



# Compliance Guide for 501(c)(3) Private Foundations

## Inside:

Types of private foundations

Activities that may jeopardize  
a foundation's exempt status

Federal information and tax  
returns that must be filed

Recordkeeping—why, what, when

Changes to be reported to the IRS

Required public disclosures

Resources for private foundations

# Contents

<b>What Is a Private Foundation?</b> .....	<b>4</b>
<b>What Are the Different Types of Private Foundations?</b> .....	<b>4</b>
<b>What Activities May Jeopardize a Private Foundation's Tax-Exempt Status?</b> .....	<b>5</b>
Private Benefit and Inurement .....	5
Special Restrictions on Private Foundation Activities .....	6
Political Campaign Intervention .....	6
Substantial Legislative Activities .....	7
Failure to File .....	8
<b>What Federal Information and Tax Returns Must Be Filed?</b> .....	<b>8</b>
Form 990-PF, Return of Private Foundation .....	8
Form 990-T, Exempt Organization Business Income Tax Return .....	10
Patient Protection and Affordable Care Act (PPACA) Health Care Tax Credit .....	11
Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Code .....	11
Employment Tax Returns .....	12
<b>Why Keep Records?</b> .....	<b>13</b>
Evaluate Charitable Programs .....	13
Monitor Budgetary Results .....	13
Prepare Financial Statements .....	13
Prepare Annual Information Returns and Tax Returns .....	13
Identify Sources of Receipts .....	14
Substantiate Revenues, Expenses and Deductions for Unrelated Business Income Tax (UBIT) Purposes .....	14
Comply with Grant-Making Procedures .....	14

## Contents (cont'd)

<b>What Records Should be Kept?</b> .....	<b>15</b>
Accounting Periods and Methods .....	15
Supporting Documents .....	17
<b>How Long Should Records Be Kept?</b> .....	<b>17</b>
Record Retention Periods .....	17
<b>How Should Changes Be Reported to the IRS?</b> .....	<b>18</b>
Reporting Changes on Form 990-PF .....	18
Determination Letter and Private Letter Ruling Requests .....	18
Making Grants to Organizations or Individuals .....	19
Requesting Advance Approval of Scholarship or Educational Grant Procedures .....	20
Termination .....	20
<b>What Disclosures Are Required?</b> .....	<b>21</b>
Public Inspection of Annual Returns and Exemption Applications .....	21
Sale of Free Government Information .....	23
Charitable Contributions—Substantiation and Disclosure .....	23
<b>How Do You Get IRS Assistance and Information</b> .....	<b>25</b>
Specialized Assistance for Tax-Exempt Organizations .....	25
Tax Publications for Exempt Organizations .....	26
Forms for Exempt Organizations .....	26
General IRS Assistance .....	27

## Compliance Guide for 501(c)(3) Private Foundations

**F**ederal tax law provides tax benefits to nonprofit organizations recognized as exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code (Code).

The Code requires that tax-exempt organizations must comply with federal tax law to maintain tax-exempt status and to avoid penalties.

In Publication 4221-PF, the IRS addresses activities that could jeopardize a private foundation's tax-exempt status. It identifies general compliance requirements on recordkeeping, reporting, and disclosure for exempt organizations (EOs) that are also private foundations, including private operating foundations and non-operating private foundations. Content includes references to the statute, Treasury regulations, IRS publications and IRS forms with instructions. Publication 4221-PF is neither comprehensive nor intended to address every situation.

To learn more about compliance rules and procedures that apply to organizations exempt from federal income tax under section 501(c)(3), see Publication 557, *Tax-Exempt Status for Your Organization*, and the *Life Cycle of a Private Foundation* on [www.irs.gov/leo](http://www.irs.gov/leo). Stay abreast of new EO information, also on this Web site, by signing up for the *EO Update*, a free newsletter for tax-exempt organizations and practitioners who represent them. For further assistance, consult a tax adviser.

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## What Is a Private Foundation?

Every organization that qualifies for tax-exempt status under section 501(c)(3) of the Code is further classified as either a public charity or a private foundation. Under section 508, every organization is automatically classified as a private foundation unless it meets one of the exceptions listed in section 509(a). Private foundations typically have a single major source of funding (usually gifts from one family or corporation rather than funding from many sources) and most have as their primary activity the making of grants to other charitable organizations and to individuals, rather than the direct operation of charitable programs.

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## What Are the Different Types of Private Foundations?

For tax purposes, it may be necessary to distinguish between the particular types of private foundations: private operating foundations, exempt operating foundations and grant-making (or non-operating) private foundations. Some tax law provisions apply to all types of private foundations, while other rules only apply to particular types of private foundations. The organization's exemption letter will indicate whether the organization has been classified as a private foundation, a private operating foundation or an exempt operating foundation. Private operating foundations and exempt operating foundations are relatively uncommon.

A **private operating foundation** is a private foundation that devotes most of its resources to the active conduct of its exempt activities as distinguished from the more common **grant-making foundation** that generally makes grants to other organizations for exempt purposes. A museum that is supported by a limited number of individuals would generally be an example of an operating foundation. A private foundation that makes grants to public charities or individuals in order to carry out its exempt purposes would generally be a private non-operating or grant-making foundation. However, grant-making private foundations may conduct their own programs as well.

While most of the restrictions and requirements that apply to private foundations also apply to private operating foundations, there are tax advantages to being classified as a private operating foundation. For example, charitable contributions to a private operating foundation qualify for a higher charitable deduction limit on the donor's tax return.

In order to demonstrate that it is a private operating foundation, an organization must meet an assets test, a support test, or an endowment test and demonstrate that it distributes substantially all (85% or more) of the lesser of its adjusted net income or minimum investment return directly for the active conduct of activities that further its exempt purposes.

Certain private operating foundations, referred to as **exempt operating foundations**, are exempt from the excise tax on net investment income that applies to other operating and grant-making foundations. This type of operating foundation must have been publicly supported for at least 10 years and have a broadly representative board with limited participation by disqualified persons. This type of private operating foundation is extremely rare.

A nonexempt charitable trust that has not obtained tax-exempt status under section 501(c)(3) is also treated as a private foundation where its unexpired interests are solely devoted to one or more charitable purposes and it has been allowed to receive tax-deductible, charitable contributions.

Access Publication 557, *Tax-Exempt Status for Your Organization*, instructions for Form 990-PF, and the *Life Cycle of a Private Foundation* at [www.irs.gov/eo](http://www.irs.gov/eo) to learn about nonexempt charitable trusts under section 4947(a)(1) and the different types of private foundations.

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## **What Activities May Jeopardize a Private Foundation's Tax-Exempt Status?**

Once a private foundation has completed the application process and has established that it is tax exempt under section 501(c)(3), the organization's officers, directors, trustees and employees have an ongoing responsibility to ensure that the organization maintains its exempt status and meets its ongoing compliance responsibilities.

A 501(c)(3) private foundation should be aware that if it does not restrict its participation in certain activities and does not absolutely refrain from others, it risks jeopardizing its tax-exempt status. The following four subsections summarize limitations on activities of private foundations.

### **Private Benefit and Inurement**

A private foundation is prohibited from allowing more than an insubstantial accrual of private benefits, including non-monetary benefits, to individuals or organizations. The intent is to ensure that a tax-exempt organization serves a public interest, not a private one. If a private benefit is substantial, it could jeopardize the organization's tax-exempt status.

In addition, no part of an organization's net earnings may inure to the benefit of a private shareholder or individual. This means that an organization is prohibited from allowing its income or assets to accrue to insiders. An example of prohibited

inurement would include payment of unreasonable compensation to an insider. An insider is a person such as an officer, director, or a key employee who has a personal or private interest in the activities of the organization. Any amount of inurement may be grounds for loss of tax-exempt status.

In addition to loss of the organization's section 501(c)(3) tax-exempt status, activities constituting inurement may result in the imposition of self-dealing excise taxes on individuals benefiting from certain transactions with a private foundation.

### **Special Restrictions on Private Foundation Activities**

There is an excise tax on the net investment income of most domestic private foundations. In addition, tax law rules impose restrictions and requirements on private foundations through the foundation excise tax provisions. These restrictions and requirements include:

- restrictions on self-dealing between private foundations and their disqualified persons (defined as substantial contributors, foundation managers, and certain other related persons);
- requirements that foundations annually distribute income for charitable purposes;
- limits on foundation holdings in private businesses;
- restrictions on investments that might jeopardize the carrying out of exempt purposes; and,
- provisions to ensure that expenditures further exempt purposes.

Violation of these provisions gives rise to excise taxes and penalties against the private foundation or in the case of self-dealing, its disqualified persons. The Code contains provisions that impose two-tier excise taxes on private foundations, foundation managers, or other disqualified persons that engage in certain prohibited acts. First-tier excise tax is automatically imposed if the foundation engages in a prohibited act, although in certain circumstances the tax may be abated, except in cases of self-dealing. Second tier taxes may be imposed if the foundation fails to take appropriate action to correct the violation within the correction period set out in the Code. Read the instructions for Form 4720 and the *Life Cycle of a Private Foundation* pages on [www.irs.gov/eo](http://www.irs.gov/eo) for additional information about private foundation excise taxes.

### **Political Campaign Intervention**

Private foundations are absolutely prohibited from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) a candidate for public office. Contributions to political campaign funds or public statements of position made on behalf of the organization in favor of or in opposition

to any candidate for public office clearly violate the prohibition against political campaign activity. Violation of this prohibition may result in revocation of tax-exempt status and/or imposition of certain excise taxes.

Certain activities or expenditures may not be prohibited depending on the facts and circumstances. For example, the conduct of certain voter education activities (including the presentation of public forums and the publication of voter education guides) in a non-partisan manner do not constitute prohibited political campaign activity. In addition, other activities intended to encourage people to participate in the electoral process, such as voter registration and get-out-the-vote drives, would not constitute prohibited political campaign activity if conducted in a non-partisan manner. On the other hand, voter education or registration activities with evidence of bias that would favor one candidate over another, oppose a candidate in some manner, or have the effect of favoring a candidate or group of candidates, will constitute campaign intervention.

The political campaign activity prohibition is not intended to restrict free expression on political matters by leaders of public charities speaking for themselves as individuals. However, to avoid jeopardizing the exemption of a foundation, organization leaders must avoid making partisan comments in official organization publications or at official functions and should clearly indicate that their comments are personal and not intended to represent the views of the organization. Go to [www.irs.gov/eo](http://www.irs.gov/eo) for additional information about the prohibition against political campaign intervention.

### **Substantial Legislative Activities**

A private foundation will jeopardize its tax-exempt status under section 501(c)(3) if a substantial part of its activities is attempting to influence legislation (commonly referred to as lobbying). Private foundations that spend money on lobbying activity will incur an excise tax on those expenditures; this tax is so significant that it generally acts as a lobbying prohibition.

Legislation includes action by Congress, any state legislature, any local council, or similar governing body with respect to acts, bills, resolutions, or similar items (such as legislative confirmation of appointive office), or by the public in referendum, ballot initiative, constitutional amendment, or similar procedure. A foundation will be regarded as attempting to influence legislation if it contacts, or urges members of the public to contact, members or employees of a legislative body for the purpose of proposing, supporting, or opposing legislation, or if the foundation advocates the adoption or rejection of legislation.

Whether a foundation's attempts to influence legislation constitute a substantial part of its overall activities is determined on the basis of all the pertinent facts and circumstances in each case. The IRS considers a variety of factors, including the



time devoted (by both compensated and volunteer workers) and the expenditures devoted by the foundation to the activity, when determining whether the lobbying activity is substantial.

Under the substantial part test, a foundation that conducts excessive lobbying in any taxable year may lose its tax-exempt status, resulting in all of its income being subject to tax. In addition, a foundation is subject to an excise tax equal to five percent of its lobbying expenditures for the year in which it ceases to qualify for exemption.

Further, a tax equal to five percent of the lobbying expenditures for the year may be imposed against organization managers, jointly and severally, who agree to the making of such expenditures knowing that the expenditures would likely result in loss of tax-exempt status.

### **Failure to File**

If a private foundation fails to file Form 990-PF (or other required Form 990 Series Return) for three consecutive years, its 501(c)(3) status will be automatically revoked as of the due date of the third return and it will be a taxable private foundation that must file income tax returns as well as Form 990-PF. See also **Filing Penalties for Form 990-PF** on page 9.

An organization whose exemption is revoked for failure to file Form 990-PF may apply for reinstatement of its exemption by filing a Form 1023 and paying a user fee. Reinstatement of exemption may be retroactive if the failure to file was for reasonable cause.

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## **What Federal Information and Tax Returns Must Be Filed?**

### **Form 990-PF, Return of Private Foundation**

Private foundations generally are required to file Form 990-PF, *Return of Private Foundation*, annually whether or not they have any taxable income for, or activity during, the year. Section 4940 of the Code imposes an excise tax of 2% on the net investment income of most domestic tax-exempt private foundations, including private operating foundations. This tax must be reported on Form 990-PF and paid annually at the time for filing that return or in quarterly estimated tax installments if the total tax for the year is more than \$500. Some exceptions apply. Exempt operating foundations are not subject to the tax. Further, some foundations are only required to pay a 1% tax. To learn more about the Form 990-PF and Section 4940 taxes, see the *Life Cycle of a Private Foundation* at [www.irs.gov/eo](http://www.irs.gov/eo).

The Form 990-PF must be filed by the 15th day of the fifth month after the end of the private foundation's annual accounting period (May 15 for calendar year taxpayers). For information concerning payment of estimated tax, see the instructions for Form 990-PF.

### Form 990-PF Schedule B

If the private foundation receives money, securities, or other property valued at \$5,000 or more directly or indirectly from any person during the year, it must complete Schedule B, *Schedule of Contributors* and attach it to Form 990-PF.

### e-Filing Requirements

Private foundations and non-exempt charitable trusts that file Form 990-PF are required to file electronically, regardless of their asset size, if they file 250 returns a year (including income tax, employment and excise tax, and information returns such as Forms W-2s and 1099s). Other private foundations are given a choice to file Form 990-PF electronically. Click on the "IRS e-file" logo at [www.irs.gov](http://www.irs.gov) to get more information on e-filing.

## FILING PENALTIES FOR FORM 990-PF

An organization that fails to file a timely complete Form 990-PF (taking into account any extensions) is subject to penalties of \$20 per day for each day the return is late (\$100 per day for large organizations with annual gross receipts in excess of \$1 million), not to exceed the lesser of \$10,000 (\$50,000 for large organizations) or 5 percent of the organization's gross receipts unless the failure to file was due to reasonable cause. The person or persons responsible for the failure to file will be subject to a penalty of \$10 per day (not to exceed \$5,000) if the return is not filed by the date specified by the IRS in a written demand for payment unless such failure to file is due to reasonable cause. Penalties also apply to failures to provide required return information or incorrect information.

Form 990-PF is also a tax return because it is used to report the tax on investment income imposed by section 4940 (or 4948 if an exempt foreign organization). Accordingly, the penalties imposed by section 6651 for not filing a return (without reasonable cause) also apply. The penalty is generally 1/2 of 1 percent of the unpaid tax for each month or part of a month the tax remains unpaid, not to exceed 25% of the unpaid tax. If there was reasonable cause, the penalty may be waived but interest is charged on any tax not paid on time. If the organization fails to file Form 990-PF for three consecutive years, then its 501(c)(3) status will be automatically revoked and it will be a taxable private foundation that must file income tax returns as well as Form 990-PF. See also **Failure to File** on page 8.

## **Form 990-T, Exempt Organization Business Income Tax Return**

A private foundation that has at least \$1,000 in gross income from an unrelated trade or business must file a Form 990-T, *Exempt Organization Business Tax Return*. Net income from income producing activities is taxable if the activities:

- constitute a trade or business,
- are regularly carried on, and
- are not substantially related to the organization's exempt purpose.

Examples of unrelated business income may include income from advertising in publications, income from gaming (except for income from traditional bingo under certain circumstances), and other income from the sale of goods or performance of services unrelated to the organization's exempt purposes. Whether an income-producing activity is an unrelated trade or business activity depends on all the facts and circumstances. For more information see IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*.

The private foundation must pay quarterly estimated tax on unrelated business income if the organization expects its tax for the year to be \$500 or more. Form 990-W, *Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations*, is a worksheet to determine the amount of estimated tax payments required.

### **Exceptions and Special Rules**

Private foundations do not have the same liberties that public charities have in conducting an unrelated trade or business. With some exceptions, a private foundation that conducts an unrelated business that gives rise to unrelated business taxable income has an excess business holding subject to excise tax (in addition to unrelated business income tax) which must be divested. Exceptions include passive investments (even if debt financed) and a functionally related business (for example, the sale of items resulting in unrelated business income in a museum gift shop).

Certain business activities are excepted from the definition of unrelated business income, and earnings from these sources are not subject to the unrelated business income tax. Exceptions generally include:

- activities, including fundraisers, that are conducted by volunteer workers, or where donated merchandise is sold;
- activities conducted by a charitable organization for the convenience of members, students, patients or employees;
- qualified convention and trade shows;
- qualified sponsorship activities; and
- qualified bingo activities.

Income from certain “passive” investment activities is usually excluded from the calculation of unrelated business taxable income. Examples of this type of income include earnings from routine investments such as certificates of deposit, savings accounts, or stock dividends, royalties, certain rents from real property, and certain gains or losses from the sale of property.

Special rules apply to income derived from real estate or other investments purchased with borrowed funds. Such income is called “debt financed” income. Debt-financed income generally is subject to the unrelated business income tax.

To learn more about unrelated business income, read Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, the Form 990-T instructions, and the Form 990-W instructions at [www.irs.gov](http://www.irs.gov).

### **Patient Protection and Affordable Care Act (PPACA) Health Care Tax Credit**

For the years 2010 to 2013, many small tax-exempt organizations that provide health insurance coverage to their employees qualify for a special tax credit designed to encourage small employers to offer health care coverage for the first time or maintain the coverage they have. A small tax-exempt employer may be entitled to a maximum credit of 25% of the employer’s health insurance expenses that count toward the credit. Eligible small tax-exempt employers described in Code section 501(c) may claim the refundable credit by filing a Form 990-T with an attached Form 8941 showing the calculation of the claimed credit. A tax-exempt employer is not eligible to claim the credit unless it is an organization described in Code section 501(c) that is exempt from tax under Code section 501(a). Consult *IRS.gov* for further information. (An enhanced version of this credit goes into effect on January 1, 2014. The maximum credit will increase from 25% to 35%.)

### **Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Code**

A private foundation and its managers may be liable for two-tier excise taxes and be required to file Form 4720, *Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code*, if they violate certain restrictions and requirements imposed on private foundations. See **Special Restrictions on Private Foundation Activities** on page 6. If a private foundation is required to file Form 4720, the return must be filed by the 15th day of the fifth month after the end of the organization’s annual accounting period (May 15 for calendar year taxpayers).

Taxes may be imposed if a private foundation engages in self dealing activities with substantial contributors or other disqualified persons. A private foundation may be subject to excise taxes if it fails to annually distribute the required portion of its income for charitable purposes or does not appropriately limit its holdings in private businesses. A private foundation is subject to excise tax liability if it makes investments that jeopardize its ability to carry out its exempt purposes or fails to ensure that its expenditures further exempt purposes.

To read about situations in which two-tier excise taxes would be imposed, see the *Life Cycle of a Private Foundation* at [www.irs.gov/leo](http://www.irs.gov/leo), the Form 990-PF instructions, and the Form 4720 instructions at [www.irs.gov](http://www.irs.gov).

### **Employment Tax Returns**

Like other employers, a private foundation that pays wages to employees must withhold, deposit, and pay employment tax, including federal income tax withholding and Social Security and Medicare (FICA) taxes. An organization must withhold federal income tax from employee wages and pay FICA on each employee who is paid more than \$100 in wages during a calendar year. To know how much income tax to withhold, a private foundation should have a Form W-4, *Employee's Withholding Allowance Certificate*, on file for each employee. Employment taxes are reported on Form 941, *Employer's Quarterly Federal Tax Return*. Any person who fails to withhold and pay employment tax may be subject to penalties. As 501(c)(3) organizations, private foundations do not pay federal unemployment tax (FUTA).

Private foundations do not generally have to withhold or pay employment tax on payments to independent contractors, but they may have information reporting requirements. If a private foundation incorrectly classifies an employee as an independent contractor, it may be held liable for employment taxes for that worker.

The requirements for withholding, depositing, reporting and paying employment taxes are explained in Publication 15, *Circular E, Employer's Tax Guide*. For help in determining whether workers are employees or independent contractors, see Publication 15-A, *Employer's Supplemental Tax Guide*. Publication 557, *Tax Exempt Status for Your Organization* also addresses the employment tax responsibilities of private foundations. These publications may be downloaded at [www.irs.gov](http://www.irs.gov).

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## Why Keep Records?

In general, a private foundation must keep books and records to show that it complies with tax rules. The organization must be able to document the sources of receipts and expenditures reported on Form 990-PF, *Return of Private Foundation*, as well as Form 990-T, *Exempt Organizations Business Income Tax Return*. See **Prepare Annual Information Returns and Tax Returns** below.

If an organization does not keep required records, it may not be able to show that it continues to qualify for tax-exempt status or whether it is a private operating foundation or a non-operating private foundation. In addition, an organization may be unable to complete its returns accurately and may be subject to penalties described under **What Federal Information and Tax Returns Must be Filed?** on page 8. When good recordkeeping systems are in place, an organization can evaluate the success of its programs, monitor its budget, and prepare accurate financial statements and returns.

### Evaluate Charitable Programs

A private foundation can use records to evaluate the success of its charitable program and determine whether the organization is achieving desired results. Good records can also help a foundation identify problem areas and determine what changes it may need to make to improve performance.

### Monitor Budgetary Results

Without proper financial records, it is difficult for a private foundation to assess whether it has been successful in adhering to budgetary guidelines. A good recordkeeping system is crucial to successful stewardship of a private foundation.

### Prepare Financial Statements

It is important to maintain sufficient financial information in order to prepare accurate and timely financial statements. A foundation may need these financial statements when working with banks, creditors, contributors, and funding organizations. Some states require private foundations to make audited financial statements publicly available.

### Prepare Annual Information Returns and Tax Returns

Records must support income, expenses, and credits reported on Form 990-PF and other tax returns. Generally, these are the same records used to monitor programs and prepare financial statements. Books and records of an exempt

organization must be available for inspection by the IRS. If the IRS examines a foundation's returns, the organization must have records to explain items reported. Having a complete set of records will speed up the examination.

### **Identify Sources of Receipts**

A private foundation may receive money or property from many sources. With thorough recordkeeping a private foundation can identify the sources of receipts. The organization needs these records to separate program from non-program receipts and taxable from non-taxable income; to establish whether it is a private operating foundation or private non-operating foundation; and to complete Schedule B, as noted in **What Federal Information and Tax Returns Must be Filed?** on page 8.

### **Substantiate Revenues, Expenses and Deductions for Unrelated Business Income Tax (UBIT) Purposes**

A private foundation needs to keep records of revenues derived from, and expenses attributable to, an unrelated trade or business so that it can properly prepare Form 990-T and calculate its unrelated business taxable income.

### **Comply with Grant-Making Procedures**

A private foundation that makes grants to individuals generally must obtain advance approval of its procedures by the IRS and keep adequate records and case histories to demonstrate that grants to individuals serve its charitable purposes. Case histories on grants to individuals must show names, addresses, purposes of grants, manner of selection, and relationship (if any) that the recipient has with any members, officers, trustees, or donors of the organization.

The foundation must also maintain copies of any reports demonstrating that the funds are used for exempt purposes. If a private foundation distributes funds to other U.S. organizations, records must show whether they are exempt under section 501(c)(3), and whether the recipient organizations are classified as public charities or private foundations. If a private foundation distributes funds to non-U.S. organizations or to U.S. organizations that are not tax-exempt under section 501(c)(3), its records must demonstrate that the foundation exercises expenditure responsibility over the use of funds to avoid penalties for taxable expenditures under section 4945 (or that the private foundation determined the foreign organization to be the equivalent of a U.S. public charity). Visit the *Life Cycle of a Private Foundation* at [www.irs.gov/eo](http://www.irs.gov/eo) for additional information about expenditure responsibility requirements and grants to foreign or non-exempt organizations.

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## What Records Should Be Kept?

Except in a few cases, the law does not require a special kind of record. A private foundation can choose any recordkeeping system, suited to its activities, that clearly shows the organization's income and expenses. The types of activities a private foundation conducts determines the type of records that should be kept for federal tax purposes. An organization should set up a recordkeeping system using an accounting method that is appropriate for proper monitoring and reporting of its financial activities for the tax year. If a private foundation has more than one program, it should keep complete records that appropriately identify the income and expense items that are attributable to each program.

A recordkeeping system should generally include a summary of transactions. This summary of transactions is ordinarily recorded in the private foundation's accounting journals and ledgers. The books must show gross receipts, purchases, expenses (other than purchases), employment taxes, and assets. For most small organizations, the checkbook might be the main source for entries in the books, while larger organizations would need more sophisticated ledgers and records. A private foundation must keep documentation that supports entries in the books.

### Accounting Periods and Methods

Private foundations must keep their financial records based on an annual accounting period called a tax year, in order to comply with annual reporting requirements.

**Accounting Periods** — A tax year is usually 12 consecutive months. There are two kinds of tax years.

**CALENDAR TAX YEAR** – This is a period of 12 consecutive months beginning January 1 and ending December 31.

**FISCAL TAX YEAR** – This is a period of 12 consecutive months ending on the last day of any month except December.

**Accounting Method** — An accounting method is a set of rules used to determine when and how income and expenses are reported. A private foundation chooses an accounting method when it files its first annual return. There are two basic accounting methods:

**CASH METHOD** – Under the cash method, a private foundation reports income in the tax year received. It usually deducts expenses in the year paid.

**ACCRUAL METHOD** – Under an accrual method, a private foundation generally records income in the tax year earned, (i.e., in the tax year in which a pledge is received, even though it may receive payment in a later year.) It records expenses in the tax year incurred, whether or not it pays the expenses that year.

For more information about accounting periods and methods, see Publication 538, *Accounting Periods and Methods*, and the instructions to Form 990-PF, *Return of Private Foundation or Section 4947(a) Nonexempt Charitable Trust Treated as a Private Foundation*.



## RECORDS MANAGEMENT

### GROSS RECEIPTS

Gross receipts are the amounts received from all sources, including contributions. A private foundation should keep supporting documents that show the amounts and sources of its gross receipts. Documents that show gross receipts include: donor correspondence, pledge documents, cash register tapes, bank deposit slips, receipt books, invoices, credit card charge slips, and Forms 1099-MISC, *Miscellaneous Income*.

### PURCHASES, INCLUDING ACCOUNTING FOR INVENTORY

Purchases are items bought, including any items resold to customers. If an organization produces items, it must account for any items sold to customers. Thus, for example, the organization must account for the cost of all raw materials or parts purchased for manufacture into finished products. Supporting documents should show the amount paid, and that the amount was for purchases. Documents for purchases include: canceled checks, cash register tape receipts, credit card sales slips, and invoices. These records will help a private foundation determine the value of its inventory at the end of the year. See Publication 538, *Accounting Periods and Methods*, for general information on methods for valuing inventory.

### EXPENSES

Expenses are the costs a private foundation incurs (other than purchases) to carry on its program. Supporting documents should show the amount paid and the purpose of the expense. Documents for expenses include: canceled checks, cash register tapes, contracts, account statements, credit card sales slips, invoices, and petty-cash slips for small cash payments.

### EMPLOYMENT TAXES

Organizations that have employees must keep records of compensation and specific employment tax records. See Publication 15, *Circular E, Employer's Tax Guide*, for details.

### ASSETS & LIABILITIES

Assets are the property, such as investments, buildings, and furniture that an organization owns and uses in its activities. Liabilities reflect the pecuniary obligations of the organization. A private foundation must keep records to verify certain information about its assets and liabilities. Records should show:

- when and how the asset was acquired
- whether any debt was used to acquire the asset
- documents that support mortgages, notes, loans or other forms of debt
- purchase price
- cost of any improvements
- deductions taken for depreciation, if any
- deductions taken for casualty losses, if any, such as losses resulting from fires or storms
- how the asset was used
- when and how the asset was disposed of
- selling price
- expenses of sale

Documents that may show the above information include: purchase and sales invoices, real estate closing statements, canceled checks, and financing documents. If a private foundation does not have canceled checks, it may be able to show payment with certain financial account statements prepared by financial institutions. These include account statements prepared for the financial institution by a third party. All information, including account statements, must be highly legible. The following defines acceptable account statements.

**IF** payment is by:      **THEN** statement must show:

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<b>check</b>	check number, amount, payee's name, and date the check amount was posted to the account by the financial institution
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<b>electronic funds transfer</b>	amount transferred, payee's name, and date the transfer was posted to the account by the financial institution
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<b>credit card</b>	amount charged, payee's name, and transaction date
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## Supporting Documents

Organization transactions such as contributions, purchases, sales, and payroll will generate supporting documents. These documents—grant applications and awards, sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks—contain information to be recorded in accounting records. It is important to keep these documents because they support the entries in books and the entries on tax and information returns. Private foundations should keep supporting documents organized by year and type of receipt or expense. Also, keep records in a safe place.

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## How Long Should Records Be Kept?

Private foundations must keep records for federal tax purposes for as long as they may be needed to document evidence of compliance with provisions of the Internal Revenue Code. Generally, this means the organization must keep records that support an item of income or deduction on a return until the statute of limitations for that return runs. The statute of limitations has run when the organization can no longer amend its return to claim a credit or refund, and the IRS can no longer assess additional tax. Generally, the statute of limitations runs three years after the date the return is due or filed, whichever is later. An organization may be required to retain records longer for other legal purposes, including state or local tax purposes. For example, an organization generally must retain information on grants for the entire period of time they are outstanding.

### Record Retention Periods

Record retention periods vary depending on the types of records and returns.

***Permanent Records*** – Some records should be kept permanently. These include the private foundation’s application for recognition of tax-exempt status, the determination letter recognizing tax-exempt status, and organizing documents, such as articles of incorporation and by-laws, with amendments, as well as board minutes.

***Employment Tax Records*** – If a private foundation has employees, it must keep employment tax records for at least four years after the date the tax becomes due or is paid, whichever is later.

***Records for Non-Tax Purposes*** – When records are no longer needed for tax purposes, a private foundation should keep them until they are no longer needed for non-tax purposes. For example, a grantor, insurance company, creditor, or state agency may require that records be kept longer than the IRS requires.

## How Should Changes Be Reported to the IRS?

### Reporting Changes on Form 990-PF

A private foundation must report name, address, and structural and operational changes on its **annual information** return, Form 990-PF . Otherwise notifying the IRS of a change will not relieve an organization of its obligation to report changes on the Form 990-PF.

**Tip:** Attach copies of any signed or state certified articles of incorporation, or association, constitution or trust instrument or other organization document, or the bylaws or other governing document showing changes. If signed or state certified copies of a government document are not available, an authorized officer may certify that the governing document provided is a complete and accurate copy of the document.

### Determination Letters and Private Letter Ruling Requests

A private foundation that has lost its exemption letter or has changed its address may request a letter affirming that the IRS recognizes the foundation's tax-exempt status. The affirmation letter serves the same purpose for grantors and contributors as the original determination letter. You may request an affirmation letter by contacting EO Customer Service or EO Determinations. If necessary, a foundation may request a copy of its original determination letter from the EO Determinations office. The request should include Form 4506-A, *Request for Public Inspection or Copy of Exempt Organization or Political Organization IRS Form*, or a letter containing the name and EIN of the organization and the requestor's contact information. A private foundation that has had a change in its private foundation status should request a determination letter from the EO Determinations office. See **How to Get IRS Assistance and Information** on page 25 for the appropriate address for the EO Determinations Office.

The IRS will not make any determination regarding the effect of completed transactions on an organization's tax exempt status. However, in certain circumstances an organization may request a determination letter or private letter ruling with regard to certain changes in structure and activities.

An organization may request a **determination letter** regarding its private foundation status in certain situations. For example, as noted above, a determination letter will be issued to classify or reclassify an organization as a public charity or a private foundation, if appropriate.

In some circumstances, a private foundation is required to give notice or receive advance approval from the IRS before undertaking a transaction. A foundation must request a **determination letter**, with respect to the following issues:

- advance approval of a scholarship program, and certain other grant-making procedures of private foundations;
- voluntary termination of a private foundation's status, except by transferring assets to, or operating as, a public charity;
- certain determinations regarding application of the neighborhood land rule;
- status as an exempt operating foundation;
- establishment of a set-aside that may be counted toward the foundation's annual minimum distribution amount;
- advance approval of private foundation's voter registration activities; and
- certain changes in an organization's accounting method and period.

If a private foundation is unsure about whether proposed changes in its purposes or activities are consistent with its status as a tax-exempt organization or as a private foundation, it may want to request a private letter ruling.

The IRS issues **private letter rulings** on *proposed* transactions and on completed transactions—if the request is submitted before the return is filed for the year in which the transaction was completed. The IRS generally does not issue rulings to private foundations on any other completed transactions. The IRS will issue letter rulings to private foundations on matters involving a private foundation's tax-exempt status, its private foundation status, as well as other matters including issues under sections 501 through 514, 4912, 4940 through 4948, 4955, 4958, 6033, 6104, and 6115.

Consult [www.irs.gov/eo](http://www.irs.gov/eo) for the appropriate procedures for preparing and submitting a request for a determination letter, private letter ruling, replacement exemption letter, or a letter reflecting a new name or address. For general information about reporting changes, you may contact EO Customer Service at (877)829-5500.

### **Making Grants to Organizations or Individuals**

Generally, if a private foundation intends to make grants to organizations or individuals and it did not describe the program in its exemption application, it should inform the IRS about the program. Funds the private foundation distributes to an individual as a grant must be made on a true charitable basis in furtherance of the purposes for which the foundation is organized. For example, the organization should be able to substantiate the basis for grants awarded to individuals to relieve poverty or under a scholarship or educational program. Publication 3833, *Disaster Relief, Providing Assistance through Charitable Organizations*, covers making grants to individuals in the case of a disaster or hardship situation.

## **Requesting Advance Approval of Scholarship or Educational Grant Procedures**

As noted above, if a private foundation is beginning an individual grant program that provides scholarships, fellowships, educational loans, or other educational grants that were not described in its exemption application, it must request advance approval of its grant-making procedures from the IRS. Advance approval is a one-time approval of the private foundation's system of standards and procedures for awarding grants. Approval will apply to succeeding grant programs if the standards and procedures under which they are conducted do not differ materially from those described in the organization's initial request for advance approval. To request advance approval, the private foundation should send a letter providing the information requested on Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, Schedule H, to the Internal Revenue Service, Tax Exempt/Government Entities, Exempt Organizations Determinations Office, P.O. Box 2508, Cincinnati, OH 45201.

Employer-related scholarship and loan programs must satisfy special requirements set out in Rev. Proc. 76-47, 1976-2 C.B. 670, applicable to scholarship programs or Rev. Proc. 80-39, 1980-2 C.B. 772, applicable to educational loan programs. An employer-related grant program is one that provides grants to an employee or to a child or an employee of a particular employer.

For information on the exclusion of scholarships from the income of an individual recipient, see Publication 520, *Scholarships and Fellowships*.

### **Termination**

When a private foundation dissolves or terminates its existence it should notify the IRS that it will no longer be filing annual returns. To do so, the organization sends a letter to the Internal Revenue Service, Tax Exempt/Government Entities, Exempt Organizations Determinations Office, P.O. Box 2508, Cincinnati, OH 45201. When the organization files its final Form 990-PF, *Return of Private Foundation or Section 4947(a) Nonexempt Charitable Trust Treated as a Private Foundation*, it should check the "Final Return" box in the header area on page 1 of the return.

However, filing a final return alone will not terminate an organization's private foundation status. Once an organization is subject to the special rules that apply to private foundations, it can only terminate its private foundation status by operating as a public charity, by transferring its assets to a section 509(a)(1) charity, or by giving notice to the IRS of termination of its private foundation status and paying any section 507(c) termination tax.

There are several ways a private foundation may terminate and avoid paying tax on its termination. An organization may voluntarily terminate its private foundation status and qualify as a public charity that meets the requirements of section 509(a)(1), (2), or (3). Before terminating its private foundation status, the organization must first notify the Internal Revenue Service, Tax Exempt/Government Entities, Exempt Organizations Determinations Office of its intention to qualify as a public charity, and it must meet the public charity requirements for a continuous 60-month period beginning with the first day of that tax year. The organization may request and receive an advance ruling of public charity status for this period. Immediately after the end of the 60-month period, it must establish that it has met the requirements of section 509(a)(1), (2), or (3).

A private foundation also may voluntarily terminate by distributing all of its net assets to one or more public charities described in section 509(a)(1) of the Code. However, the recipient organization must have been in existence and have been a public charity for at least 60 continuous months.

Generally, if a private foundation willfully and flagrantly or repeatedly violates the private foundation excise tax provisions, it may be terminated involuntarily and will be liable for tax under section 507(c) of the Code.

Finally, a private foundation that transfers substantial assets to another private foundation under procedures set out in section 507(b)(2) has not terminated its private foundation status. In this case, the recipient foundation takes on any liabilities of the transferor foundation under the foundation excise tax provisions.

Access the *Life Cycle of a Private Foundation* at [www.irs.gov/eo](http://www.irs.gov/eo) for additional information about the termination process.

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## What Disclosures Are Required?

There are a number of disclosure requirements for private foundations. Detailed information on federal tax law disclosure requirements for 501(c)(3) tax-exempt organizations can be found in Publication 557, *Tax Exempt Status for Your Organization* on the IRS Web site at [www.irs.gov/eo](http://www.irs.gov/eo).

### Public Inspection of Annual Returns and Exemption Applications

A private foundation must make the following documents available for public inspection and copying upon request and without charge (except a reasonable charge for copying). The IRS also makes these documents available for public inspection and copying.

**Exemption Application** – A private foundation must make available for public inspection its approved exemption application, Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, along with each of the following documents:

- all documents submitted with Form 1023;
- all documents the IRS requires the organization to submit in support of its application; and
- the determination letter issued by the IRS.

**Form 990-PF** – A private foundation must make available for public inspection its annual information return, Form 990-PF, with schedules, attachments, and supporting documents filed with the IRS. Returns need to be available for disclosure for only three years after the later of the due date or filing date of the return.

**Form 990-T** – A private foundation must make its 990-T available for public inspection for three years beginning on the last day (including extensions) for filing the return. Read the instructions to Form 990-T at [www.irs.gov/eo](http://www.irs.gov/eo) for information regarding how the returns are to be made public.

### Public Inspection and Disclosure Procedures

A private foundation may place reasonable restrictions on the time, place, and manner of in person inspection and copying, and may charge a reasonable fee for providing copies. It can charge no more for the copies than the per page rate the IRS charges for providing copies. A tax-exempt organization does not have to comply with individual requests for copies if it makes the documents widely available. This can be done by posting the documents on a readily accessible website. However, it must still allow public inspection by office visitation.

All publicly available information may be obtained from the IRS by filing Form 4506-A, *Request for Public Inspection or Copy of Exempt Organization or Political Organization IRS Form*. An organization may obtain a complete copy of its own application by filing Form 4506, *Request for Copy of Tax Return*.

For details on the public inspection and disclosure rules and procedures for 501(c)(3) organizations, go to the *Life Cycle of a Private Foundation*, or read the instructions for Forms 990-PF, 990-T, and 1023 at [www.irs.gov/eo](http://www.irs.gov/eo).

## PENALTIES

Penalties apply to responsible persons of a tax-exempt organization who fail to provide the documents as required. A penalty of \$20 per day may apply for as long as the failure continues. A \$10,000 maximum penalty applies to a failure to provide an information return; no maximum penalty applies to application requests.

## **Sale of Free Government Information**

If a private foundation offers to sell goods or services that are available free from the federal government, the organization must disclose that fact in a conspicuous and easily recognized format. A private foundation that intentionally disregards this requirement is subject to a penalty.

## **Charitable Contributions—Substantiation and Disclosure**

While many private foundations do not engage in fundraising activities, some do solicit contributions, and a foundation may need to be familiar with the tax rules requiring substantiation and the disclosure rules imposed on foundations that receive certain *quid pro quo* contributions.

### **Recordkeeping Rules**

A donor cannot claim a tax deduction for any cash, check or other monetary contribution unless the donor maintains a record of the contribution in the form of either a bank record (such as a cancelled check) or a written communication from the private foundation (such as a receipt or a letter) showing the name of the private foundation, the date of the contribution, and the amount of the contribution.

### **Substantiation Rules**

A donor cannot claim a tax deduction for any single contribution of \$250 or more unless the donor obtains a contemporaneous acknowledgment of the contribution from the recipient charitable organization. A private foundation may assist the donor by providing a timely written statement including the name of the public charity, date, amount of the contribution, and description of any non-cash contributions.

In addition, the acknowledgment should indicate whether any goods or services were provided in return for the contribution. If any goods or services were provided in return for a contribution, the organization should provide a good faith estimate of the value of goods or services provided in return for the contribution.

The private foundation may either provide separate acknowledgments for each single contribution of \$250 or more or one acknowledgment to substantiate several single contributions of \$250 or more. Separate contributions are not aggregated for purposes of measuring the \$250 threshold.

There are no IRS forms for the acknowledgment. Letters, postcards, or computer-generated forms with the above information are acceptable. An organization can provide either a paper acknowledgment, or an electronic acknowledgment, such as an e-mail, to the donor.



### Disclosure Rules That Apply to *Quid Pro Quo* Contributions

Contributions are deductible only to the extent that they are gifts and no consideration is received in return. Depending on the circumstances, ticket purchases and similar payments made in conjunction with fundraising events may not qualify as charitable contributions in full. A contribution made by a donor partly in exchange for goods or services is known as a *quid pro quo* contribution. A donor may only take a charitable contribution deduction to the extent that the contribution exceeds the fair market value of the goods and services the donor receives in return for the contribution and the donor intends to make a partial gift under the circumstances.

If a private foundation conducts fundraising events such as benefit dinners, shows, and membership drives where something of value is given to those in attendance, it must provide a written statement informing donors of the fair market value of the specific items or services it provided in exchange for contributions. Token items and services providing only an intangible religious benefit need not be taken into account. A private foundation should provide the written disclosure statement in advance of any event, determine the fair market value of any benefit received, and state this information in fundraising materials such as solicitations, tickets, and receipts. The disclosure statement should be made, at the latest, at the time payment is received. Subject to certain exceptions, the disclosure responsibility applies to any fundraising circumstance where each complete payment, including the contribution portion, exceeds \$75.

Read Publication 1771, *Charitable Contributions—Substantiation and Disclosure Requirements*, and Publication 526, *Charitable Contributions*, for details on the federal tax law for organizations such as private foundations, that receive tax-deductible charitable contributions and for taxpayers who make contributions.

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## How Do You Get IRS Assistance and Information?

The IRS offers help, through assistors and with reading material which is accessible either online, via mail, by telephone, and at IRS walk-in offices in many areas across the country. IRS forms and publications can be downloaded from the Internet and ordered by telephone.

### Specialized Assistance for Tax-Exempt Organizations

Get help with questions about applying for tax exempt status, annual filing requirements, and information about exempt organizations through the IRS, Exempt Organizations (EO).

#### EO Web Site

[www.irs.gov/eo](http://www.irs.gov/eo)

#### **Highlights:**

- The *Life Cycle of a Private Foundation*—details the compliance obligations of private foundations.
- Subscribe to the *EO Update*, a periodic newsletter with information for tax-exempt organizations and tax practitioners who represent them.

#### EO Web-based Training

[www.stayexempt.irs.gov](http://www.stayexempt.irs.gov)

#### EO Customer Service

(877) 829-5500

#### EO Determinations Office Mailing Address

Internal Revenue Service  
TE/GE, EO Determinations Office  
P.O. Box 2508  
Cincinnati, OH 45201

## Tax Publications for Exempt Organizations

Get publications via the Internet or by calling the IRS at (800) 829-3676.

**Pub 1**, *Your Rights as a Taxpayer*

**Pub 15**, *Circular E, Employer's Tax Guide*

**Pub 15-A**, *Employer's Supplemental Tax Guide*

**Pub 463**, *Travel, Entertainment, Gift, and Car Expenses*

**Pub 517**, *Social Security and Other Information for Members of the Clergy and Religious Workers*

**Pub 526**, *Charitable Contributions*

**Pub 538**, *Accounting Periods and Methods*

**Pub 557**, *Tax-Exempt Status for Your Organization*

**Pub 571**, *Tax-Sheltered Annuity Plans (403(b) Plans) for Employees of Public Schools and Certain Tax-Exempt Organizations*

**Pub 583**, *Starting a Business and Keeping Records*

**Pub 598**, *Tax on Unrelated Business Income of Exempt Organizations*

**Pub 1771**, *Charitable Contributions—Substantiation and Disclosure Requirements*

**Pub 1828**, *Tax Guide for Churches and Religious Organizations*

**Pub 3079**, *Tax-Exempt Organizations and Gaming*

**Pub 3833**, *Disaster Relief, Providing Assistance Through Charitable Organizations*

**Pub 4220**, *Applying for 501(c)(3) Tax-Exempt Status*

**Pub 4221-PC**, *Compliance Guide for 501(c)(3) Public Charities*

**Pub 4221-NC**, *Compliance Guide for Tax-Exempt Organizations (other than 501(c)(3) Public Charities and Private Foundations)*

**Pub 4302**, *A Charity's Guide to Vehicle Donations*

**Pub 4303**, *A Donor's Guide to Vehicle Donations*

**Pub 4630**, *Exempt Organizations Products and Services Catalog*

**Pub 4779**, *Facts about Terminating or Merging Your Exempt Organization*

## Forms for Exempt Organizations

Get forms via the Internet or by calling the IRS at (800) 829-3676.

**Form 941**, *Employer's Quarterly Federal Tax Return*

**Form 944**, *Employer's Annual Federal Tax Return*

**Form 990**, *Return of Organization Exempt From Income Tax*

- Form 990-EZ**, *Short Form Return of Organization Exempt From Income Tax*
- Form 990-PF**, *Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation*
- Form 990-N**, *Electronic Notice (e-Postcard) For Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ (available electronically only)*
- Form 990-T**, *Exempt Organization Business Income Tax Return*
- Form 990-W**, *Estimated Tax on Unrelated Business Taxable Income for Exempt Organizations*
- Form 1023**, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*
- Form 1023-EZ**, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*
- Form 1024**, *Application for Recognition of Exemption Under Section 501(a)*
- Form 1041**, *U.S. Income Tax Return for Estates and Trusts*
- Form 4506**, *Request for Copy of Tax Return*
- Form 4506-A**, *Request for Public Inspection or Copy of Exempt Organization or Political Organization IRS Form*
- Form 4720**, *Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code*
- Form 5578**, *Annual Certification of Racial Non-Discrimination for a Private School Exempt from Federal Income Tax*
- Form 5768**, *Election/Revocation of Election by an Eligible Section 501(c)(3) Organization to Make Expenditures to Influence Legislation*
- Form 8282**, *Donee Information Return*
- Form 8283**, *Noncash Charitable Contributions*
- Form 8868**, *Extension of Time To File an Exempt Organization Return*
- FinCEN Form 114**, *Report of Foreign Bank and Financial Accounts*

**General IRS Assistance**

Get materials on the latest tax laws, assistance with forms and publications, and filing information.

- IRS Web site** **[www.irs.gov](http://www.irs.gov)**
- Federal tax questions** **(800) 829-4933**
- Employment tax questions** **(800) 829-4933**
- Order IRS forms and publications** **(800) 829-3676**

