activities, and administrative expenses.

If the return does not provide sufficient information, the reader will look at Part I, column (d), line 25 to find the total dollar amount paid out in grants, and then compare it to Part I, column (d), line 24 – just one line above – to find "Total operating and administrative expenses." Because there is no clear definition of administrative costs, the reader often will reach the conclusion that the full amount on line 24 is made up merely of overhead expenses. It will be helpful if the return preparer examines the ratio of grants (line 25) to

² In general, an operating foundation primarily runs its own programs by spending at least 85 percent of its adjusted net income directly for the active conduct of its own activities rather than by making grants to other organizations. The definitional requirements to be an operating foundation are set forth in Code Section 4942(j).

other costs (line 24) and determines whether the return provides a fair picture of all the foundation's operations, including overhead.

Separating Direct Charitable Activities. As part of their charitable operations, some foundations conduct their own programs in addition to the grants they make. For example, a foundation may sponsor its own research and publish the results. Known as "direct charitable activities," the costs attributable to them must be included in Part I, but they are not broken out separately. The opportunity to summarize these direct activity expenses is provided in Part IX-A. Readers frequently do not review Part IX-A and conclude that all these expenses therefore must be administrative overhead. Here are two suggestions that a preparer may consider to help clarify the true nature of these costs:

1. On page 1 of the return, make a cross-reference to the description of Direct Charitable Activities in Part IX-A. More specifically, add an asterisk (*) next to total operating and administrative expenses on column (d), line 24. Then at the bottom of page 1 state: "This figure includes xxx (total dollar amount) in charitable programs conducted directly by the foundation – See Part IX-A for details."
2. On a separate attached schedule, provide a detailed explanation of all the foundation's expenses for the year. The IRS recognizes that administrative cost information can be misconstrued and, therefore, the instructions for the return encourage adding more information, stating: "If you want to provide an analysis of disbursements that is more detailed than column (d), you may attach a schedule..." By preparing a separate attachment, the foundation can categorize its expenses in a more meaningful fashion and minimize the chance of misinterpretation. If this approach is taken, it is recommended that the foundation insert an asterisk (*) after the figure on column (d), line 26 (total expenses and disbursements). Then, at the bottom of page 1, add: "See attached schedule xxx for a more complete explanation of all disbursements."

A Full Description of Direct Charitable Activities is Important. If a private foundation's only charitable activity is grantmaking, the foundation will not have any direct charitable activities and Part IX-A will be completed by entering "N/A." If the foundation does have direct charitable activities, it will greatly benefit the foundation if the preparer makes certain that such activities are fully reported as required.

As noted above, direct charitable activities are those programs that are operated *directly* by the foundation rather than by making a grant to another organization to implement. The instructions to the return provide 10 different examples of direct activities including: conducting scientific or public policy research; conducting an educational conference; and supporting the services of foundation staff on boards or advisory committees of other charities or public commissions. In most cases, a foundation will be better served by describing these direct charitable activities and their costs on a separate attachment (the space provided on the return is limited). It is most advantageous if the description of each activity is drafted with care to convey the value it provides.

The IRS instructions call for the foundation to report both direct and indirect expenses in identifying the true costs of these activities. Examples of direct costs are the compensation and travel expenses of employees directly engaged in the activity. Examples of indirect costs are occupancy expenses (rent and utilities) or the expenses of other departments (accounting or payroll) so long as these indirect expenses are

allocated in a reasonable manner that is used consistently. Report the total amounts in Part IX-A.

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#5 – Compensation of Trustees/Employees and Time Spent. Part VIII of the return requires a listing of all officers, directors, trustees, and foundation managers³ together with a complete description of each person's compensation and time devoted to the position. Providing individual (or home) addresses is not required. The address of the foundation is sufficient. Media stories alleging examples of excessive compensation paid to governing board members (directors or trustees) or to staff (usually the chief executive officer) have triggered many of the concerns voiced by members of Congress and state regulators. Probably no part of the private foundation tax return is more sought after by the media than the compensation schedules.

For most foundations, the compensation information is provided in separate attachments (or schedules). Prepare these attachments with care and make certain that the attachments fully reflect what is being paid or provided. In Part VIII, for each compensated officer, director, or trustee and for each of the five highest-paid employees, there must be a separate entry for compensation (salary or fee), contributions to employee benefit plans and deferred compensation, and "expense account, other allowances." The IRS instructions require that this last category include all taxable and nontaxable fringe benefits such as indemnification payments, club memberships, spousal travel, expense accounts, the employer portion of health, dental, and life insurance premiums plus the value of the personal (non-business) use of housing, automobiles or other assets owned or leased by the foundation.

For each of the positions previously noted, Part VIII also requires an estimate of time spent performing work for the foundation. Increasingly, the news media and regulators are looking more closely at the column entitled "Title and average hours per week devoted to position." As a result, accuracy here is important. The form calls for "hours per week," and the instructions say a "numerical estimate of the average hours per week devoted to the position is required for the answer to be considered complete." Moreover, the instructions state that phrases such as "as needed" or "as required" are unacceptable entries. Using "part time" as an answer also does not satisfy the requirement. Keep in mind that those reviewing the return are likely to take the hours devoted per week and the compensation paid and convert the amount to its equivalent for full time work.

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#6 – Loans to Officers or Directors. The practice of making loans to foundation board members or executives has attracted strong criticism in the media (note that some state laws may limit or prohibit such loans). All loans and similar financial arrangements (such as a salary advance) made to officers, directors, trustees, foundation managers, or other disqualified persons⁴ must be reported. A similar report must be made if the transaction is with a substantial contributor to the foundation or to family members of any of the persons mentioned above.

³ A *foundation manager* is defined in Code Section 4946(c) as an officer, director or trustee of a foundation (or a person having powers or responsibilities similar to those persons) and, with respect to any act or failure to act, any employee of the foundation having final authority or responsibility (either officially or effectively) with respect to such act or failure to act.

⁴ *Disqualified persons*, as defined in Code Section 4946, and include: foundation managers (see footnote 3), substantial contributors to the foundation and certain family members of these persons (spouses, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren). Most government officials also are disqualified persons.

If any such loans have been made, check to see that the appropriate schedule is attached and fully completed. Attaching the schedule is required; failure to provide all the required information makes the return incomplete. The following must be clearly spelled out for each separate loan or similar transaction:

- Borrower's name and title
- The original amount
- The balance due
- The date of the note
- The maturity date
- The repayment terms
- The interest rate
- The security provided by the borrower
- The purpose of the loan
- A description and the fair market value of the consideration furnished by the foundation (e.g., cash - \$1,000; or shares of XYZ common stock - \$9,000)

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#7 - Reporting Private Foundation Tax Violations. Since initial enactment in 1969, the private foundation rules and the Form 990-PF have been designed to have a significant self-regulation component. If violations of the tax rules have occurred during the year (whether intentional or inadvertent), the foundation is required to disclose the violation and take appropriate steps for correction. One example of an unintentional violation would be starting a scholarship program without realizing that the procedures must be approved in advance by the IRS. Filing the return is viewed by some foundations as a statement of accountability to the public providing a full and fair description of the affairs and activities of the foundation, and, to the extent that problems have been encountered, providing information to show that they have been corrected.

If a violation has occurred, the foundation may be required to file a Form 4720. Part VII-B of the Form 990-PF is entitled: "Statements Regarding Activities for Which Form 4720 May Be Required." Make appropriate inquiries to determine if any violations have occurred during the tax year. If so, the preparer must check the correct box in this Part and ensure that appropriate actions have been taken and file a Form 4720 if applicable.

A common error here is found in line 1a(4): "Did the foundation pay compensation to, or reimburse the expenses of, a disqualified person?" Preparers often check the "No" box; this entry would be incorrect, for example, if a salary is paid or travel expenses are reimbursed to a chief executive officer who is a disqualified person. However, reasonable compensation is an exception to the self-dealing rules enabling the preparer to check line 1b in the "No" column since the payments did not fail to qualify under an exception.

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#8 – Recovery of Amounts Previously Counted as Qualifying Distributions. On occasion, amounts paid out by a private foundation that count as qualifying distributions in meeting the 5-percent minimum distribution requirement are paid back. Examples include recoveries of part or all of a grant previously made; scholarship (or program related investment) loan repayments; or proceeds from the sale of property the cost of which was treated as a qualifying distribution when the property was acquired (such as computer equipment that had been used in charitable activities). When such amounts are paid back, they must be added to the regular 5-percent distribution calculation for that year. These amounts must be entered in Part XI, line 4a.

#9 – Changes in the Bylaws Should Be Acknowledged and Attached. If, during the year, the foundation made changes in its governing instruments such as its articles of incorporation, bylaws, or trust agreement, the instructions require that a “conformed” copy of the changes be attached. In addition, in the case of a change, check the “Yes” box in Part VII-A, line 3. A conformed copy is one that agrees with the original document and all its amendments. Include a written declaration signed by an officer authorized to sign for the foundation, certifying that the attachment is a complete and accurate copy of the original document.

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#10 – Information on Grant Guidelines Should Be Thorough. Many individuals or charitable organizations who review a private foundation’s tax return are looking for information that will let them know whether it makes sense to submit a grant request to the foundation. The return calls for information about grantmaking in Part XV, line 2. While there is ample opportunity to provide this information, some preparers instead provide only a limited summary of the foundation’s grant guidelines. This approach may not serve the foundation well as it suggests that the foundation has decided not to communicate openly to the public about its grantmaking programs. On the contrary, it generally is considered a “best practice” for a foundation to provide a thorough explanation of its grantmaking guidelines: how to contact the foundation, the form preferred for applications, any submission deadlines, and any restrictions or limitations (types of grants, geographic areas preferred, etc.). Because the space available on the return is limited, many foundations add an attachment to the return that includes a complete copy of its grant guidelines and reference to its website, if it has one, where similar information may be reviewed and downloaded.

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The statements and conclusions that appear in this document represent and are based upon our best judgment regarding the application of federal income tax laws arising under the Internal Revenue Code, judicial decisions, administrative regulations, published rulings, tax form instructions and other tax authorities existing as of April 15, 2004. The statements and conclusions do not address any state, local, foreign, or other tax consequences and are not binding upon the Internal Revenue Service or the courts. There is no guarantee that the Internal Revenue Service will not successfully assert a contrary position. Furthermore, no assurance can be given that future legislative or administrative changes, on either a prospective or retroactive basis, would not adversely affect the accuracy of the statements and conclusions herein. PricewaterhouseCoopers LLP undertakes no responsibility to advise any party of any new developments in the application or interpretation of the federal income tax laws.