G. FORM 990

by
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1. Introduction

Traditionally, the analysis of the Form 990, *Return of Organization Exempt from Income Tax*, has been the province of revenue agents, state auditors, and grant-making foundations. Changes in the disclosure rules under section 6104 and the publication of returns on the Internet widely expanded the potential users of Form 990 information. For many years, an interested person had to request a copy of the Form from the Internal Revenue Service. In order to facilitate access, Congress enacted parallel rules requiring disclosures directly by tax-exempt organizations. Obtaining information from an organization had potential drawbacks if a requestor and the organization were not on friendly terms. Despite the requirements of the law, some organizations simply refused to allow access to their returns. But all of that has changed with the universal availability of the Internet. Now any interested person can have instant access to the Form 990 for any 501(c)(3) organization via computer.

Several things must happen in order for this increased disclosure of Form 990 to be of maximum benefit to the public. First, the information entered on Form 990 must become more standardized and reliable. Second, potential users of the data must become more familiar with the requirements for proper completion of the return so that they will understand the data they are viewing. The Service itself will benefit if these things occur. Public disclosure promotes accountability and discourages inappropriate activities which, in turn, enhances voluntary compliance and thereby assists the IRS in the administration of the tax law.

The purpose of this article is to address both needs. Both Form 990 filers and Form 990 users should find it helpful. This article is not intended to be a line by line analysis of the form, but rather, in part, a discussion of the more common errors that are made and an explanation of the reasons for some of the information requested.

2. History and Development

Form 990 has been around for more than 50 years. The first 990 was filed for tax years ending in 1941. This comparatively simple two page form included only three yes/no questions, an income statement, and a balance sheet, although some line items required attached schedules. For example, individuals paid a salary of $4,000 or more were required to be listed on a schedule showing their name, address and amount paid. Similarly, contributions exceeding $4,000 received from any one person were required to be itemized.

By 1947, the form (including instructions) had reached four pages, although some portions applied only to certain types of organizations such as farmers' cooperatives. The required financial information was far more extensive than that of the first 990. Although the income statement now contained a separate line item for compensation of officers, the requirement of a separate schedule for the "highly compensated" seems to have vanished. The requirement for a list of large contributors remained, but the reporting threshold for individual contributions was reduced to $3000. By this time, a group return procedure had also been implemented. The early returns were continuous use forms; a new form was not published each year.

For 1976, the Form 990 itself consisted of two pages plus three and one-half pages of instructions. Schedule A consisted of four pages plus four pages of instructions. Now (as of 2000) the form is up to six pages for the 990 itself, six pages for Schedule A, at least two pages for Schedule B (including instructions), and a separate 42 page instruction book.

Although the increase in the length of the form appears quite dramatic, a closer look does not show that the return requires a requisite increase in reporting. Some portion of the increase is due to the use of noticeably larger print in the current form. Some changes are intended to address specific concerns and apply only to certain organizations. For example, the liabilities portion of the balance sheet has one additional line to accommodate the separate reporting of tax exempt bonds. To be sure, there are also items that, in 1976, were required only of Schedule A filers (501(c)(3) organizations) that are now required of all 990 filers. On balance, however, the amount of increased reporting is modest considering the increase in the complexity of new law that became applicable to exempt organizations during the same period.

3. Filing Requirements

A. General Rule

Filing requirements for exempt organizations are set forth in I.R.C. 6033(a)(1). Unless specifically excused, all 501(c) organizations (or organizations treated as if they were 501(c) organizations) must file an annual information return

> *stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the internal revenue laws as the Secretary may by forms or regulations prescribe.*

Nonexempt charitable trusts described in I.R.C. 4947(a)(1) and nonexempt private foundations are, pursuant to I.R.C. 6033(d), treated as 501(c)(3) organizations for purposes of the filing requirements.

On July 1, 2000, Pub. L. 106-230 was enacted. The new legislation contained a number of provisions relating to reporting by I.R.C. 527 political organizations. Of relevance to this article was the decision, by Congress, to require political organizations to file Forms 990. The filing requirement applies to all tax years beginning after June 30, 2000.

The filing requirement applies to I.R.C. 527 organizations that are required to file a Form 1120-POL under I.R.C. 6012(a)(6). These are political organizations that have more than $100 in political organization taxable income or political organizations that have more than $25,000 in gross receipts without regard to whether they have such taxable income.

In addition to the general filing requirement of I.R.C. 6033(a), Congress has mandated the submission of certain specific items of information by 501(c)(3) organizations. These items are listed in I.R.C. 6033(b). For example, I.R.C. 6033(b)(8)(A) requires organizations that have made an I.R.C. 501(h) election to file specific information with respect to lobbying expenditures as defined in I.R.C. 4911.

If a required return is not filed, I.R.C. 6652(c) imposes a penalty of $20 per day until the return is filed. This penalty also applies to failure to include any of the information required to be shown on a return filed under section 6033 or to show the correct information. The maximum penalty with respect to any one return may not exceed the lesser of $10,000 or 5 percent of the gross receipts of the organization for the year. If the organization's gross receipts exceed $1,000,000, the penalty is $100 per day, not to exceed $50,000. If the Service contacts the organization and the return is not filed by the date specified, a $10 per day penalty may be imposed on any manager of the organization failing to comply. The maximum penalty imposed on all persons for failures with respect to any one return shall not exceed $5,000.

Rev. Rul. 77-162, 1977-1 C.B. 400, provides that an organization that omits material information from its Form 990, and neither supplies the information when requested nor establishes reasonable cause for the omission, has failed to file a return for purposes both of the penalties imposed by I.R.C. 6652(d)(1) and the statute of limitations under I.R.C. 6501(c)(3). What is reasonable cause? Generally, reliance upon a knowledgeable professional such as a CPA or attorney is considered reasonable cause if the organization furnishes the professional with all the necessary information.

For 1998, the most recent year for which complete information is available, penalties were assessed and paid on 9,216 returns. The total dollar amount collected was $10,680,269.

B. Organizations not required to file

Under I.R.C. 6033 there exceptions to the general requirement that an information return be filed. Generally speaking, there are mandatory exceptions and authority for the Service to excuse organizations from filing on a showing that "such filing is not necessary to the efficient administration of the revenue laws." Over the years, the discretionary authority has been exercised a number of times to excuse classes of organizations from filing.

Organizations not required to file (either because they are mandatorily excepted or because they belong to a class excused from filing) are:

1. Churches, interchurch organizations, conventions or associations of churches, integrated auxiliaries of a church (such as men's or women's organizations, religious schools or mission societies);

2. Church-affiliated organizations that are exclusively engaged in managing funds or maintaining retirement programs. (These organizations are described in Rev. Proc. 96-10, C.B. 1966-1 C.B. 577.);

3. A school below college level affiliated with a church or operated by a religious order;

4. A missionary society sponsored by, or affiliated with one or more churches or church denominations, if more half of the society's activities are conducted in, or directed at foreign countries;

5. An exclusively religious activity of a religious order;

6. A state institution whose income is excluded from gross income under I.R.C. 115;

7. An organization described under I.R.C. 501(c)(1);

8. Organizations, such as private foundations that file a form 990-PF or a black lung benefit trust that file an information return in the 990 series other than the Form 990 itself;

9. A religious or apostolic organization described in I.R.C. 501(d);

10. A foreign organization whose annual gross receipts from sources within the U.S. are $25,000 or less;

11. A governmental unit or affiliate of a governmental unit (Certain organizations, such as some state hospitals, might otherwise have Form 990 filing requirements).;

12. Organizations whose annual gross receipts are normally $25,000 or less.

C. Consequences of not filing

The statute of limitations for assessment of tax is generally three years from the date the return is filed; see I.R.C. 6501(a). I.R.C. 6501(c)(3) states explicitly that if no return is filed, tax may be assessed at any time. Thus, if no return is filed, and even though no return is required, the taxpayer is unprotected because the statute of limitations never begins to run. See G.C.M. 34223, *Southern Maryland Agricultural Fair Association v. Commissioner*, 40 B.T.A. 549 (1939), and *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957).

Theoretically, the filing of Form 990 may be sufficient to begin running the statute of limitations for Form 990-T, *Exempt Organization Business Income Tax Return*, under certain circumstances. If the taxpayer discloses sufficient facts on Form 990 (filed in good faith within the meaning of I.R.C. 6501(g)(2)) to apprise the Service of the potential existence of unrelated business taxable income, then the statute of limitations will begin to run. The return must state the nature of the income-producing activity with sufficient specificity to enable the Service to determine whether the income is from an activity related to the organization's exempt purpose. In addition, the return must disclose the gross receipts from this activity. See Rev. Rul. 69-247, 1969-1 C.B. 303 and *California Thoroughbred Breeders Association v. Commissioner*, 47 T.C. 335 (1966). Ever since that case was decided, Form 990 has a specific line item designed to insure that the statute cannot run unless there is an unrelated business income tax liability and a Form 990-T has been filed. Line 78(b) asks whether, if an organization has an unrelated trade or business income liability, a Form 990-T has been filed. If an organization has such a liability, still answers yes to the question and has not filed the return, the statute won't run. The rationale would be that the organization would have provided an inaccurate answer to the question. Similarly, if in response to the first part of the question the organization states that it had no unrelated business gross income, the statute would not begin to run.

Another possible adverse consequence of not filing, with respect to organizations eligible for tax-deductible contributions, is the risk of being dropped from Publication 78, *Cumulative List of Organizations*. If an organization appears on the Business Master File with a Form 990 filing requirement, yet does not file, it will be contacted by the Service Center. If it does not respond, it will eventually be dropped from Pub. 78. The organization should respond by filing a return and checking the box indicating it is not required to file. The Business Master File (BMF) will be changed to show that the organization is not required to file and the organization will continue to appear in Pub. 78.

D. Relationship with State Filing Requirements

Thirty-seven states and some local governments now accept Form 990 or 990EZ in satisfaction of their filing or registration requirements. I.R.C. 501(c)(3) organizations should note that if they file returns with the Service containing attachments that the Service does not require, the attachments will be scanned and made publicly available even though they were not required to be filed.

Because of this widespread use of Form 990, the Service works closely with state officials when making changes to the form. For example, while the Service is concerned with the accuracy of all items reported, state regulators have a particular interest in the accuracy of fundraising costs. The recent changes in the instructions for Part I, line 1a (reporting contributions at gross, not net of fundraising expenses) to emphasize accurate reporting were a particular interests of state officials.

4. Disclosure

In general, Forms 990 and 990-EZ, including Schedule A and certain information on Schedule B, must be available for public inspection. This does not include nondisclosable contributor information. These disclosure requirements were discussed in detail in Topic O of the FY 2000 CPE text. Schedule B is moving toward a situation where all of the nondisclosable contribution information required by Form 990 can be filed on Schedule B and easily removed before the return is made public. This is still a work in process. Schedule B (at least with respect to non-I.R.C. 6104(d) contributor information) is open to public inspection for section 527 political organizations completely.

Possibly one of the most important events in the disclosure arena has been the creation of websites providing PDF images of Forms 990, 990-EZ, and 990-PF. These include www.grantsmart.com and www.guidestar.org. Many organizations post their returns on their own websites. Some states are also providing significant online resources. For example, Minnesota provides access to a database of financial information on more than one million organizations that have registered to solicit contributions in that state.

5. GAAP for Nonprofits

Much of the confusion and controversy dealing with Form 990 stems from conflicts between the requirements of the IRS and other regulators and generally accepted accounting principles, or GAAP. For example, GAAP requires accounting for volunteer labor. Yet, as will be discussed in greater detail below, contributions reported on line 1 of Form 990 should not include the value of volunteer labor.

What is GAAP? Where does it come from? Why does it matter? A complete answer to these questions is beyond the scope of this article. Briefly, GAAP refers to "published pronouncements by the American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB), and to general usage by organizations similar to the one being audited." (*Financial and Accounting Guide for Not-For-Profit Organizations,* by Gross, Warshauer, & Larkin)

The Service does not require that Form 990 be completed according to GAAP, or that exempt organizations have audited financial statements. In fact, some Service requirements, such as the use of cash basis accounting for the public support test, are in direct conflict with GAAP. Other users of financial information such as state regulators, lenders, and grant-making organizations often do require compliance with GAAP. Thus, an exempt organization may have some difficulty in complying with these varying requirements. At various points in Form 990, an effort has been made to enable exempt organizations to more easily reconcile the differences between GAAP and the tax laws. There is also a movement to use Form 990 to satisfy multiple filing requirements, such as state filings.

6. Detailed Discussion of Form 990

A. Overview of Quality of Filings

It is widely acknowledged that many Forms 990 contain significant errors or omissions. In this era of mass availability, leaders in the nonprofit community have redoubled their efforts to improve the quality of information reported on Forms 990.

A 1998 study reported in the *Chronicle of Philanthropy* and summarized at the Quality 990 website (www.qual990.org) stated that 52% of Forms 990 containing errors failed to complete Schedule A. 17% did not have the signature of an officer. 10% did not list the correct tax year. Similar errors appeared on Forms 990-EZ. In addition, 15% of Form 990-EZ filers should have filed Form 990.

Another recent study by the Philanthropic Research Institute and also summarized at the website identified in the preceding paragraph reported several types of errors in a sample of 1,794 990s. About 20% contained arithmetic errors. Approximately 30% failed to state their primary exempt purpose in Part III. Many reported income net of related expenses. Compensation was incorrectly reported in many cases.

These findings are based on an analysis of returns accepted for filing and subsequently made available to the public. Even before returns are accepted for filing, they are screened and an effort is made to perfect them. In that process, Service personnel report that the single most common error on Forms 990 as filed is an EIN -- name control mismatch. That is, the EIN and the name on the return do not match the

information on the Business Master File (BMF). The BMF only records the name that an organization uses on its application for exemption. Mismatches often occur because organizations file Form 990 using an acronym or d/b/a (doing business as) name that does not appear on the BMF. The Service Center attempts to deal with this issue by corresponding with organizations.

B. Part I – Revenue, Expenses, and Changes in Net Assets

(1) Part I, lines 1-12, Revenue

Part I **Revenue, Expenses, and Changes in Net Assets or Fund Balances** (See Specific Instructions on page 16.)

Revenue	1	Contributions, gifts, grants, and similar amounts received:			
	a	Direct public support	1a		
	b	Indirect public support	1b		
	c	Government contributions (grants)	1c		
	d	**Total** (add lines 1a through 1c) (cash $ _____ noncash $ _____)		1d	
	2	Program service revenue including government fees and contracts (from Part VII, line 93)		2	
	3	Membership dues and assessments		3	
	4	Interest on savings and temporary cash investments		4	
	5	Dividends and interest from securities		5	
	6a	Gross rents	6a		
	b	Less: rental expenses	6b		
	c	Net rental income or (loss) (subtract line 6b from line 6a)		6c	
	7	Other investment income (describe ▶)		7	
	8a	Gross amount from sales of assets other than inventory — (A) Securities / (B) Other	8a		
	b	Less: cost or other basis and sales expenses	8b		
	c	Gain or (loss) (attach schedule)	8c		
	d	Net gain or (loss) (combine line 8c, columns (A) and (B))		8d	
	9	Special events and activities (attach schedule)			
	a	Gross revenue (not including $ _____ of contributions reported on line 1a)	9a		
	b	Less: direct expenses other than fundraising expenses	9b		
	c	Net income or (loss) from special events (subtract line 9b from line 9a)		9c	
	10a	Gross sales of inventory, less returns and allowances	10a		
	b	Less: cost of goods sold	10b		
	c	Gross profit or (loss) from sales of inventory (attach schedule) (subtract line 10b from line 10a)		10c	
	11	Other revenue (from Part VII, line 103)		11	
	12	**Total revenue** (add lines 1d, 2, 3, 4, 5, 6c, 7, 8d, 9c, 10c, and 11)		12	

This is the portion of Part I on which organizations report revenues. The line items detail specific forms of revenue. For example, line 2 asks for program service revenue; line 5 asks for dividends and interest from securities and line 9(a) asks for gross revenue from special events. Line 9(a) makes it clear that when contribution income in received in a special event it is reported on line 1(a) that asks for contribution income. Sometimes a buyer intentionally pays more for an item than its fair market value because he or she wishes to make a gift. For example, a buyer may intentionally purchase a ticket to a charitable banquet for far more than the dinner's value. The amount received in excess of the value is a contribution and is reported on line 1(a). That part of the payment that equals the fair market value of the banquet is reported on line 9(a).

One of the most common errors made in this section is with respect to the reporting of contributions. Contributions received should be reported on line 1a, 1b, or 1c (depending on the source) at the gross amount received. Fundraising expenses are not subtracted. When an organization hires a professional fundraiser, it should report, in line 1(a), the entire amount of a gift solicited in its name by the fundraiser. It should not report a net figure after the fundraiser subtracts a fee (even though the organization receives only the net amount). Users of Form 990 should be aware that this is a common error that may make it difficult to fairly judge the effectiveness of an organization's fundraising efforts or the percentage of funds raised actually used to further the organization's exempt purposes.

Another persistent source of confusion is the proper classification of Medicare and Medicaid revenues. Although these amounts are received from government agencies, they are not government grants. They are payments for services provided to specific individuals and are therefore properly classified as program service revenue and reported on line 2. Furthermore, because patients choose their medical providers and thus direct who will receive the payments, the individual patients are considered the payors for purposes of the public support test. See Rev. Rul. 83-153, 1983-2 C.B. 48.

The Form 990 instructions explain in some detail how to distinguish between dues (reported on line 3) and contributions (reported on line 1a). Dues and assessments received that compare reasonably with membership benefits available are reported on line 3. Such benefits can include subscriptions to publications or discounts on goods or services, but do not include intangible benefits, such as the right to vote or hold office. Organizations described in I.R.C. 501(c)(5), (6), or (7) generally provide benefits that have a reasonable relationship to dues, although benefits to members may be indirect. These benefits could include representation services, lobbying, or social activities.

On the other hand, if a member pays dues mainly to support the organization's activities and not to obtain benefits of more than nominal monetary value, those dues are properly reported as a contribution on line 1a. The same is true of that portion of dues exceeding the value of goods or services provided in return.

However, the instructions do not discuss distinguishing dues from other types of income, such as program service revenue (properly reported on line 2) or income from special events (properly reported on line 9a). Reg. 1.509(a)-3(h)(1) provides a useful explanation of the difference. If an organization uses "membership fees" as a means of selling admissions, merchandise, services, or the use of facilities to members of the general public who have no *common goal or interest* (other than the desire to purchase these items), then the income from these fees is not membership fees. [emphasis added] Furthermore, the common sense meaning of the word "member" implies an ongoing relationship between the individual and the organization, not a discrete transaction. The correct classification of this income will depend on the facts and circumstances

surrounding the transaction, including the exempt purpose of the organization involved. Consider the following examples:

Example (1)

The Main Street Jazz Society is a 501(c)(3) organization whose purpose is the promotion and preservation of jazz as an art form. Membership dues are $50 per person per year. In return, members receive the Society's newsletter and tickets to the Society's annual concert series. The fee paid as dues approximates the retail price of the six concerts, less a ten percent discount. Tickets are also sold directly to the general public. Under these circumstances, the fees paid by members as dues would be properly reported on line 3 as membership dues.

Example (2)

Consider the same facts as in Example (1), except that the Society also sells "sustaining memberships" for $100 per year. Purchasers of such memberships receive no additional benefits, except that their names are listed in the concert programs. Under these facts, the $50 above the regular membership fee would be properly reported as contributions on line 1a.

Example (3)

The Main Street Preservation Association is a 501(c)(3) organization whose purpose is the preservation of an historic area of a city. Annually, it puts on a jazz concert to raise funds for its preservation activities. Tickets are sold to the general public. On the ticket, a portion of the ticket price is designated as "membership." However, these "members" have no other contact with the association, and the association has no record of their names. Income from an activity of this nature is properly reported on line 9a as income from special events. No portion of the ticket price should be reported as dues or contributions.

Many organizations collect dues, insurance premiums, or other amounts which are then paid over to another organization. As long as the collecting organization has no right to use the funds for itself, and the recipient reports the funds on its Form 990, the collecting organization should not report these amounts on its Form 990. Furthermore, such amounts are not "gross receipts" for purposes of determining whether an organization is required to file Form 990. See Rev. Rul. 73-364, 1973-2 C. B. 393.

One area of conflict between GAAP and Form 990 requirements, as noted earlier, is in reporting contributions of volunteer labor. Statement of Financial Accounting Standards No. 116 (FASB 116), issued June, 1993, establishes standards of financial

accounting and reporting for contributions received and contributions made. It applies to *all* entities, not just non-profits. FASB 116 begins by defining "contribution":

> *an unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner. Other assets include securities, land, buildings, use of facilities or utilities, materials and supplies, intangible assets, services, and unconditional promises to give those items in the future.*

Donated services (or the use of facilities) are not to be reported in Part I of Form 990. The areas of conflict are evident when the return is compared to the organization's audited financial statements.

(2) Part I, Lines 13 through 17 - Expenses

This portion of the revenue and expense statement captures totals from the Part II analysis of expenses and enters it in Part I. It also provides the filing organization a line to enter payments that are made to affiliates. This line, line 16, is used to report certain types of payments to closely related organizations. For example, a local organization might be required to pay a certain percentage of its revenues to its parent organization. Such payments would be reported on line 16. Pass throughs of dues paid by members are not reported here, since such payments would not have been reported as income.

Expenses	13	Program services (from line 44, column (B))	13	
	14	Management and general (from line 44, column (C))	14	
	15	Fundraising (from line 44, column (D))	15	
	16	Payments to affiliates (attach schedule)	16	
	17	**Total expenses** (add lines 16 and 44, column (A))	17	
Net Assets	18	Excess or (deficit) for the year (subtract line 17 from line 12)	18	
	19	Net assets or fund balances at beginning of year (from line 73, column (A))	19	
	20	Other changes in net assets or fund balances (attach explanation)	20	
	21	Net assets or fund balances at end of year (combine lines 18, 19, and 20)	21	

(3) Part I, Lines 18 through 21 - Net Assets

This portion of Part I focuses on changes in net assets or fund balances. An organization might have more expenses than revenues for the year. Line 18 asks for the excess or the deficit. Line 19 asks the filing organization to enter the figure from its balance sheet for the net assets or fund balances at the beginning of the year. Line 20 asks for other changes (apart from the impact of revenue and expenses) in net assets or fund balances that may have occurred. An example might be an adjustment to the asset balance from an earlier year's activities. The final line reconciles these changes and shows the net assets or fund balances at the end of the year.

(4) Part II -- Statement of Functional Expenses

Part II is a detailed analysis of the expenses that were reported as a total in Part I. It lists a number of common expenses to be analyzed. They include expenses such as the compensation paid to officers, directors, and the like; accounting fees, travel, and interest.

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Part II Statement of Functional Expenses All organizations must complete column (A). Columns (B), (C), and (D) are required for section 501(c)(3) and (4) organizations and section 4947(a)(1) nonexempt charitable trusts but optional for others. (See Specific Instructions on page 20.)

	Do not include amounts reported on line 6b, 8b, 9b, 10b, or 16 of Part I.		(A) Total	(B) Program services	(C) Management and general	(D) Fundraising
22	Grants and allocations (attach schedule) (cash $ _____ noncash $ _____)	22				
23	Specific assistance to individuals (attach schedule)	23				
24	Benefits paid to or for members (attach schedule)	24				
25	Compensation of officers, directors, etc.	25				
26	Other salaries and wages	26				
27	Pension plan contributions	27				
28	Other employee benefits	28				
29	Payroll taxes	29				
30	Professional fundraising fees	30				
31	Accounting fees	31				
32	Legal fees	32				
33	Supplies	33				
34	Telephone	34				
35	Postage and shipping	35				
36	Occupancy	36				
37	Equipment rental and maintenance	37				
38	Printing and publications	38				
39	Travel	39				
40	Conferences, conventions, and meetings	40				
41	Interest	41				
42	Depreciation, depletion, etc. (attach schedule)	42				
43	Other expenses (itemize): a	43a				
b		43b				
c		43c				
d		43d				
e		43e				
44	Total functional expenses (add lines 22 through 43). *Organizations completing columns (B)-(D), carry these totals to lines 13—15*	44				

Traditional accounting requires classification of expenses by object, e. g. rent, office supplies, or salaries and wages. This traditional format appears in Column A of Part II. Note that expenses reported in lines 6b (rental expenses), 8b (cost or basis of assets sold), 9b (expenses of special events), 10b (costs of goods sold), and 16 (payments to affiliates) of Part I should *not* be reported in Part II.

Each expense item reported in Column A can be allocated among the three functions listed in Columns B, C, and D. Column B reports program service expenses, Column C reports management and general expenses, and Column D reports fundraising expenses.

The FY 2000 return requires I.R.C. 4947(a)(1) trusts, I.R.C. 501(c)(3) and I.R.C. 501(c)(4) organizations to complete all columns. All the other filers must complete Column A, but they have the option of whether to complete the other columns. When the Part II format was designed, it was thought that particular information was needed from the I.R.C. 4947(a)(1) organizations, I.R.C. 501(c)(3) and (4) organizations. The Service

continues to monitor to see if more detailed reporting is required for the non I.R.C. 4947(a)(1) organizations.

A common error in this section is the incorrect use of line 43 to report "other expenses" when more specific reporting is called for. Many organizations include expenses in this category even though line items for the expenses in question appear on lines 22 through 42. For example, one 1999 Form 990 included the following in "other:" donations that should have been reported on line 22 or 23, utilities that should have been reported on line 36 as part of occupancy expenses, and office expenses should have been reported, at least in part, on line 33, Supplies. Line 33 itself was blank.

The knowledgeable Form 990 reader is well aware that the amounts reported in columns B, C, and D of part II may be subject to a considerable amount of manipulation. There is a desire to maximize amounts classified as "program services" and minimize amounts reported in the other two categories, particularly fundraising costs. When an organization combines educational campaigns with fundraising solicitations and reports any of these joint costs as program service expenses in column B, it must also, at the end of Part II, report on total joint costs and their allocation. The knowledgeable Form 990 reader will check both sections to have a clearer picture of the organization's true fundraising costs.

Reporting of Joint Costs. Did you report in column (B) (Program services) any joint costs from a combined educational campaign and fundraising solicitation? . . . . . ▶ ☐ Yes ☐ No

If "Yes," enter **(i)** the aggregate amount of these joint costs $_____; **(ii)** the amount allocated to Program services $_____; **(iii)** the amount allocated to Management and general $; and **(iv)** the amount allocated to Fundraising $

Form 990 in the News

An article appearing in the May 18, 2000 issue of The Chronicle of Philanthropy included several creative excuses used by organizations receiving millions of dollars in contributions yet reporting no fundraising costs on Form 990: our internal accounting system doesn't break out fundraising expenses separately, so we don't have to report them separately on Form 990; only the cost of hiring outside fundraisers needs to be reported separately; by leaving the fundraising lines blank (rather than putting zero), we are saying that fundraising expenses are included elsewhere on Form 990; we believe that solicitation costs are part of our overhead and therefore should be classified as a program expense; since our purposes is to raise money and distribute it to other organizations, fundraising is our program, and we report fundraising costs as program expenses.

Concern over the accuracy of the allocation of fundraising costs and a desire to have the same rules apply to all nonprofits prompted the issuance of the AICPA's Statement of Position 98-2 concerning the allocation of joint costs. Many organizations allocate significant portions of fundraising costs to "program services" if any portion of an activity contains information about the organization and its programs, or provides

information deemed "educational." Bear in mind that while the Service does not require organizations to follow SOP 98-2, states and other organizations that require accrual basis reporting often do. The rules of SOP 98-2 are more specific than anything the Service has imposed to date. In general, the SOP imposes three criteria that must be met -- purpose, audience, and content. If any single criterion is not met, 100% of the costs must be allocated to fundraising.

The purpose criterion generally requires that the joint activity request the audience to take specific action in furtherance of the organization's exempt purpose. A request to contribute to the organization does not satisfy this requirement. For example, an organization whose exempt purpose includes fighting cancer sends out a mailing including a brochure which encourages readers to stop smoking and gives them suggestions on how to do so. This call for specific action meets the purpose criterion. However, an activity will fail the purpose criterion if a professional fundraiser is used whose compensation is based on the amount of funds raised.

The audience criterion relates to the selection of the recipients of a mailing or other message. If recipients are selected because they previously contributed to the organization, the audience criterion is probably not met.

The content criterion is met if the activity calls for specific action and the need for the action is clearly evident. It appears that an organization meeting the purpose criterion should have no difficulty meeting the content criterion so long as the required "call to action" is clearly related to the organization's exempt purpose. Thus, an organization advocating organic farming could not satisfy this criterion by enclosing a stop smoking brochure with its fundraising appeal.

Form 990 in the News

The widespread availability of Form 990 means that errors or omissions can have a serious impact on an organization in ways that have nothing to do with taxes or the Internal Revenue Service. On July 28, 2000 the Kansas City Business Journal reported on a labor dispute between a large hospital system and its nurses. The nurses' union looked at 990s filed by the hospital system, and reported 27-45% of its budgets devoted to management related expenses. When these findings were made public, the hospital said that actual management expenses were about 10% of budget. The reason for the difference? The hospital claimed that, unlike most of its competitors, it classified items such as food service and housekeeping as "management and general."

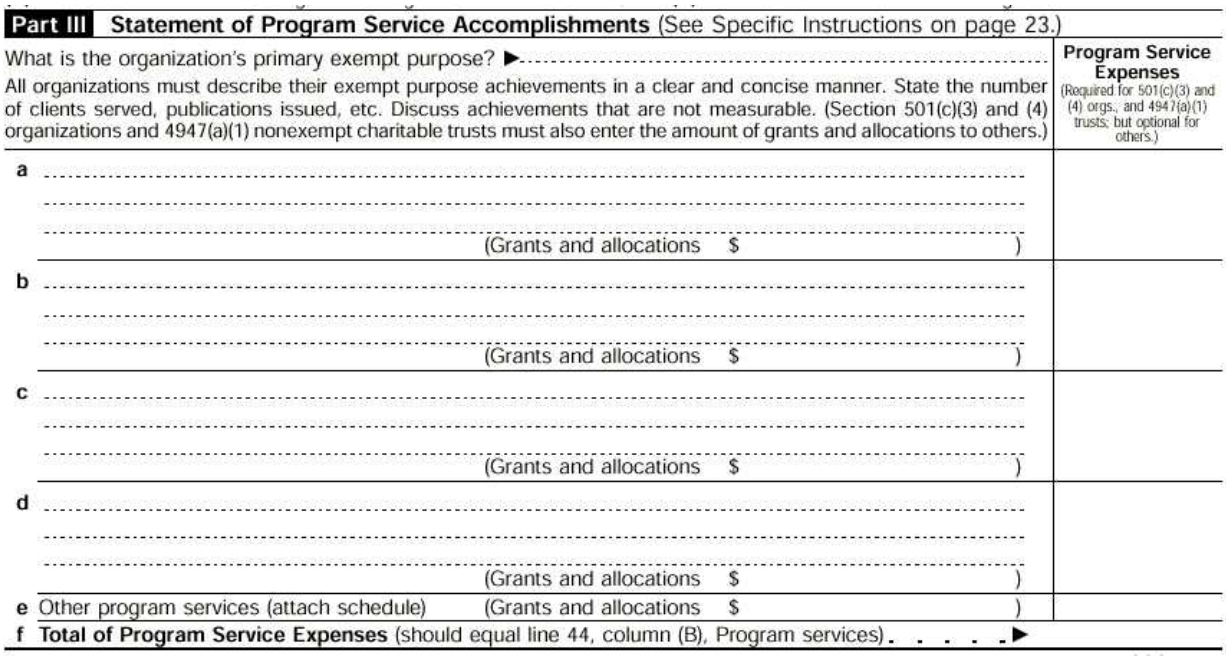
(5) Part III -- Statement of Program Service Accomplishments

Part III is the only place on Form 990 that gives an organization the opportunity to showcase its mission and its accomplishments. Given the increased public availability of

Form 990, this information is readily available to donors looking for effective organizations to support. Vague descriptions of activities or goals are probably not helpful to prospective donors. To which of the following organizations would you prefer to contribute?

- Paid for medical care for 373 homeless children
- Worked to facilitate provision of medical care for homeless children

Organizations must state in Part III their primary exempt purpose and then describe their four largest program services. They must state each service's objective and enter the expense or a reasonable estimate of the expense. I.R.C. 501(c)(3) and (4) organizations and I.R.C. 4947(a)(1) trusts must show the amount of their grants and allocations to others separately and must enter the total expenses for each program service reported. (An attachment required by line 22 asks for the donee's name and amount given in the case of grants to individuals. Part III requires a total amount for grants and allocations to others.) Other organizations are not required to report dollar amounts. If dollar amounts are reported, the total reported should equal line 44, column B in Part II.



Part III Statement of Program Service Accomplishments (See Specific Instructions on page 23.)

What is the organization's primary exempt purpose? ▶

All organizations must describe their exempt purpose achievements in a clear and concise manner. State the number of clients served, publications issued, etc. Discuss achievements that are not measurable. (Section 501(c)(3) and (4) organizations and 4947(a)(1) nonexempt charitable trusts must also enter the amount of grants and allocations to others.)

Program Service Expenses (Required for 501(c)(3) and (4) orgs., and 4947(a)(1) trusts; but optional for others.)

a .....
.....
.....
(Grants and allocations $)

b .....
.....
.....
(Grants and allocations $)

c .....
.....
.....
(Grants and allocations $)

d .....
.....
.....
(Grants and allocations $)

e Other program services (attach schedule) (Grants and allocations $)

f **Total of Program Service Expenses** (should equal line 44, column (B), Program services). . . . . ▶

(6) Part IV, IV-A, and IV-B -- Balance Sheets and Reconciliation

In the past, traditional non-profit accounting involved the use of so-called "fund accounting," in which assets and related items were segregated according to their use. For example, financial statements for a single organization might include a current unrestricted fund, a current restricted fund, an endowment fund, and a building fund.

Each fund requires a complete set of financial statements, so that a review of all of them is necessary to get a complete picture of the organization's financial position. The presentation of information in this format can be extremely confusing. FASB 117 attempts to deal with this problem by stating that financial statements should report on the entity as a whole, not on separate fund groups. Thus, the financial statements of non-profit organizations will be more similar to those of for-profit organizations.

The balance sheet used by the entity should not resemble its for-profit counterparts in all respects. The latter contain capital accounts - accounts which mean very little in the nonprofit world.

FASB 117 does not apply to a number of filers. These include credit unions, VEBAs, supplemental employee benefit trusts, I.R.C. 501(c)(12)s and other mutual benefit organizations.

(7) Part IV, Lines 45 through 66 – Assets and Liabilities

There are balance sheet issues that need highlighting. Line 50 asks for receivables from officers, directors and key employees. An attachment requires a schedule showing each receivable separately. For each receivable, the schedule should list: the borrower's name and title; the original amount; the balance due; the maturity date; the repayment terms; the interest rate; the security provided by the borrower; the purpose of the loan; a description and fair market value of the property the lending organization gave the borrower in exchange for the note - cash - $1000; or 100 shares of XYZ, Inc. - $9000. This schedule is fully disclosable.

The need for the information is obvious. With the form's and now the Code's emphasis on executive compensation, this completes a picture of financial benefit even where the arrangements are noncompensatory.

New for the FY 2000 return, line 55 adds a checkblock showing the method the filer is using -- cost or FMV -- to value investment in securities on the balance sheet. This was added because some organizations use FMV.

Line 63, that asks for information on the liability portion of the balance sheet and requires an attachment on loans ***from*** officers, directors and key employees. The design of the question is very similar to line 50. The unpaid balance of all the loans is entered on the form and information about each loan, similar to the information asked for in the attachment to line 50 is attached.

(8) Part IV, Lines 67 through 74 - Net Assets or Fund Balances

This portion is designed to adapt the form to both SFAS 117 and non-SFAS 117 filers. There are two parts to it. The first part is for organizations that follow SFAS 117. It asks organizations to classify and report their net assets in three groups: unrestricted funds; temporarily restricted funds and permanently restricted funds.

Unrestricted net assets are those that are neither temporarily nor permanently restricted by donor-imposed conditions. The key is donor imposition. A designation as to the use of the funds or an appropriation by the organization's board of directors doesn't create a restriction.

A donor's temporary restriction may require that funds be used in a later period or after a certain date. Donors could create a temporarily restricted fund by restricting to a specified purpose.

Permanently restricted net assets are assets, such as works of art or land that are donated with stipulations that they be used for specified purpose and be preserved and not sold. Permanently restricted funds are also those that are donated with the stipulation that they be invested to provide a permanent source of income. A classic example of a permanently restricted fund is a fund for a professorship at a university.

SFAS 117 balance sheets tell a reader something about fund availability. Part I of the form when it characterizes revenue doesn't currently have that capacity. One suggestion the Service is considering is modifying Part I so that a form's reader could know whether an organization is being given unrestricted, temporarily restricted or permanently restricted contributions.

(9) Parts IV A & B -- Reconciliation Statements

As was suggested earlier, Part I does not follow GAAP rules. These two subsections are designed to permit organizations to explain discrepancies between their Part I reporting and their audited financial statements.

Potentially, one of the more common discrepancies must involve donated (volunteer) labor. This has to be so because of the nonprofit sector's reliance on volunteer efforts. It is hard to measure this reliance since so much of occurs at the grassroots level. Insofar as it is measured by accountants, however, it shows up as a revenue item in financial statements prepared according to GAAP.

(10) Part V List of Officers, Directors, Trustees, and Key Employees

Part V **List of Officers, Directors, Trustees, and Key Employees** (List each one even if not compensated; see Specific Instructions on page 25.)

(A) Name and address	(B) Title and average hours per week devoted to position	(C) Compensation (If not paid, enter -0-.)	(D) Contributions to employee benefit plans & deferred compensation	(E) Expense account and other allowances

75 Did any officer, director, trustee, or key employee receive aggregate compensation of more than $100,000 from your organization and all related organizations, of which more than $10,000 was provided by the related organizations? ► ☐ **Yes** ☐ **No**
If "Yes," attach schedule—see Specific Instructions on page 26.

As was indicated in the discussion on the history of the form, reporting on the compensation of officers, including their names and addresses and the amount paid to each of them, has existed in some form since 1941. In 1969, Congress enacted I.R.C. 6033(b)(6) and (7), that required the provision of this information by all 501(c)(3) organizations. Similar information is required of all other exempt organizations by Reg. 1.6033-2(a)(2)(ii)(g). The 1996 CPE text included an article on "Reporting Compensation on Form 990. (The 1996 CPE article is so complete that we are inserting part of it as follows.)

7. Form 990 Instructions on Reporting Compensation

A. General Principles

The compensation with which Form 990 is concerned is compensation paid in return for a person's performance of services for the organization. The instructions to Part V of Form 990 construe compensation more broadly than other parts of the Code. 1990 CPE at 171 contains a comprehensive discussion of the various forms of compensation, but also focuses on whether the compensation is includible in an employee's gross income. By contrast, Form 990 generally requires that all compensation be reported, **whether or not**

includible in gross income (although there are major exceptions to this rule of total inclusion, discussed below). Also, in the case of deferred compensation, the focus is on the time that the EO pays or becomes obligated (or potentially obligated) to pay it as well as the time that the employee or independent contractor receives a disbursement.

Form 990 Part V and Form 990 Schedule A Part I divide employee compensation into three categories (the discussion below includes officers, directors, and trustees in the term "employee" as well as rank-and-file employees, except where otherwise provided). Column (C) includes salaries, bonuses, and similar cash payments during the year. Column (D) includes deferred compensation (whether or not funded, vested, or pursuant to a qualified I.R.C. 401(a) plan, and including payments to welfare benefit plans and future severance payments). Column (E) includes fringe benefits (**including nontaxable fringe benefits unless de minimis under I.R.C. 132(e)**) and **expense allowances which are reportable as income on the recipient's return**. The form and instructions in some places refer to Column (C) payments as "compensation" as distinguished from Column (D) or (E) payments, although in other places they are referred to collectively as "compensation." Form 990-PF contains the same three categories but labels them differently.

B. De Minimis Fringe Benefits

De minimis fringe benefits under I.R.C. 132(e) are an exception to the requirement that all fringe benefits be reported. A de minimis fringe benefit is defined as any benefit the value of which is (after taking into account the frequency with which the employer provides similar fringes to its employees) so small as to make accounting for it unreasonable or administratively impracticable.

Frequency is generally measured with respect to the individual employee and not with respect to the workforce as a whole, unless it is administratively difficult to do so (such as measuring each employee's personal use of the copy machine). Reg. 1.132-6(b). Thus, the more frequently an employee receives a particular benefit, the less likely it will be viewed as de minimis.

Reg. 1.132-6(e) provides examples of de minimis fringe benefits:

> occasional typing of personal letters by a company secretary; occasional personal use of an employer's copying machine, provided that the employer exercises sufficient control and imposes sufficient restrictions on the personal use of the machine so that at least 85% of the use is for business purposes; occasional cocktail parties, group meals, or picnics for employees and their guests; traditional birthday or holiday gifts of property (not cash) with a low fair market value; occasional theater or sporting event tickets; coffee, doughnuts, and

> soft drinks; local telephone calls; and flowers, fruit, books, or similar property provided to employees under special circumstances (e.g., on account of illness, outstanding performance, or family crisis).

The same regulation lists the following non-de-minimis fringes:

> season tickets to sporting or theatrical events; the commuting use of an employer-provided automobile or other vehicle more than one day a month; membership in a private country club or athletic facility, regardless of the frequency with which the employee uses the facility; employer-provided group term life insurance on the life of the spouse or child of an employee; and use of employer-owned or leased facilities (such as an apartment, hunting lodge, boat, etc.) for a weekend.

However, the blanket exclusion of employer-provided group term life insurance payable on the death of a spouse or dependent from de minimis fringes was postponed until further notice by Notice 89-110, 1989-2 C.B. 447. For the time being, such insurance is deemed de minimis if the face amount does not exceed $2000; if it exceeds $2000, only the excess (if any) of the cost of the insurance over the amount paid for by the employee on an after-tax basis is taken into account.

Prop. Reg. 1.274-8(d)(2) indicates that a traditional retirement award, such as a gold watch, presented upon completion of a lengthy term of service with the employer, such as 25 years, qualifies as a de minimis fringe.

Benefits provided in the form of cash or cash equivalent (e.g., through a gift certificate or credit card) generally do not qualify as a de minimis fringe, even if the cash is intended and used for property or services which would be a de minimis fringe if provided in kind. Reg. 1.132-6(c). An exception applies to cash for occasional meals and local transportation necessitated by overtime work (but not where the cash is calculated based on the amount of overtime). Reg. 1.132-6(d)(2)(i).

Another exception to the cash/cash equivalent rule is cash for local transportation necessitated by unusual circumstances with respect to the employee and the lack of safety of other available means of transportation. Reg. 1.132-6(d)(2)(iii). Such benefits are de minimis only to the extent that the transportation cost exceeds $1.50 per one-way commute--the first $1.50 is not excludible as a de minimis fringe. The frequency of such benefits is considered not to be administratively difficult to determine under Reg. 1.132-6(b)(2). "Unusual circumstances" are determined with respect to the employee at issue: a

temporary change in schedule from day shift to night shift would be unusual; a permanent change would no longer be unusual. Safety concerns are crime in the area and time of day. For example, if an employee is temporarily working a late shift and if it would be unsafe to wait for a midnight bus in a dangerous area of town, the employer's payment of cab fare (in excess of $1.50 per one-way commute) would be a de minimis fringe. This exception does not apply to "control employees" as defined under Reg. 1.61-21(f)(5) and (6).

Another special rule applies to transit passes. Public transit passes sold for commuting purposes by employer to employee at a discount not exceeding $21 in any month are a de minimis fringe. Reg. 1.132-6(d)(1). The same rule applies to free passes or bona fide reimbursement arrangements not exceeding $21 in value in any month. If transit pass benefits or meal/transportation benefits do not meet the value or frequency limitations, then no part of the benefits are de minimis. Reg. 1.132-6(d)(4). [Note: I.R.C. 132(f)(2) has been amended to change this dollar limitation to $65 for tax years beginning before 1/1/2002. For tax years beginning after 12/31/2001, the limitation is $100 per month.]

None of the special rules or examples in the regulation may be used to create a general rule defining a de minimis fringe. Reg. 1.132-6(d)(3). For example, the fact that $252 worth of transit passes annually ($21 per month for 12 months) may be a de minimis fringe does not mean that any fringe benefit valued less than that must also be. Also, the fact that commuting use of an employer's vehicle more than one day a month is an example of a non-de-minimis fringe does not mean that any use less than that is de minimis.

Another major category of de minimis fringe benefits is certain employer-provided eating facilities, defined with particularity under I.R.C. 132(e)(2) and Reg. 1.132-7. While generally there are no rules for de minimis fringe benefits which prohibit discrimination in favor of highly compensated employees (Reg. 1.132-6(f)), there are such rules for employer-provided eating facilities.

C. Expense Allowances and Working Condition Fringe Benefits

The Form 990 instructions indicate that only the portion of expense allowances of employees which is **reportable as income on their separate returns** is reportable in Column (E) as expense allowance compensation. Various Code sections and regulations essentially provide that, instead of requiring an employee to report certain payments from the employer as gross income and then to deduct them, the employee may simply exclude such payments from gross income (or the employer may exclude such payments from

the reported wages). Similarly, the Form 990 instructions indicate that only the **fee portion** of payments to independent contractors, **as opposed to the portion for deductible expense allowances**, should be reported as compensation. In effect, these rules exclude **working condition** fringe benefits from compensation which must be reported on Form 990, as discussed below.

The Form 990 instructions also indicate, however, that in the case of employees certain payments should always be reported as expense allowance compensation: payments made under **indemnification arrangements**, and the value of **personal use of housing, automobiles, or other assets** owned or leased by the organization or provided for the organization's use without charge. However, the value of personal use of assets is generally reportable as income on the employee's return anyway, although certain exceptions exist such as I.R.C. 119 (lodging furnished for the employer's convenience). The regulations under I.R.C. 132(d) and other sections help define which payments are for personal use.

What is an expense allowance? Expense allowances include advances of expenses, reimbursements, and expenses charged by the employee/independent contractor to the employer/client, as with credit cards. See, e.g., Reg. 1.62-2(d)(1); Reg. 1.162-17(b)(1). An arrangement with the same economic effect exists where the employer/client makes a payment on behalf of the employee/ independent contractor directly to a third party (e.g., where an employer buys air tickets from an airline for the employee's flight). Such a payment, as well as an advance or reimbursement to an employee or charge by an employee, may qualify for exclusion from the employee's gross income as a working condition fringe benefit under I.R.C. 132(a)(3).

I.R.C. 132(d) defines a working condition fringe as a benefit (property or services) provided to an employee which would be deductible under I.R.C. 162 or 167 by the employee if the employee paid for the benefit. Reg. 1.132-5(a)(v) indicates that cash advances may qualify as working condition fringe benefits. The regulation also contains detailed rules relating to allocation of vehicles between personal and business use, substantiation of expenses (which cross-reference I.R.C. 274, discussed below), employer-provided transportation for security concerns, testing by employees of products of the employer, and parking. Bona fide volunteers are treated for I.R.C. 132(d) purposes as employees with a profit motive under I.R.C. 162. There generally are no nondiscrimination rules in determining whether an expense allowance qualifies as a working condition fringe benefit, except for testing of employer products. Reg. 1.132-5(q).

The line between an expense allowance and a fringe benefit is not always clear; an expense with any element of personal benefit to the

employee/independent contractor may be viewed as a fringe benefit. However, if the expense is fully deductible under I.R.C. 162, then it qualifies as a working condition fringe.

In the case of an employee, an expense allowance or in-kind fringe benefit **should be reported as compensation** on Form 990 if one or more of the following conditions applies:

- it is treated by the EO as wages to the employee for withholding purposes;

- it qualifies neither as a working condition fringe benefit that (in the case of expense allowances) meets the accountable plan rules under I.R.C. 62 (discussed in the Appendix to this article), nor as a de minimis fringe;

- it relates to an indemnification arrangement or the value of personal use of housing, automobiles, or other assets owned or leased by the organization or provided for the organization's use without charge.

D. Overreporting

In the event that the Form 990 instructions require overreporting of actual compensation (e.g., the reporting of deferred compensation in both the year earned and the year paid), an EO can attach a statement to its Form 990 explaining how the compensation as reported is overstated. EOs are welcome to explain the entire compensation package for an individual.

E. Valuation

Another criticism of Form 990 is the difficulty of valuing certain benefits. The Service recognizes that precise actuarial cost figures may not be readily available for defined benefit plans and other plans, and allows reasonable estimates. Although many EOs hire an actuary to determine the estimate, it is not required that an EO do so in order for its estimate to be reasonable. Reasonable estimates based on available facts are acceptable, but the refusal to estimate merely because of difficulty is not.

Where the Code or regulations allow or require a specific valuation procedure for a fringe benefit (e.g., for vehicles, planes, employer-provided meals, employer parking), that valuation procedure is also allowed or required for Form 990 purposes.

F. Key Employees

Some EOs in the past avoided reporting the compensation of their top executives by not formally classifying them as "officers" under the governing instruments. Form 990 now requires compensation data for "key employees," defined as those with the powers or responsibilities of officers, directors, or trustees.

G. Compensation Splitting by Related Organizations

In the past, a popular scheme of larger EOs such as hospitals and universities was to have a top executive paid by several related entities thus making the executive's total compensation as reflected on each EO's own Form 990 appear smaller than it actually was. While the compensation may have been properly split among the entities (i.e., the official may have been performing services furthering the different business purposes of the various entities), in some cases splitting apparently was done solely to avoid full compensation disclosure on Form 990; in others to create an improper business expense deduction for a taxable subsidiary (discussed further below). In any event, the compensation paid by related entities appears to be a perquisite of a high executive position with the main organization, and may be negotiated by the executive as part of the (informal) compensation package with the main organization.

Since 1992, new rules set out in the Form 990 instructions apply to aggregating compensation paid by related organizations, based on the system used in the Massachusetts state return for charities that solicit contributions from the public. Compensation from related organizations must be reported where the total compensation from the organizations related to the EO exceeds $10,000, and the total compensation from the reporting EO and the related organizations exceeds $100,000.

The instructions go into some detail in defining a "related" organization. Generally speaking, a related organization is any entity that owns or controls or is owned or controlled by (directly or indirectly) the filing organization, or that supports or is supported by the filing organization. A 50% test is used for ownership or control. The rules look at commonality of officers, directors, trustees, and key employees, and the power to appoint such, in determining "control." As in I.R.C. 509(a)(3), "support" includes furthering the purposes of the supported organization.

This portion of the article discusses in greater detail the extent to which an expense allowance is reportable as compensation on Form 990. The key

issue generally is whether the expense is deductible by the employee in determining adjusted gross income (or by the independent contractor in determining taxable income); to the extent it is not, then the expense allowance will generally constitute compensation unless it qualifies as a de minimis fringe benefit. The primary Code sections involved are I.R.C. 62, 162, and 274.

(1) I.R.C. 62 and 162

I.R.C. 162(a) allows a deduction for all ordinary and necessary expenses incurred in carrying on a trade or business. I.R.C. 162(a) deductions may be taken by an employee in the business of performing services as an employee, as well as by an independent contractor in the business of performing services for clients. I.R.C. 212, which allows a deduction to individuals for ordinary and necessary expenses incurred for the production of income, would apply to an independent contractor who is not engaged in a business for purposes of I.R.C. 162.

I.R.C. 62(a), which defines adjusted gross income ("AGI"), bears on the issue with respect to employees. Expenses paid or incurred by an employee in connection with the performance of services as an employee are deductible from the employee's gross income in determining AGI, but only under an expense allowance arrangement with the employer which requires the employee to substantiate the expenses and to return amounts in excess of the substantiated expenses within a reasonable period of time. See I.R.C. 62(a)(2) and (c); Reg. 1.62-2. Reg. 1.62-2(c)(2) refers to such an expense allowance arrangement as an "accountable plan." In general, if an expense allowance arrangement fails to meet any of the three requirements (business connection, substantiation, and return of amounts in excess of expenses), then it is a "nonaccountable" plan. However, if an arrangement meets the accountable plan rules except for the allowance of other bona fide expenses related to the employer's business that are not deductible (e.g., travel that is not away from home), then part of the expense allowance is treated as an accountable plan and part as a nonaccountable plan. Reg. 1.62-2(d)(2).

Amounts paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employees' Form W-2, and are not subject to the withholding and payment of employment taxes. Reg. 1.62-2(h)(1). Conversely, all amounts paid under a nonaccountable plan generally are included in the employee's gross income as wages and are subject to employment tax withholding. Reg. 1.62-2(h)(2)(ii). **Amounts paid under a nonaccountable plan should be reported as expense allowance compensation on Form 990**. Also worth noting is Prop. Reg.

1.62-2(b)(1), reprinted at 1995-2 I.R.B. 55, which provides that where a plan is nonaccountable due solely to the rule of 50% nondeductibility of entertainment and meals under I.R.C. 274(n), the nondeductible amounts are not treated as wages--such amounts should not be treated as compensation for Form 990 purposes either.

Some of the most difficult issues concerning business deductions involve entertainment, meals, and travel expenses. Depending on the circumstances, such expenses may be deductible. For instance, I.R.C. 162(a)(2) expressly allows a deduction for travel expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a business. However, I.R.C. 262 generally precludes deductibility of personal, living, or family expenses. The problem arises where an expense is related to business but also involves personal benefit. The mere fact that an expense charged by an employee/independent contractor to the employer/client is allowed by the latter does not necessarily mean that the expense is a business expense for tax purposes. The regulations under I.R.C. 162 and 274 to a large extent distinguish business expenses from personal expenses. See, e.g., Regs. 1.162-2 and 1.274-2 (which distinguish between deductible business and nondeductible personal travel expenses (including meals) of a "mixed" business/personal trip); Reg. 1.274-2 (which identifies the deductible (business) portion of entertainment expenses).

(2) I.R.C. 274

Another important provision in determining the deductibility of business expenses is I.R.C. 274, which limits the deductibility of certain expenses that otherwise would be deductible under I.R.C. 162. I.R.C. 274 was enacted in 1962 to curb deductions for entertainment, meals, travel, and similar expenses that confer substantial personal benefits on the recipients and that have only a remote connection with the needs of the business. In addition to denying deductions, I.R.C. 274 establishes strict requirements for substantiating allowable deductions.

In some instances, I.R.C. 274 disallows a deduction to the employer but not to the employee or independent contractor recipient where an expense allowance exists, and therefore has little effect with respect to EOs. For example, I.R.C. 274(a) disallows an I.R.C. 162 deduction for certain entertainment, amusement, or recreation expenses, including country club dues. Suppose a physician employee of a taxable health care organization pays the dues for entry into a golf and country club. She says that she hates golf but deems it necessary to play in order to establish important business contacts

with other club members. She accounts to her employer for the club dues in the manner required under the I.R.C. 62 and 274 regulations, establishing that the club was used entirely for business purposes, and the employer reimburses her for the dues. The employer would like to deduct the reimbursement expense, but I.R.C. 274(a) prohibits the deduction (unless it treats the reimbursement expense as compensation to the physician on Form W-2).

Is the physician also prohibited from using the club dues expense as a deduction to offset her reimbursement income from the hospital? No. I.R.C. 274(e)(3) and the regulations allow an I.R.C. 162 deduction to an employee/independent contractor incurring an expense under an expense allowance arrangement with her employer/client to the extent of substantiated business use of the club, except where the employer/client treats the expense allowance as compensation to the employee/independent contractor on its return. See Prop. Reg. 1.132-5(s)(2), Examples 1 and 2. Where expense allowances exceed expenses or an accounting is not required or not adequately done, the deduction may be disallowed in whole or part at the employee/independent contractor level as well. See Reg. 1.274-5T(f) (for employees); Reg. 1.274-5T(g) (for independent contractors).

The reason for the I.R.C. 274(e)(3) rule is to prevent the "double disallowance" of a deduction at both the employer and employee levels (or at both the client and independent contractor levels). Where the employer/client incurs a nondeductible expense directly, the employee/independent contractor does not have a deduction to lose. However, where an expense allowance exists, a deduction is available at both the employee/independent contractor level and the employer/client level. Since the distinction between the two situations is only a matter of form rather than substance, the I.R.C. 274(e)(3) rule is needed to ensure that both situations have the same tax result.

However, the picture changes significantly where the employer/client is an EO, since EOs generally pay no tax and therefore do not care whether expenses are deductible or not. Where the employer/client is an EO and I.R.C. 274(e)(3) applies, I.R.C. 274 has no disallowance effect whatever (except in the limited situation where the employer is carrying on unrelated business), even though the potential for the abuse that I.R.C. 274 is intended to correct clearly exists (i.e., expenses for entertainment, meals, and travel with little connection to the purposes of the EO).

The same I.R.C. 274(e)(3) rule (i.e., allowing a deduction at the employee/independent contractor level for expenses covered by an expense allowance) applies to certain other expenses for which a deduction is otherwise disallowed under I.R.C. 274: lavish business meals or meals at which the

taxpayer or an employee is not present (I.R.C. 274(k)); certain luxury water transportation expenses (I.R.C. 274(m)(1)); and 50% of meal and entertainment expenses (I.R.C. 274(n)). The regulations apparently extend the I.R.C. 274(e)(3) rule to gifts otherwise disallowed as a deduction under I.R.C. 274(b). Reg. 1.274-5T(f), (g).

However, the I.R.C. 274(e)(3) rule does not apply to the nondeductibility of certain foreign travel under I.R.C. 274(c); of certain conventions held outside the North American area or held on cruise ships under I.R.C. 274(h); of certain entertainment tickets and skyboxes under I.R.C. 274(l); and of travel expenses for education under I.R.C. 274(m)(2). Such expenses are not deductible at any level as a business expense, and **allowances for such should be reported on Form 990.** Although the I.R.C. 274(e)(3) rule does not on the face of the statute apply to spousal travel expenses under I.R.C. 274(m)(3), Prop. Reg. 1.132-5(s) and (t), as discussed above, effectively applies the 274(e)(3) rule.

A current area of some controversy with respect to this form is the explicitly required reporting of payments for contracted management services. Since 1999, the instructions to Form 990 have stated:

> *If you pay any other person, such as a management services company, for the services provided by any of your officers, directors, trustees, or key employees, report the compensation and other items as if you had paid them directly.*

This instruction was, in part, a reaction to the practice of some individuals who incorporated themselves to avoid reporting of their compensation. The instruction has been the subject of considerable comment, some in favor and some opposed. In an effort, to be responsive to these concerns the Service recently requested comments on how to simplify reporting of compensation and, at the same time, protect against abuse. See Announcement 2001-33, 2001-17 I.R.B. 1137.

Seeking comment in this area should be interpreted as an effort to sort out the interests inherent in reporting for Part V. The Service has a continuing interest in the integrity of the reporting to reflect the Congressional intent of I.R.C. 6033(b)(6) and (7) as it is extended in Reg.1.6033-2(a)(2)(ii)(g). It also has a reporting interest because the ultimate design of the form needs to enhance the administration of I.R.C. 4958.

Form 990 in the News

On October 1, 2000 the Asbury Park Press reported that a housing organization tripled the compensation of its president from $89,419 for 1998 to $276,000 for 1999.

This item was reported in connection with the president's conviction on felony tax evasion charges with respect to income from another entity.

H. Part VI -- Other Information

Part VI is an interesting melange of questions that serve various aspects of the compliance process. For example, the Tax Court, in California Thoroughbred Breeders Association v. Comm. (47 T.C. 335), held that the statute of limitations on UBIT may begin to run when Form 990 is filed if there is enough information on the return to disclose the presence of unrelated business income. The purpose of question 78a is to force organizations with unrelated business income to file Form 990-T in order to begin the running of the statute. If an organization answers "no" to question 78a, it can't very well argue later that Form 990 disclosed the existence of unrelated business income. With the enactment of a number of special taxes applicable to Form 990 filers, similar questions are useful in other areas.

For example, I.R.C. 527(f) requires I.R.C. 501(c) organizations to pay I.R.C. 527 tax on expenditures for I.R.C. "exempt function" purposes. Generally, these are expenditures to support a run for public office. Line 81(a) asks whether the filer has made such expenditures. Line 81(b) asks whether a Form 1120-POL, U.S. Income Tax Return for Certain Political Organizations.

Line 89(b) and 89(c) present a variation on this theme. These lines have questions relating to the I.R.C. 4958 tax. Under I.R.C. 4958, the tax falls not on the filing organization but on organization managers and other disqualified persons. The two questions serve similar purposes. One is that since the item is disclosable, the public can monitor the responses. The second, arguably, may be (and this is not completely clear) that it allows the statute of limitations to run; because the government has been informed by the return of the I.R.C. 4958 liability. In a similar situation Regs. 301.6501(n)-1(a) starts the running of the statute under I.R.C. 4941, where a private foundation in its 990-PF discloses that a self-dealing act has occurred. This is so even though the person subject to the tax, the self-dealer, did not sign the return.

In Part VI, there are also questions, line 83, about public inspection and, in line 90(b), the number of employees currently employed.

8. Parts VII & VIII -- Analysis of Income Producing Activities and Relationship of Activities to the Accomplishment of an Exempt Purpose

These two parts are interrelated. Their purpose is to analyze income producing activities to identify unrelated business activity. The filer is asked to list all of the income sources reported in Part I except contributions. Line 93 should list each activity

that generates program service revenue. In fact, the return notes that the total of items reported in Part VII should, with the addition of contributions reported on line 1d, equal the total income reported in Part I. The specific instructions for Part VII also identify matching line items in Parts I and VII.

Part VII Analysis of Income-Producing Activities (See Specific Instructions on page 30.)

Enter gross amounts unless otherwise indicated.	Unrelated business income		Excluded by section 512, 513, or 514		(E) Related or exempt function income
	(A) Business code	(B) Amount	(C) Exclusion code	(D) Amount	
93 Program service revenue:					
a					
b					
c					
d					
e					
f Medicare/Medicaid payments					
g Fees and contracts from government agencies					
94 Membership dues and assessments					
95 Interest on savings and temporary cash investments					
96 Dividends and interest from securities					
97 Net rental income or (loss) from real estate:					
a debt-financed property					
b not debt-financed property					
98 Net rental income or (loss) from personal property					
99 Other investment income					
100 Gain or (loss) from sales of assets other than inventory					
101 Net income or (loss) from special events					
102 Gross profit or (loss) from sales of inventory					
103 Other revenue: a					
b					
c					
d					
e					
104 Subtotal (add columns (B), (D), and (E))					
105 **Total** (add line 104, columns (B), (D), and (E)) ▶					

Note: *Line 105 plus line 1d, Part I, should equal the amount on line 12, Part I.*

Part VII is laid out in spread sheet format so that each line item has to analyzed under a series of columns. Column E, for example, reports revenue from activities related to the organization's exempt purpose. A museum's admission fees listed as a specific revenue source in line 93 would be reported in this column. Income from municipal bonds reported in Part I a line 5 item and, therefore counted in Part VII as a line 96 item, is reported in Column E. It is reported that way because it is not excluded from gross income by I.R.C. 512, 513, or 514. One never reaches the question because it is excluded from gross income by I.R.C. 103.

If any amounts are reported in Column E, a corresponding entry must be made in Part VIII explaining how the income-generating activity contributed to the organization's exempt purpose or explaining the basis for the exclusion from gross income. If no amounts are reported in Column E, then Part VIII should not be completed.

Part VIII	**Relationship of Activities to the Accomplishment of Exempt Purposes** (See Specific Instructions on page 31.)
Line No. ▼	Explain how each activity for which income is reported in column (E) of Part VII contributed importantly to the accomplishment of the organization's exempt purposes (other than by providing funds for such purposes).

Returning to Part VII and still working backwards, enter in Column D any revenue received that is excludable from unrelated business income under the provisions of I.R.C. 512, 513, or 514. If an amount is entered in Column D, an exclusion code must be entered in Column C. These exclusion codes are provided in the specific instructions for Form 990. For example, exclusion code 05 applies to income from the sale of donated merchandise.

Finally, enter in Column B any revenue from activities unrelated to the organization's exempt purpose. An entry in Column B requires the corresponding entry in Column A of a business code. These codes are provided in the instructions for Form 990-T. For example, the code for "management and consulting services" is 541610.

9. Part IX -- Information Regarding Taxable Subsidiaries and Disregarded Entities

Part IX	**Information Regarding Taxable Subsidiaries and Disregarded Entities** (See Specific Instructions on page 31.)			
(A) Name, address, and EIN of corporation, partnership, or disregarded entity	(B) Percentage of ownership interest	(C) Nature of activities	(D) Total income	(E) End-of-year assets
	%			
	%			
	%			
	%			

Part IX requires reporting of ownership interests in taxable subsidiaries and disregarded entities. It also requires the reporting of total income and the value at the year's end of the assets of the entity. Holdings of 50% or more must be reported. Requiring information about taxable subsidiaries has long been a feature of Form 990, but the reference to disregarded entities was new with the 1999 return.

While the instructions with respect to taxable subsidiaries are quite straightforward, the nature of disregarded entities requires a little tweaking here. For example, if the disregarded entity does not have its own EIN, the parent is to state that it uses the organization's EIN. Since the financial information of a disregarded entity is supposed to be reported on its parent's return, Columns D and E will report amounts included elsewhere on the return. The form's instructions explain how this is done.

10. Part X -- Information Regarding Transfers Associated with Personal Benefit Contracts

Part X **Information Regarding Transfers Associated with Personal Benefit Contracts** (See Specific Instructions on page 31.)

(a) Did the organization, during the year, receive any funds, directly or indirectly, to pay premiums on a personal benefit contract? . . . . . ☐ **Yes** ☐ **No**

(b) Did the organization, during the year, pay premiums, directly or indirectly, on a personal benefit contract? ☐ **Yes** ☐ **No**

Note: *If "Yes" to* ***(b),*** *file Form 8870* ***and*** *Form 4720 (see instructions).*

Part X is new for the 2000 Form 990. its purpose is to identify organizations participating in so-called charitable split-dollar life insurance arrangements. No similar section appears on Form 990-EZ, 990-EZ filers who participate in such arrangements must make a similar declaration in a statement attached to the return.

If an organization actually paid premiums under these arrangements, the premiums must be reported on Form 8870 and an excise tax under I.R.C. 170(f)(10) equal to the premium must be paid on Form 4720.

11. Schedules A and B

A complete discussion of Schedules A and B will be published in a future article.

12. The Future of Form 990

TE/GE is currently studying electronic filing of Form 990. One of our first tasks is to request public comment on this issue. An announcement to be published in the Internal Revenue Bulletin is currently in process. The announcement will ask for comments on such issues as which version of Form 990 should be electronically filed first and what type of electronic filing system should be developed.