THE 990-PF: HOW TO REAP SAVINGS AND AVOID PITFALLS

Know the Opportunities and Risks

Over the years, we have examined thousands of tax returns of private foundations, filed before becoming Foundation Source clients. What we have found is that many tax practitioners are unfamiliar with the nuances of the form, which is highly specialized. They therefore may miss important opportunities for the foundation and unknowingly subject the foundations to scrutiny.

MISSED OPPORTUNITIES FOR SAVINGS

- **Not counting administrative expenses:** Some preparers are under the misconception that only grants will satisfy a foundation's minimum distribution requirement (MDR). In fact, legitimate administrative expenses count toward the satisfaction of the MDR, and not counting them can cause a foundation to scramble, making hasty grants (and perhaps wasting funds) in order to avoid a shortfall penalty. A better understanding of qualifying expenses can maximize the funds available for planned, strategic grantmaking.

- **Not using investment-related expenses to offset investment income:** Frequently, return preparers fail to apply investment-related expenses to offset the investment income, resulting in a higher tax bill for the foundation.

- **Failing to determine eligibility for the reduced 1% tax rate:** After its formation year, a foundation may qualify to cut its excise tax liability in half, provided certain conditions are met. There is a section on the foundation's tax return where calculations are made to determine whether the foundation has met these conditions. However, preparers often fail to complete this part of the return altogether! (For more information on this topic, read *Lowering Foundation Excise Taxes*.)

Not counting legitimate administrative expenses toward the MDR can cause the foundation to scramble unnecessarily.

- **Failing to properly calculate excess grant carryover:** For any year in which a foundation grants significantly more than its MDR, the excess grants may be "banked" as grant carryover to help satisfy a future year's MDR. The carryovers expire if not applied toward the foundation's MDR within five years. When preparers calculate and apply carryovers incorrectly, **the damage isn't limited to a lost opportunity**. Miscalculations actually place the foundation's true MDR in doubt and create the false and dangerous impression that the foundation has satisfied its MDR when it has not. Correction may require filing several years' worth of amended returns.

COMMON PITFALLS

The 990-PF is a potential minefield for the unwary or inexperienced tax preparer. Here are just a few of the most common mistakes:

- **Failing to fully and properly complete the form:** There are several general errors commonly made by preparers. First, there are often inaccuracies reflecting assets on the balance sheet. In addition, the capital gain or loss on the sale of a donated asset is often improperly calculated due to a failure to apply the donor's carryover basis. Finally, many returns are submitted without mandatory attachments or schedules. These errors can cause confusion for an IRS reviewer or a miscalculation of the excise tax due, leading to additional penalties.

- **Calculating the MDR incorrectly:** Often, return preparers miscalculate the MDR, arriving at a figure much lower than the actual amount. If a foundation fails to meet its MDR in a given year, it will be required to file a penalty return, Form 4720, and will be subject to a 30% penalty on the shortfall amount. Moreover, if the penalty is assessed, the foundation will be ineligible to qualify for a reduced excise tax rate for five years.

- **Using the accrual method of accounting to show satisfaction of MDR:** Treasury Regulations mandate that even foundations using this common method of accounting for financial reporting purposes must use cash basis accounting to determine whether a foundation has met its MDR. Using the accrual method could lead to a 30% penalty and cause a foundation to become ineligible for the reduced excise tax rate for five years.

- **Failing to make estimated tax payments:** Larger foundations with even moderate investment income may be required to make quarterly estimated tax payments. Without proper guidance from their preparers, many foundations incur penalties for failure to make these interim payments on time—or at all.

- **Failing to track foundation insiders:** A private foundation is expected to keep track of all individuals and organizations that are considered insiders (technically, "disqualified persons"). Insiders, who include substantial contributors to the foundation, are prohibited from engaging in financial transactions with the foundation (sales, loans, leases, etc.). Engaging in them may result in a self-dealing violation and penalty. Any insider who engages in a self-dealing transaction is personally responsible for a 10% penalty, which may not be forgiven by the IRS even if inadvertent, well-intentioned, and beneficial to the foundation. Preparers often fail to report substantial contributors properly on the annual return and fail to keep track of who is a substantial contributor with respect to the foundation. As a result, a foundation's board or officers may not realize that certain individuals or companies are considered insiders with respect to the foundation and may permit the foundation to engage in forbidden transactions.

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AN OUNCE OF PREVENTION

If you'd like to maximize your client's foundation tax savings and minimize their exposure, consider recommending Foundation Source's services—and do so soon! If your client's foundation is under our management early in the year, we can ensure that any problems that may have occurred in prior years (or on prior returns) are corrected early, and opportunities that could have been taken advantage of in the past are not missed again. Please call us to discuss how we can help your client get the most from their foundation during tax season and on every other day of the year.

ABOUT FOUNDATION SOURCE

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Foundation Source is the nation's largest provider of comprehensive support services for private foundations. Our complete outsourced solution includes foundation creation (as needed), administrative support, active compliance monitoring, philanthropic advisory, tax and legal expertise, and online foundation management tools.

Now in our second decade, Foundation Source provides its services to more than 1,500 family, corporate, and professionally staffed foundations, of all sizes, nationwide. We work in partnership with wealth management firms, law firms, accounting firms, and family offices as well as directly with individuals and families. Foundation Source is headquartered in Fairfield, Connecticut.

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