CHAPTER ONE

Tools, Concepts, Filing, and Reporting Requirements

Forms 990, 990-EZ, and 990-PF are designed to accomplish many purposes that go far beyond simply reporting to the Internal Revenue Service (referred to in this book as the IRS). The forms present myriad financial and programmatic information that allows federal and state regulators to scrutinize the activities of organizations qualifying for tax-exemption as public and private charities, civic and business leagues, labor unions, social clubs, and many other types of nonprofit organizations. Those that financially support nonprofits with their time and money, as well as those journalists and scholars who record and scrutinize their performance and impact on society, use the forms to gather information. It is, therefore, crucial that these annual returns be prepared, not only as a financial document, but also as a tool for communicating an organization's mission and accomplishment to the public.

Accurate and complete preparation of the forms should be given top priority as the forms enter the electronic age, accessible to one and all on the Internet. A copy of the forms must also be provided to anyone who asks and is willing to pay a modest fee. A nonprofit organization's public reporting responsibilities have entered another dimension and deserve careful attention. Chapters 2, 3, and 4 lead the reader through the forms line-by-line and give instructions and suggestions for preparing the forms. Even though they are classified as a tax-exempt organization, some nonprofits receive business income subject to the normal income tax. Chapter 5 considers the preparation of form 990-T, required to be filed to report business income, and presents ideas for maximizing deductions and minimizing the resulting tax liability. Lastly Chapter 6 reviews procedures and choices for informing the IRS of changes in an organization's activities and structure as it evolves and changes over the years.

In March 1997, the IRS contracted with the Urban Institute of Washington, D.C., to receive and place the forms for the years 1996 through 2001 on CD-ROM with the hope that Forms 990 would be made available on the Internet. In a coordinated effort, Philanthropic Resources, Inc. began in 1998 to digitize the information so that it can be sorted and searched. Information from prior 990s of some 40,000 public charities was originally entered (www.guidestar.org). The Guidestar site provides an abstract of information they glean from the forms and also posts the complete form.[1] The IRS is also studying an electronic filing system for 990s to eliminate the paperwork altogether and allow them to more effectively monitor exempts in a statistical and focused fashion.

In essence, and now in fact, the Forms 990 are public documents. Yet another reason for a tax-exempt organization to pay careful attention to completion of the forms is the requirement that copies of the three most recent years' returns must be given upon request to those who pay a modest fee. Between 1984 and 1997, an organization had to allow anyone who knocked on its door a look at its Forms 990 and 1023 or 1024 in its office. Since June 8, 1999, a copy of the forms must also be furnished to anyone willing to pay a fee as discussed in §1.2(a). Forms 990 are also used for a wide variety of state and local reporting purposes. In many states, an exempt organization can satisfy its annual filing requirement by furnishing a copy of Form 990 to the appropriate state authority. Many grant-making foundations request a copy of Form 990 in addition to or in lieu of audited financial statements, to verify an organization's fiscal activity. The open-records standards applicable in many states also require all financial reports and records be open to the public.

The Forms 990 illustrated in the appendices to Chapters 2 through 5 provide a wealth of information. An organization's basic financial information—revenues, expenses, assets, and liabilities—are classified into meaningful categories to allow the IRS to evaluate a nonprofit's ongoing qualification for federal tax exemption under Internal Revenue Code (IRC) §501 (hereinafter code section numbers are simply identified with the symbol "§"). The returns are also used by funders, state and federal regulators, journalists, and many other persons to evaluate the scope and type of a nonprofit's activity. Information pertaining to the accomplishment of the organization's mission is presented—how many persons are served, papers researched, reports completed, students enrolled, and the like. Extensive details are furnished for grants paid to support other organizations and disbursed as aid to the poor, sick, students, and others in need. For leagues, details regarding payments to members are provided. Details are furnished to reflect overall compensation for services, sales of assets, and loans (if any) to or from persons who run and control the organization. The program accomplishment reports should particularly be prepared with a view to presenting the organization to funders and other supporters. Some use the information to compare nonprofit organizations statistically.

A comprehensive survey of the federal tax rules pertaining to tax-exempt organizations of all sorts—charitable, business, social, and civic organizations—are contained in another of the author's books in the Wiley Nonprofit Series, *Tax Planning and Compliance for Tax-Exempt Organizations,* now in its third edition and supplemented annually for current developments and new forms. Citations to the *Tax Planning and Compliance* book can be found throughout this book for readers who want to study the issues in more depth.

A long list of questions on Forms 990 and 990-PF fish for failures to comply with the federal and, to some extent, state requirements for donor and member disclosures, mandatory payout, political and lobbying activity, transactions with nonexempt organizations, insider transactions, and more. In sum, the returns are designed to show that a nonprofit organization is entitled to maintain its tax-exempt status and also to provide a wealth of other information of interest to funders, constituents, and regulators. Readers might also find the annual tax compliance checklists for preparation of Forms 90, 990-PF, and 990-T provided in the *Tax Planning and Compliance* volume useful. They are designed to survey a wide range of tax issues, including state and payroll reporting requirements, satisfaction of the disclosure rules, and many other issues. The types of questions that can be answered with information on the forms follow:

- Do Parts III and VII of Form 990 and Parts IX-A, IX-B, and XV of Form 990-PF indicate the organization's activities focus on an exempt purpose?
- Do the fund-raising costs shown in Part I, line 15, and detailed in column (d) of Part II, Form 990, equal too high a percentage of the total expenses, indicating that the nonprofit fails the commensurate test?[2]
- Does column (b) of Part VII of Form 990 and Part XVI-A of Form 990-PF show a high percentage of unrelated business revenues in relation to the total revenues, indicating that the organization is devoted to business interests rather than exempt purposes?[3]
- Do payments in Part II, lines 24 through 30, Part V of Form 990 and Part I, lines 13 through 16, and Part VIII of Form 990-PF reflect high compensation payments to private individuals?[4]

- Is the amount a public charity reported on Schedule A, Part VI-A or B for lobbying expenditures excessive (private foundations can spend none and some nonprofits exempt in categories other than 501(c)(3) can spend an unlimited amount)?[5]
- Do a public charity's sources of support shown in Part IV of Schedule A indicate it receives 33⅓ percent of its support from the public so it continues to be classified as a public charity under 509(a)(1) or (a)(2)?[6]

It is extremely important by way of introduction to remind readers that tax-exempt organizations are taxpayers. Though certain types of revenues they collect may not be subject to income tax under §501(c), they are subject to all of the sections contained in the Internal Revenue Code and the tax rules imposed by the states in which they operate. Many of the problems nonprofits ask the author to solve stem from lack of awareness of this fact. Matters that deserve attention include federal payroll taxes, gift and estate taxes, donor and dues deductibility rules that impact persons who provide the revenues, and other federal issues, such as labor laws and employee retirement plans (Employee Retirement Income Security Act [ERISA] rules). Throughout this handbook, references to the author's *Tax Compliance* book are tied to points about which readers may benefit by a more thorough discussion.

Finally, representatives of federally tax-exempt organizations must also inform themselves of the wide variety of state and local tax compliance and filing requirements beyond the scope of this handbook to which the nonprofit may be subject. Due to the increasing globalization of activity fostered by the Internet, readers must pay close attention for new developments in this regard. Professional help should be sought; certified public accountant (CPA) and bar association referral services are available to recommend persons with nonprofit organization experience. For those organizations that cannot afford to pay, a nonprofit management assistance program can be found. Many civic-minded CPAs, lawyers, and businesspeople volunteer their time through local bar and CPA societies, the United Way, retired executive groups, and the like.

1.1 FIND OUT WHY THE NONPROFIT QUALIFIES FOR TAX EXEMPTION

Either Form 1023 or 1024 is filed to seek IRS recognition of tax exemption. Ideally, this application is filed before a Form 990 is due at the end of a newly created organization's first fiscal year closing. A nonprofit seeking to be classified under IRC §501(c)(3) as a charity does not qualify until it files Form 1023 for recognition. Once the IRS determines exemption is permitted, qualification is granted retroactive to date of formation. For other categories of tax-exempt organization, Form 1024 is filed. Submitting Form 990 for an organization that has not yet sought recognition of exemption will bring an IRS request that Form 1023 or 1024 be filed. The author recommends that tax return preparers review the application and any IRS correspondence pertaining to a nonprofit's qualification. For many reasons, it is important to know why the IRS granted exempt status. Forms 990, 990-EZ, and 990-PF ask each year, "Did the organization engage in any activity not previously reported to the IRS?" To identify revenues as related or unrelated to the nonprofit's mission necessitates an understanding of an entity's exempt functions. The starting point for evaluating whether a proposed program might in any way endanger the organization's exempt status is the rationale for their original qualification.

The world of tax-exempt organizations includes a broad range of nonprofit institutions: churches, schools, charities, business leagues, political parties, schools, country clubs, and united giving campaigns conducting a wide variety of pursuits intended to serve the public good. All exempt organizations share the common attribute of being organized for the advancement of a group of persons, rather than particular individuals or businesses. Most exempt organizations are afforded special tax and legal status precisely because of the unselfish motivation behind their formation. The common thread running through the various types of exempt organizations is the lack of private ownership and profit motive. A broad definition of an *exempt organization* is "a nonprofit entity operated without self-interest to serve a societal or group mission that pays none of the income or profit to private individuals."

Federal and state governments view nonprofits as relieving their burdens and performing certain functions of government. Thus, many nonprofits are exempted from the levies that finance government, including income, sales, ad valorem, and other local property taxes. This special status recognizes the work they perform essentially on behalf of the government. In addition, for charitable nonprofits, labor unions, business leagues, and other types of exempt organizations, the tax deductibility of dues and donations paid to them further evidences the government's willingness to forgo money in their favor. At the same time, deductibility provides a major fund-raising tool. For complex reasons, some of which are not readily apparent, all nonprofits are not equal for tax deduction purposes, and not all "donations" are deductible.[7]

On the federal level, IRC §501 exempts 28 specific types of nonprofit organizations, as well as pension plans (IRC §401) from income tax. Although exempt organizations are often perceived as charitable, many other types of nonprofits are classified as tax-exempt under the federal income tax code. Labor unions, business leagues, community associations, cemeteries, employee benefit societies, social clubs, and many other types of organizations are listed in IRC §501. For purposes of federal tax exemption, each category has its own distinct set of criteria for qualification.[8]

1.2 FILING FORMS 990

The annual Forms 990 are submitted to a processing center devoted exclusively to exempt return filings. In 1997, the IRS centralized the filing of Forms 990-EZ, 990-PF, 990-T, 1041-A, 4720, 5227, 5578, and 5768 in the Ogden, Utah, Service Center. The centralization was planned to improve the speed and accuracy of return processing through a consolidation of expertise on exempt organization matters. In a similar fashion, the applications for recognition of initial qualification for tax-exempt status, Forms 1023 and 1024, are all filed with the Cincinnati, Ohio, Key District Office.[9] Examination of exempt organizations is the responsibility of the Dallas, Texas, Key District; technical advice and rulings continue to be issued by the Washington office.

The forms have evolved slowly over the years through cooperative efforts between the IRS, nonprofit organizations, the American Institute of Certified Public Accountants (AICPA), the American Bar Association (ABA), and state officials. Page 6 of Form 990, added by Congressional mandate, reveals the related and unrelated nature of an organization's revenues.[10] Part IV-A and B was added in response to Financial Accounting Standards Board (FASB) pronouncements in 1995. Although no major changes are expected in the near future, readers should always consult the current supplement to this book for new versions. The author has suggested redesign of Schedule A to contain one summary page that prompts attachment of detailed attachments only by those public charities to which they apply. Presently, a complete filing must contain all six pages, at least three of which are almost always inapplicable.

(a) Who Is Required to File What

The numerous categories of organizations exempt from income tax are reflected in the different types of returns to be filed. Not all organizations are required to file annual reports with the IRS. Churches, their affiliated organizations, and divisions of states or municipalities, in a manner similar to the Form 1023 rules, do not file Form 990, except for 990-T. Modest-sized organizations may also be excused from filing. The different types of exempt organization annual reports and their basic requirements are as follows:

- *No form filed*. Organizations with gross annual receipts "normally" under $25,000, churches and certain of their affiliates, and other types of organizations listed in §1.2(d) need not file; but see why to file below.

- *Form 990-EZ.* All exempt organizations, except for private foundations, whose gross annual receipts equal between $25,000 and $100,000 and whose total assets are less than $250,000 file Form 990-EZ.[11] (See Appendix 2A.)
- *Form 990.* All exempt organizations, except private foundations, whose gross annual receipts are more than $100,000 or that have assets of more than $250,000 must file Form 990. (See Appendix 2B.) Section 501(c)(3) organizations that are public charities also file Schedule A. (See Appendix 3A.)
- *Form 990-PF.* All private foundations (PFs) file Form 990-PF annually, regardless of annual receipts or asset levels (yes, even if the PF has no gross receipts). (See Appendix 4A.)
- *Form 990-T.* Any organization exempt under §501(a), including churches, state colleges and universities,[12] and §401 pension plans (including individual retirement accounts), with $1,000 or more gross income from an unrelated trade or business must file Form 990-T. (See Appendix 5A.)
- *Form 990-BL.* Black lung trusts, §501(c)(21), file an annual Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Persons.
- *Form 4720.* Form 4720 is filed to report excise taxes and to claim abatement of such taxes imposed on §501(c)(3) charities and their insiders for conducting prohibited activities. (See Appendix 4B.)
- *Form 5500.* One of several Forms 5500 may be due to be filed annually by pension, profit sharing, and other employee welfare plans. Form 5500-EZ is filed for one-participant pension benefit plans.
- *Form 5768.* The form filed to elect or revoke an election by a public charity to measure its permissible lobbying expenditures under §501(h).[13]
- *Forms 941, 1099, W-2, W-3, and other federal and state compensation reporting forms* are filed to report payments to workers that perform personal services for tax-exempt organizations.[14]

(b) Federal Filing Not Required

The list of organizations not required to file is reproduced each year in the instructions to Form 990. The most recent version should be consulted if there is any question about filing requirements. The instructions for 2000 list the following organizations as being excused from filing:

- Churches and their affiliates, a convention or association of churches, an integrated auxiliary of a church (such as a men's or women's society, religious school, mission society, or youth group) or an internally supported, church-controlled organization[15]
- Church-affiliated organizations that are exclusively engaged in managing funds or maintaining retirement programs and are described in Rev. Proc. 96-11, 1996-1 C.B. 577
- Schools below college level affiliated with a church or operated by a religious order
- Mission societies sponsored by or affiliated with one or more churches or church denominations, if more than half of the societies' activities are conducted in or directed at persons in foreign countries
- Exclusively religious activities of any religious order
- State institutions whose income is excluded from gross income under §115
- Section 501(c)(1) organizations that are instrumentalities of the United States and organized under an act of Congress[16]
- Governmental units and their affiliates granted exemption under §501(a)[17]
- Religious and apostolic organizations described in §501(d) that file Form 1065
- A limited liability company (LLC) or limited liability partnership (LLP) that elects to be treated as a disregarded entity the transactions of which are reported as the parent's information[18]

(c) Why File Even If Not Required To?

Annual filings of Form 990-EZ are advisable for organizations whose annual gross receipts are below the $25,000 mark to ensure that the organization remains on the IRS mailing list to receive the forms for annual filing and other announcements issued by the IRS every year or so. Particularly for a volunteer organization that changes treasurers each year it is useful to file to change the address as officers change. The amount of the gross receipts is input in Item K on Form 990-EZ without completing any other information. Prudence also dictates that any organization seeking donations should ensure that its name is listed in IRS Publication 78, the master list of qualifying charitable organizations. Omission from the list may cause two problems: disallowance of charitable contribution deduction to donors and unwillingness of private foundations or other donors to grant funds to the organization.

The extended 27-month deadline for submitting applications for recognition of exemption[19] creates a possible dual filing dilemma. A new nonprofit organization should file a Form 990 for the first fiscal year closing even if it has not yet filed Form 1023 or 1024 for recognition of its exempt status. Item F at the top left of page 1 of Form 990 is checked to indicate "exemption application is pending." When the new nonprofit has not yet filed an application for exemption so that it cannot say the application is pending, the IRS may reject the return.

Until exempt status is entered into the master data bank, the IRS expects the yet-to-be-determined exempt status organization to file Form 1120 or 1041. Even if the application for federal identification number lists the organization as a nonprofit, it is considered a taxpaying entity due to file income tax returns until the application for exemption is filed. When revenues in excess of expenses exist, tax is due to be paid even if the tax is ultimately recovered on an amended return. If income tax returns are filed, gross income received in the form of voluntary donations should be treated as nontaxable income because such donations are gifts.[20]

Whether to submit a protective filing for an expectant exempt organization that is not required to file Form 990 can also be a tough call. Say the new organization is technically not required to file a 990 because its gross revenue in the first year or two is less than $25,000 or it is a church or church affiliate. The issue is whether voluntary filing of a protective 1120 to start the statute of limitations colors the IRS's consideration of its exemption and whether this remote possibility outweighs the value of protection from tax assessments and reduction of penalties. The submission of financial information on a 1023 has been found not to constitute the filing of a return,[21] so penalties for late filing may not be excusable. An added dimension faces a new organization that may possibly be denied exempt status. Filing of Form 990 by a not-yet-recognized organization, in the good-faith belief that it qualifies as an exempt organization, starts the period of limitations for collection of income tax.[22] The time required to appeal an adverse determination can be years, so filing 990s may furnish valuable protection from tax assessments for an organization ultimately found not to be exempt. Such a filing may also provide a "reasonable cause" excuse to reduce or eliminate penalties for failure to file Forms 1120 or 1041 and pay the tax due.

The statute of limitations for assessment of the unrelated business income tax (UBIT) on Form 990-T starts to run when an organization submits a Form 990 that contains sufficient facts (shown in Part VII) from which the

UBIT can be determined.[23] Say, for example, an exempt organization lists an amount for affinity card revenues on its 990, Part VII, column D. The number is reported on line 103, labeled as royalty income, and identified in column C with the exclusion code 15 for "royalty income excluded by §512(b)(2)." Assume that, after years of fighting in court, the IRS prevails (actually it lost the battle) in treating part or all of the royalty payment as unrelated income.[24] If the revenue is clearly disclosed and identified, tax can be collected for only three years prior to the decision. Note that substantial underpayment penalties might be assessed for the open years.[25]

If recognition of exemption is received after the organization has been in existence for more than a year, treatment as a taxable entity may also occur on a state level. In Texas, for example, a new nonprofit corporation must either furnish evidence of the federal exemption or seek exemption within approximately 15 months of its creation, or pay a franchise tax. Otherwise, the charter is revoked. If tax is paid and the IRS subsequently issues recognition of exemption retroactive to the date of incorporation, the tax will be refunded.

(d) Filing Deadline

The due date for Forms 990 gives tax practitioners and exempt organizations a reprieve. The forms are due to be filed within 4½ months after the end of the organization's fiscal year, rather than the 2½ allowed for Form 1120 (for-profit corporations) and the 3½ months for Form 1041 (trusts). An extension of time can be requested if the organization has not completed its year-end accounting soon enough to timely file. The new extension Form 8868 has been issued for 2000 returns and is shown in Appendix 1A. For Forms 990-T and 990-PF, an extension of time to file does not extend the time to pay the tax.

The penalty for late filing is $20 a day (up from $10) for organizations with gross receipts under $1 million a year, not to exceed the greater of $10,000 or 5 percent of the annual gross receipts for the year of late filing.[26] The penalty can also be imposed if the form is incomplete as filed. The penalty for a large organization (more than $1 million of annual gross receipts) is $100 a day up to a maximum penalty of $50,000.

(e) Group Returns and Annual Affidavit

The parent organization in "general supervision or control" of a group of subsidiary exempt organizations covered by a group exemption letter may assume the burden of filing a consolidated Form 990 for its subordinate organizations or require each subordinate file its own return.[27] The parent files its own separate 990. The parent and the subordinates must each file separate 990-Ts. To be included in a group Form 990, there must be two or more consenting subordinate member organizations with the following attributes:

- Affiliated with the central organization at the time its annual accounting period ends
- Subject to the central organization's general supervision or control
- Exempt from tax under a group exemption letter that is still in effect
- Use the same accounting period as the central organization

When the parent or controlling member of the group takes responsibility for filing a consolidated Form 990, each affiliate member covered by the group exemption must annually give written authority for its inclusion in the group return. A declaration, made under penalty of perjury, that the financial information to be combined into the group Form 990 is true and complete is included. An attachment showing the name, address, and employer identification number of included local organizations is attached to the group return. An affiliate choosing not to be included in the group return files a separate return and checks block H(c) on page 1 of Form 990. Each year, 90 days before the end of the fiscal year, the parent organization separately reports a current list of subsidiary organizations to the Ogden, Utah, Service Center.[28]

1.3 PUBLIC INSPECTION OF FORMS 990 AND 1023 OR 1024

An actual copy of Forms 990, 990-PF, or 990-EZ for the three most recent years and Form 1023 or 1024 must be given by tax-exempt organizations to anyone requesting one.[29] If the request is made in person at the organization's office, the copy must be provided immediately. In response to a written request, the copy must be mailed within 30 days. Between 1987 and 1997, the returns had to be made available for inspection in the organization's offices. The Regulations provide the following rules:

- An organization may charge $1 for the first page and 15 cents for each subsequent page.
- Payments must be accepted in cash, money orders, personal checks, or credit cards.
- Written requests can be transmitted by mail, electronic mail, facsimile, or private delivery service, or in person and must contain the address to which the copies can be mailed.

- Alternative methods an organization can use to make the forms widely available through electronic media instead of furnishing copies.

If the organization that charges a fee for copying receives a request containing no payment, it must, within seven days of receipt of the request, notify the requester of its prepayment policy and the amount due. If the copy charge exceeds $20 and prepayment is not required, the organization must obtain the requester's consent to the charge. An organization can satisfy its public inspection requirement by making its returns available on the Internet either through its own site or a database of other exempt organizations on another site. The forms will be considered widely available only if posted in the same format used by the IRS to post forms and publication on the IRS Web site. The site must contain instructions to enable the user to download and print the forms without charge.

If the exempt organization is the subject of a harassment campaign, the regulations contain procedures for applying to the key district office for relief. As an example, the regulation indicates the receipt of 200 requests following a national news report about the organization is not considered harassment. Receipt of 100 requests from known supporters of another organization opposed to the policies and positions the organization advocates are said to be disruptive to the organization's operations and to thereby constitute harassment.

An organization having more than one administrative office must have a copy available at each office where three or more full-time employees work. Service-providing facilities are not counted for this purpose if management functions are not performed there. A branch organization that does not file its own Form 990 because it is included in a group return must make the group return available.

A request to see a copy of the return can also be sent to the District Director of the Internal Revenue Service in the area in which the organization is located, or to the National Office of the IRS. Form 4506-A can also be used to request a copy of any return, and a photocopying fee will be imposed.

Up to a $10,000 penalty can be imposed against the person(s) responsible for a failure to disclose the returns. The penalty is $20 for each day the failure continues. An additional $10 per day, up to a maximum of $5,000, can also be imposed if the organization's manager(s) refuse to furnish the required information after a written request by the IRS. If more than one person is responsible, they are jointly and severally liable for the penalties.[30]

(a) Disclosures Not Required

The names and addresses of the organization's contributors are not subject to public inspection and can be omitted from the copy made available to the public, except for private foundations and political organizations. All other parts of the form, including officer and key employee compensation and Schedule A for public charities (except for major donor list attached for Part VII-A) must be disclosed. Forms 990-T and 1120-POL are considered nonpublic returns and need not be made available. Certain political organizations are now required to file Forms 990 that must be available for public inspection.

(b) Private Foundations

Prior to 2000, the annual return of a private foundation, Form 990-PF, was made available under a system dating from 1969 that differed from the other Form 990 rules in several respects. The foundation managers made the form open for inspection by any citizen at the principal office during regular business hours, on request made within 180 days after the date of publication of notice of its availability.[31] Effective March 13, 2000, private foundations are subject to the rules outlined above for Form 990 filers, with one important difference. Private foundations must disclose the names of their contributors and amounts donated. Effective for returns filed after March 13, 2000, a newspaper notice of availability is no longer required, though the state of New York continues the requirement in that state.

1.4 ACCOUNTING ISSUES

Good accounting is the key to successful preparation of federal information returns for a nonprofit organization.[32] The trick is to allocate and attribute revenues and expenses to the proper lines and columns on Forms 990. Both for those organizations that want to properly reflect activity costs and those that want to maximize deductions to offset unrelated business income,[33] proper identification of allocable expenses is an important goal. The functional expense display found on page 2 of Form 990 is the same as the reporting prescribed by generally accepted accounting standards. Three types of expenses are reported: program, administrative, and fund-raising. The Better Business Bureau, National Center for Nonprofit Boards, regulatory agencies, and funders generally recommend that the sum of an organization's administrative and fund-raising costs equals no more than 25 percent of total expenditures. Thus the desired proportion for spending on programs and mission-related activities is 75 percent. The total for each type of expense is shown on page 1, lines 13, 14, and 15, and in detail on page 2, Part II, making it easy for viewers to calculate the ratios.

Documentation and cost accounting records must be designed to capture revenues and costs by function, including joint cost allocations. When expenses are attributable to more than one function, organizations must develop techniques to have verifiable bases upon which expenses may be related to program or supporting service functions. The functional classification of expenses permits an organization to tell the reader of the financial statements not only the nature of its expenses, such as salary, supplies, and occupancy, but also the purpose for which they were made. At a minimum, all 990 filing organizations need to maintain the following:

- A staff salary allocation system is essential for recording the time employees spend on tasks each day. The possibilities are endless. Each staff member should maintain an individual computer database or fill out a time sheet. The reports should be completed often enough to ensure accuracy, preferably weekly. In some cases, as when personnel perform repetitive tasks, preparing one week's report for each month or one month each year might be sufficient. Percentages of time spent on various functions can then be tabulated and used for accounting allocations.
- Office/program space utilization charts to assign occupancy costs can be prepared. All physical building space rented or owned must be allocated according to its usage. Floor plans must be tabulated to arrive at square footage of the space allocable to each activity center. In some cases, the allocation is made by using staff/time ratios, or the converse. For dual-use space, records must reflect the number of hours or days the space is used for each purpose.
- Direct program or activity costs should be captured whenever possible. The advantages include reduction of unrelated business income, proof of qualifying distributions for a private foundation, and insurance against an IRS challenge for low program expenditures. A minimal amount of additional time should be required by administrative staff to accumulate costs by programs. A departmental accounting system is imperative. Some long-distance telephone companies will assist in developing a coding system that quantifies the phone charges by department. As another example, the organization can establish separate accounts with vendors for different departments.
- Joint project allocations must be made on a reasonable and fair basis recognizing the cause-and-effect relationship between the cost incurred and where it is allocated. Four possible methods of allocating include: activity-based allocations (identifying departmental costs);

equal sharing of costs (e.g., if three projects, divide by three); cost allocated relative to standalone cost (e.g., what it would cost if that department had to hire and buy independently); and cost allocated in proportion to cost savings.[34]

- Supporting, administrative, or other management costs should be allocated to departments to which the work is directly related. The organization's size and the scope of administrative staff involvement in actual programs determine the feasibility of such cost attributions. Staff salaries are most often allocable. Say, for example, that the executive director is also the editor of the organization's journal. If a record of time spent is maintained, his or her salary and associated costs could be attributed partly to the publication. When allocating expenses to unrelated business income, an exploitation of exempt functions rule may apply to limit such an allocation.[35]
- A computer-based fund accounting system, in which department codes are automatically recorded as moneys are expended, is preferable. The cost of the software is easily recouped in staff time saved, improved planning, and possibly tax savings due to a reduction in income and excise taxes.

(a) Tax Accounting Methods

Plainly and simply, the instructions for Forms 990 say that an organization should generally use the same accounting method on the return to figure revenue and expenses as it regularly uses to keep its books and records.[36] So long as the method clearly reflects income, either the cash or accrual method may be used. For its simplicity, many organizations use the cash method in their early years, meaning only the actual cash received and expended is reported as the financial activity for the year. What is called the *accrual method* reports transactions when a binding obligation to pay or receive occurs. As discussed below, a promise to make a donation is counted under the accrual method when a unconditional pledge is received. Similarly, an expense is recorded when the obligation to pay for the goods and services occurs, not when paid. There are a number of reasons, however, that a new nonprofit might instead select the accrual method.

Once an organization adopts either the cash or accrual method for 990 reporting purposes, it must file Form 3115 to change the method under procedures outlined in Chapter 6. A change from the cash to accrual method of accounting may need to be made, for example, by an organization that has, in its initial years or for whatever reason, not used the accrual method and chooses to begin to do so. Customarily, this situation arises when the organization engages a CPA to issue audited reports of its financial condition.

An organization that changes its method of reporting contributions and grants to comply with a change required by the FASB standards, however, is not required to file Form 3115.[37] The prior year effect of such a change is reported on line 20 of Part I of Form 990 and Part III of Form 990-PF, rather than on the beginning balance sheet. The many exempt organizations that adopted the new standards in 1996 and 1997 made significant changes in their financial reporting systems without permission.

The cash method of accounting must be used by public charities for purposes of calculating public support percentages under §170(b)(1)(A)(vi) and §509(a)(2) on Schedule A.[38] Private foundations must also tally the §4942 minimum distribution requirements on a cash basis.[39]

(b) Professional Accounting Standards

The FASB issues the rules followed by CPAs in presenting financial information. The standards are referred to as generally accepted accounting principles (GAAP). Though an organization is not required to follow GAAP, the accountant's report must take exception in the covering opinion, or say, if the information is not presented according to GAAP. It is said that a "clean" accountant's opinion can be issued only for financials prepared according to GAAP. Thus, many nonprofit organizations apply these rules in maintaining and reporting financial information. The FASB continually studies and improves financial reporting by nonprofit organizations, and readers should be alert for changes. The rules are found in the periodically updated AICPA Audit and Accounting Guide for Not-For-Profit Organizations.[40] A brief introduction to the accounting concepts follows.

Financial Accounting Standards Board Statement (SFAS) No. 116, Accounting for Contributions Received and Contributions Made, affects the manner in which contributions are to be reported on GAAP financial statements. This Statement of Financial Accounting Standards (SFAS) defines a contribution as "an unconditional transfer of cash or other assets to an entity, or as a settlement or cancellation of its liabilities in a voluntary non-reciprocal transfer by another entity acting as other than an owner." The FASB further provides that the following inflows of assets are not included in the definition of contributions:

- Transfers that are exchange transactions, in which both parties receive goods or services of commensurate value

- Transfers in which the organization is acting as an agent, trustee, or intermediary for the donor (i.e., the organization has little or no discretion concerning the use of the assets transferred)
- Tax exemptions, tax incentives, and tax abatements

Contributions received in the form of charitable pledges are included in revenue when the pledge is unconditionally made or promised, rather than when paid in cash or other assets. A condition is a future and uncertain event. Thus, a pledge to match funding the organization raises from others is conditional and not reported until the matching gifts have been received. For the value of a pledge to be reported, there must be "sufficient evidence in the form of verifiable documentation that a promise was made and received." Restricted and unrestricted gifts of all kinds and in whatever form—cash, securities, other property, or in-kind—are subject to reporting as current revenue under this rule. Factors indicating a bookable pledge are compared in the following list to those indicating the gift is conditional and therefore not recordable (noted in parenthesis):

- Written evidence exists (no written promise made).
- Documents contain language such as *promise*, *agree*, *will*, or *binding* (no *hope*, *intend*, *may*, or *expect*).
- Pledge payments are scheduled for specific dates in the future (no specific payment dates indicated in documents).
- Donor's economic position indicates ability to pay pledged amount (collectibility of pledge is questionable).
- Donor has history of timely payment of pledged amounts (donor has no history).
- Donee has taken specific steps—signed contract to build the new building or sought matching pledges—in reliance on pledge (no action taken or obligation entered into as result of pledge).
- Pledge was made in response to solicitation of formal pledges (promise is unsolicited or funding request sought no pledge).
- Public recognition or announcement of pledge is made (no announcement).

Pledges of donations to be received beyond the current year are discounted by applying an appropriate rate of interest (return the organization is currently earning on its investments or cash reserves). The increase (called *accretion*) in the value of the pledge each year is reported as a donation in that year. An allowance for uncollectable pledges must be provided to cover the inevitable uncollectable pledge (and reflected as a reduction of the revenue, not as an expense).

Contributed services provided by volunteers are recognized as income for financial purposes (but not for tax purposes) if one of two conditions exists when the services are received:

- The services create or enhance nonfinancial assets (volunteers construct a building or set for a theater performance).
- Services are of a type that require specialized skills, are provided by individuals possessing those skills, and would typically have to be purchased if not provided by donations. SFAS No. 116 lists by example professions, such as doctors, lawyers, teachers, and carpenters.

Donated facilities produce recognizable income equal to the fair rental value of the facilities but not more than the organization would otherwise pay for its needed facilities. The present value of a binding multiyear lease is reported as income in the year the agreement is arranged. Again note that the value of such a donation is not reported as revenue on Form 990 or counted as support in calculating public charity status. In-kind donations of land, building, equipment, supplies, food, and other tangible property are recorded for both financial and tax reporting purposes. A testamentary bequest is recorded as income when the amount of the bequest can be accurately determined. A specific bequest of a certain amount or particular property is recorded when there is no uncertainty about its being subject to death taxes or other obligations of the decedent. The discounted present value of the organization's share of assets in a split-interest agreement is reported as a gift of current income in the year its ownership is made certain under the intention-to-give concepts defining unconditional gifts.

Increases or decreases in an organization's investment in an affiliated entity are reported on Part I, line 7 (990) as other investment income, or possibly on line 11 as other revenue, depending on the reason why the organization is holding the property. For tax purposes, affiliated but legally independent exempt organizations must each file their own Forms 990, except for members of an affiliated association holding a group exemption.

Contributions or grants paid out by the organization are recognized as an expense in the year the promise to pay is made, regardless of whether the cash or other asset is actually disbursed. Matching, conditional, or otherwise contingent promises to pay are booked at the time the uncertainty is removed because the condition is met.

SFAS No. 117, Financial Statements for Not-for-Profit Organizations, redesigned financial statement presentation and made obsolete the different systems previously prescribed for hospitals, colleges, health and welfare, and all other not-for-profit organizations. Donations received are identified as subject to one of three types of restrictions:

- *Permanently restricted net assets*, such as moneys to be used to pay scholarships only, an endowment fund from which only the dividends and interest may be used, and long-lived assets, such as buildings or collections.
- *Temporarily restricted net assets* funds given to accomplish a particular program service or to buy certain assets over a period of time.
- *Unrestricted net assets* will identify all other resources of the not-for-profit organization freely available for use in accomplishing the organization's purposes and subject only to the control of the organization's board or officers.

A *Statement of Activity* for all organizational funds and programs replaces the statement of financial position and results of operations, also called statement of revenues and expenses. The statement is designed to help donors, creditors, and others assess an organization's service efforts functionally. In other words, the total cost of major program services is reported along with separate amounts for supporting services (management, fund-raising, and membership development expenses). Additionally, health and welfare organizations report total expenses in their natural categories—personnel, occupancy, interest, grants to others, and so on. For hospitals and all other nonprofits, this report is encouraged but not required. Current earnings on all funds, including those permanently restricted, are to be reported on the statement of activity. Revenues subject to restrictions, such as capital gains on endowment funds, are separately identified but still reported as current earnings.

SFAS No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations, addresses the way in which nonprofit organizations account for equity securities, the value of which is readily determinable, and investments in debt securities. Investments in land, a partnership, a subsidiary corporation, or other investments are not addressed in this SFAS. Marketable equity and debt securities are reported at their fair market value. Such investments are initially reported at their acquisition cost (including brokerage and other transaction fees) if purchased and at fair value if they are received as donations or through an agency transaction. Changes in fair value of such investments are reflected in the statement of activity (income statement) as unrealized gain or loss and increase or decrease unrestricted net assets unless their use is temporarily or permanently restricted by donors to a specified purpose or future period. Such unrealized gains and losses are not recognized for tax purposes, but instead are reflected in Part I, line 20 (990), or Part III, line 3 or 5 (990-PF) as an item reconciling book to tax income. Consequently, the tax gain or loss reported upon sale or other disposition of such investments is different from that reflected for financial purposes. Similarly, the FASB permits investment revenues to be reported net of related expenses, such as custodial fees and investment advisory fees; such expenses are reported in Part II of Form 990.

SFAS No. 136, Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others, sets forth the rules for "agency transactions." A nonprofit is an agent when it accepts a donation with the obligation to pay the money to another entity. Such a payment is recorded as a liability, rather than revenue, by the agent. If the agent, or collecting organization, possesses a "variance power," or some discretion and control over the regranting of the gift, it recognizes the payment as revenue. Also, if it receives the money on behalf of a financially interrelated organization over which it has the ability to influence the operating and financial decisions, and in which it has an ongoing economic interest, it reports revenue. This rule was effective for years beginning after December 15, 1999.

Statement of Position 94-3, Reporting of Related Entities by Not-for-Profit Organizations, was proposed in February 1999 to be issued as an SFAS entitled *Consolidated Financial Statements: Purposes and Policy*. Combined financial reports must be issued for organizations with interlocking control and economic interests. Federal tax returns must, however, be filed independently for each separate organization. Form 990 cannot be prepared from or readily compared to such financial statements.

Statement of Position 98-2, Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising, provides standards for reporting money spent for materials and activities that combine fund-raising activities with educational or other elements. Direct mail, telethons, special events, and a variety of methods are used by nonprofits to concurrently raise money and advance the mission. An athletic contest for handicapped persons or a cancer-warning-signs brochure may embody requests for funding alongside the program content. Three rather complicated tests—purpose, audience, and content—are applied to determine whether any of the joint costs of such activities can be allocated to program or management, rather than all being treated as fund-raising costs. As described in the introduction to this section, allocation of expenses to the three functions displayed on page 2 of Form 990 (program, management, and fundraising) requires cost accounting systems that capture people's time, space, and expenses devoted to each function. To make a joint cost allocation, the content of written materials and audience solicited are examined to find the primary motivation for an activity. The FASB suggests a test that asks, "Does the program component of the joint activity call for specific action by the recipient that will help accomplish the organization's mission?"

Appendix 1A

The most recent version of this form is located at *www.wiley.com/go/blazek_990*.

Form **8868**
(December 2000)
Department of the Treasury
Internal Revenue Service

Application for Extension of Time To File an Exempt Organization Return

▶ File a separate application for each return.

OMB No. 1545-1709

- If you are filing for an **Automatic 3-Month Extension, complete only Part I** and check this box . . . . ▶ ☐
- If you are filing for an **Additional (not automatic) 3-Month Extension, complete only Part II** (on page 2 of this form).

Note: ***Do not complete Part II unless you have already been granted an automatic 3-month extension on a previously filed Form 8868.***

Part I **Automatic 3-Month Extension of Time—**Only submit original (no copies needed)

Note: ***Form 990-T corporations*** *requesting an automatic 6-month extension—check this box and complete Part I only* . . . ▶ ☐

All other corporations (including Form 990-C filers) must use Form 7004 to request an extension of time to file income tax returns. Partnerships, REMICs and trusts must use Form 8736 to request an extension of time to file Form 1065, 1066, or 1041.

Type or print File by the due date for filing your return. See instructions.	Name of Exempt Organization	**Employer identification number**
	Number, street, and room or suite no. If a P.O. box, see instructions.	
	City, town or post office, state, and ZIP code. For a foreign address, see instructions.	

Check type of return to be filed (file a separate application for each return):

☐ Form 990	☐ Form 990-T (corporation)	☐ Form 4720
☐ Form 990-BL	☐ Form 990-T (sec. 401(a) or 408(a) trust)	☐ Form 5227
☐ Form 990-EZ	☐ Form 990-T (trust other than above)	☐ Form 6069
☐ Form 990-PF	☐ Form 1041-A	☐ Form 8870

- If the organization does **not** have an office or place of business in the United States, check this box . . . . ▶ ☐
- If this is for a **Group Return,** enter the organization s four digit Group Exemption Number (GEN) ____________ . If this is for the **whole** group, check this box ▶ ☐ . If it is for part of the group, check this box ▶ ☐ and attach a list with the names and EINs of all members the extension will cover.

1 I request an automatic 3-month (6-month, for **990-T corporation**) extension of time until ____________ , 20 ___,
to file the exempt organization return for the organization named above. The extension is for the organization s return for:
▶ ☐ calendar year 20 ___ or
▶ ☐ tax year beginning ____________ , 20 ___, and ending ____________ , 20 ___.

2 If this tax year is for less than 12 months, check reason: ☐ Initial return ☐ Final return ☐ Change in accounting period

3a If this application is for Form 990-BL, 990-PF, 990-T, 4720, or 6069, enter the tentative tax, less any nonrefundable credits. See instructions . . . . $

b If this application is for Form 990-PF or 990-T, enter any refundable credits and estimated tax payments made. Include any prior year overpayment allowed as a credit . . . . $

c **Balance Due.** Subtract line 3b from line 3a. Include your payment with this form, or, if required, deposit with FTD coupon or, if required, by using EFTPS (Electronic Federal Tax Payment System). See instructions . . . . $

Signature and Verification

Under penalties of perjury, I declare that I have examined this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete, and that I am authorized to prepare this form.

Signature ▶ Title ▶ Date ▶

For Paperwork Reduction Act Notice, see Instruction Cat. No. 27916D Form **8868** (12-2000)

Form 8868 (12-2000) Page **2**

- If you are filing for an **Additional (not automatic) 3-Month Extension, complete only Part II** and check this box ▶ ☐

Note: ***Only complete Part II if you have already been granted an automatic 3-month extension on a previously filed Form 8868.***

- If you are filing for an **Automatic 3-Month Extension, complete only Part I** (on page 1).

Part II Additional (not automatic) 3-Month Extension of Time—Must File Original and One Copy.

Type or print File by the extended due date for filing the return. See instructions.	Name of Exempt Organization	**Employer identification number**
	Number, street, and room or suite no. If a P.O. box, see instructions.	For IRS use only
	City, town or post office, state, and ZIP code. For a foreign address, see instructions.	

Check type of return to be filed (File a separate application for each return):

☐ Form 990 ☐ Form 990-EZ ☐ Form 990-T (sec. 401(a) or 408(a) trust) ☐ Form 1041-A ☐ Form 5227 ☐ Form 8870
☐ Form 990-BL ☐ Form 990-PF ☐ Form 990-T (trust other than above) ☐ Form 4720 ☐ Form 6069

STOP: Do not complete Part II if you were not already granted an automatic 3-month extension on a previously filed Form 8868.

- If the organization does **not** have an office or place of business in the United States, check this box ▶ ☐
- If this is for a **Group Return,** enter the organization s four digit Group Exemption Number (GEN) ______ . If this is for the **whole** group, check this box ▶ ☐ . If it is for **part** of the group, check this box ▶ ☐ and attach a list with the names and EINs of all members the extension is for.

4 I request an additional 3-month extension of time until ______ , 20___.

5 For calendar year ______ , or other tax year beginning ______ , 20___ and ending ______ , 20___ .

6 If this tax year is for less than 12 months, check reason: ☐ Initial return ☐ Final return ☐ Change in accounting period

7 State in detail why you need the extension ______

8a If this application is for Form 990-BL, 990-PF, 990-T, 4720, or 6069, enter the tentative tax, less any nonrefundable credits. See instructions $ ______

b If this application is for Form 990-PF, 990-T, 4720, or 6069, enter any refundable credits and estimated tax payments made. Include any prior year overpayment allowed as a credit and any amount paid previously with Form 8868 $ ______

c **Balance Due.** Subtract line 8b from line 8a. Include your payment with this form, or, if required, deposit with FTD coupon or, if required, by using EFTPS (Electronic Federal Tax Payment System). See instructions $ ______

Signature and Verification

Under penalties of perjury, I declare that I have examined this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete, and that I am authorized to prepare this form.

Signature ▶ Title ▶ Date ▶

Notice to Applicant—To Be Completed by the IRS

☐ We **have** approved this application. Please attach this form to the organization s return.

☐ We **have not** approved this application. However, we have granted a 10-day grace period from the later of the date shown below or the due date of the organization s return (including any prior extensions). This grace period is considered to be a valid extension of time for elections otherwise required to be made on a timely return. Please attach this form to the organization s return.

☐ We **have not** approved this application. After considering the reasons stated in item 7, we cannot grant your request for an extension of time to file. We are not granting a 10-day grace period.

☐ We **cannot consider** this application because it was filed after the due date of the return for which an extension was requested.

☐ Other ______

Director By: ______ Date

Alternate Mailing Address — Enter the address if you want the copy of this application for an additional 3-month extension returned to an address different than the one entered above.

Type or print	**Name**
	Number and street (include suite, room, or apt. no.) Or a P.O. box number
	City or town, province or state, and country (including postal or ZIP code)

Form **8868** (12-2000)