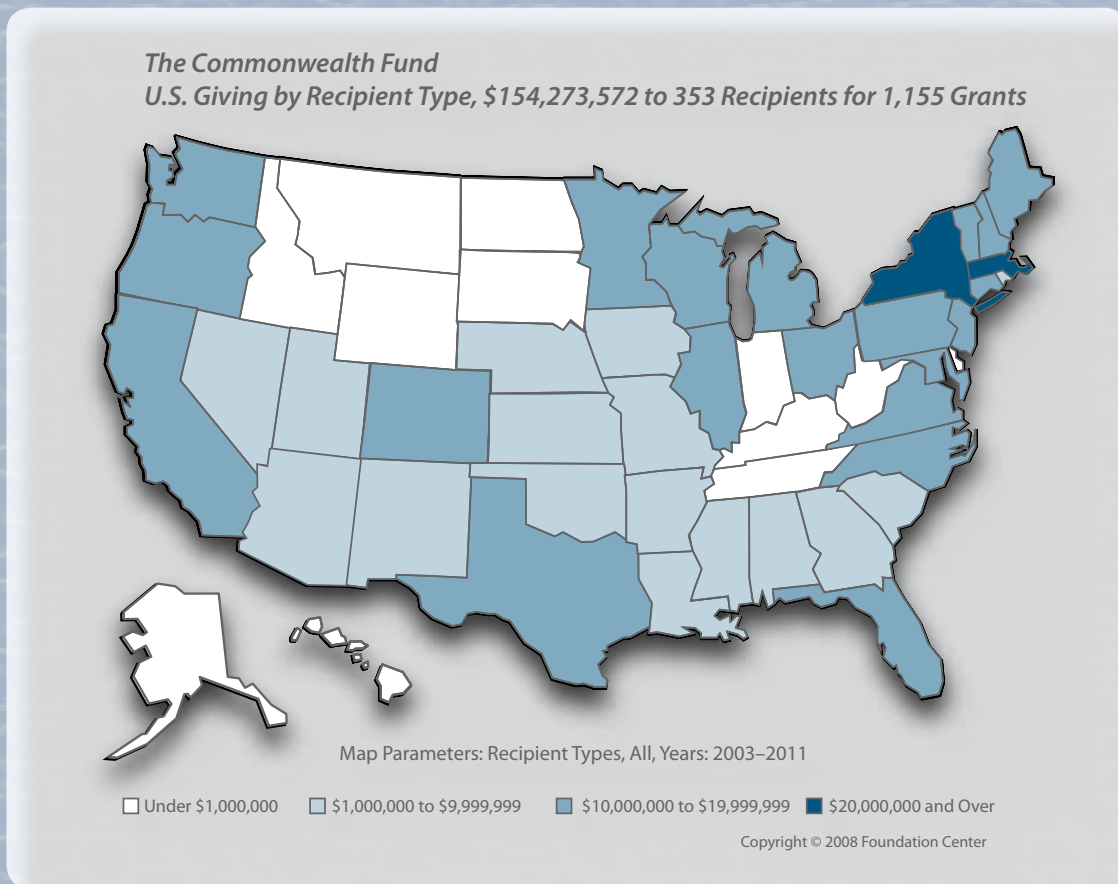




# Modernizing the 990-PF to Advance the Accountability and Performance of Foundations *A Modest Proposal*



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*Cover: The 990-PF tax return for private foundations requires reporting all grants annually, but few foundations are able to file their returns electronically, and the submitted information on grants can not be assembled into a comprehensive, researchable database. In contrast, The Foundation Center's technologically advanced Grantsfire and eGrants reporting system, which includes mapping capabilities, generates a comprehensive database on foundation grants. A modernized 990-PF would encourage foundations to use that system as an alternative to reporting grants directly on the tax return.*

**The Commonwealth Fund** is a private foundation that promotes a high performance health care system providing better access, improved quality, and greater efficiency. The Fund's work focuses particularly on society's most vulnerable, including low-income people, the uninsured, minority Americans, young children, and elderly adults.

The Fund carries out this mandate by supporting independent research on health care issues and making grants to improve health care practice and policy. An international program in health policy is designed to stimulate innovative policies and practices in the United States and other industrialized countries.

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# Modernizing the 990–PF to Advance the Accountability and Performance of Foundations: A Modest Proposal



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## Overview

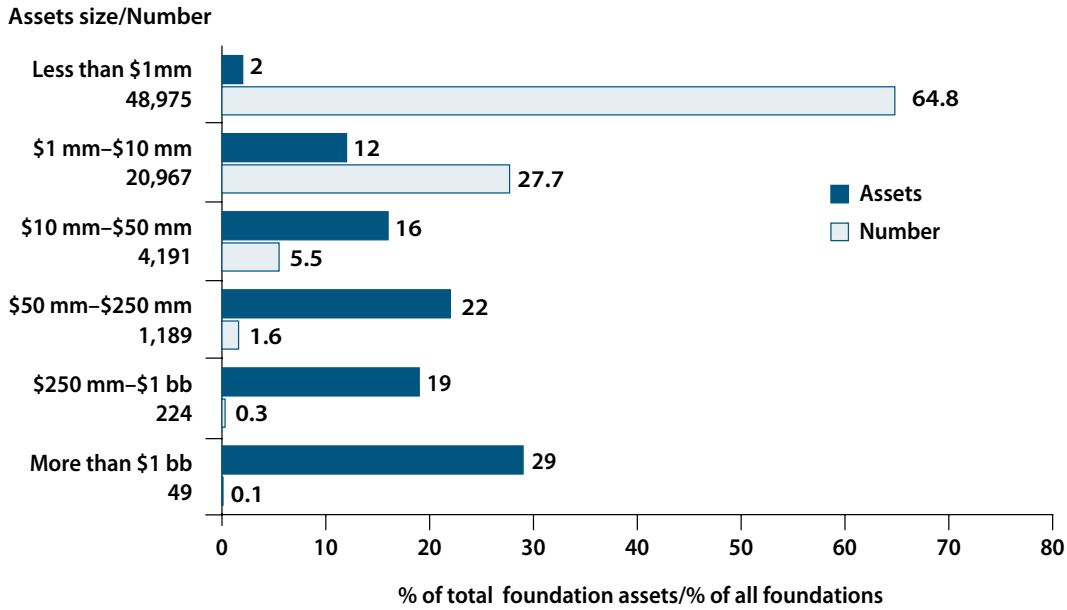
Today there are more than 75,000 private foundations in the United States, with total assets of around \$565 billion.<sup>1</sup> The size distribution of these organizations is highly skewed: 273 large foundations with endowments of \$250 million or more account for 48 percent of the sector's total resources (Exhibit 1). On the other end of the distribution, some 49,000 very small foundations with assets under \$1 million hold about 2 percent of the sector's wealth, and another group of 21,000 with assets between \$1 million and \$10 million hold 12 percent. This diversity of size is more than matched by diversity of missions, operating models, goals, and strategies—making the objective of ensuring the accountability and performance of these important institutions a formidable one.

Private foundations exist under the watchful eye of the United States Congress, which has delegated their oversight to the Internal Revenue Service. In each state, offices of the state attorneys general also bear regulatory responsibility, but because of the limited resources typically available for this purpose, the IRS is by default the only real regulator of foundations—except in instances where an attorney general has been alerted to the possibility of significant misbehavior by a foundation.

To obtain the information needed to exercise its regulatory responsibilities, the IRS relies principally on an annual filing by private foundations—the Form 990-PF tax return. While it also conducts periodic audits of individual foundations, the sheer number of organizations, together with the IRS's record of reaping minimal revenue from costly audits, makes the 990-PF filing the overwhelming choice of regulatory tool. The 990-PF also provides foundations with an important tool for self-regulation, helps journalists serve as accountability watchdogs, and generates data used by the Foundation Center to maintain its databases and research reports on the foundation sector.<sup>2</sup>

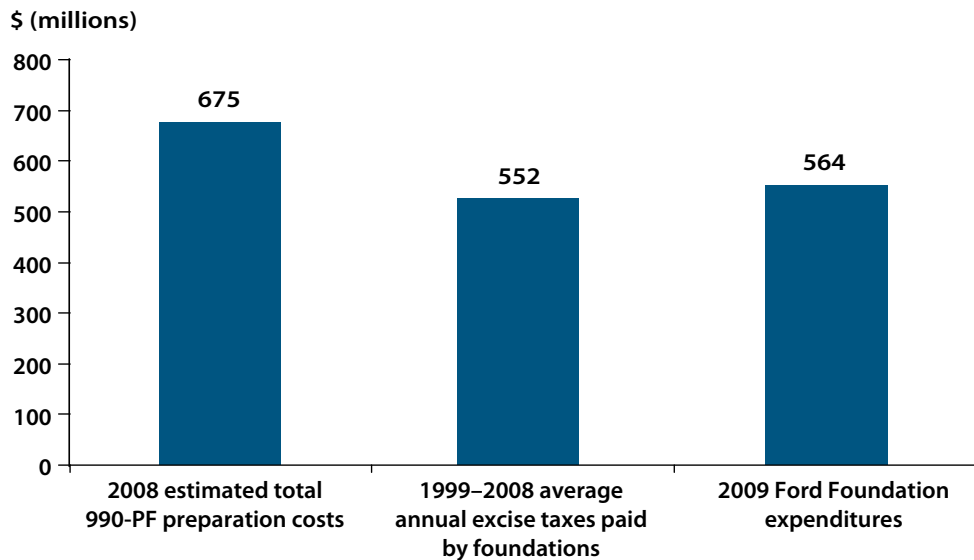
If the 990-PF is a necessary requirement of private foundations, it is also a costly one: estimated total filing costs in 2008 for all foundations was \$675 million (Exhibit 2).<sup>3</sup> To put this number in perspective, it is the equivalent of the required payout for charitable purposes of a perpetual foundation with \$13 billion in assets. Such a foundation would be the second largest, falling somewhere in between the Bill and Melinda Gates Foundation and the Ford Foundation. Further, combined 990-PF preparation costs are greater than the \$552 million in average total annual excise tax receipts generated by the return.<sup>4</sup> Clearly, the return should

**Exhibit 1. With more than 75,000 organizations and enormous variations in size, missions, and strategies, the foundation sector presents many regulatory and accountability challenges.**



Source: The Foundation Center.

**Exhibit 2. The annual cost for all foundations of filing the 990-PF return is greater than the average annual excise tax revenues that it generates, and the foregone charitable expenditures amounted to more than the annual outlays of the second largest foundation in 2008.**



Note: Estimated total 990-PF preparation costs based on time estimates in IRS 990-PF filing instructions and hourly costs estimated by The Commonwealth Fund.

Source for Excise Tax Revenues: [www.irs.gov/taxstats/charitablestats](http://www.irs.gov/taxstats/charitablestats), IRS data files.

Source for Ford Foundation: 2009 Annual Report Financial Statements.

be structured for maximum efficiency so that it can meet its regulatory aims while minimizing forgone charitable expenditures.

As described below, the 990-PF has served its principal purpose of eliminating the abuses in the foundation field that existed prior to 1970 and has helped steer foundations away from inappropriate activities since that time. But it has failed to keep up with the evolution of the foundation sector over the last 40 years. As both an instrument of basic regulation and tax collection and a tool for promoting strong performance among private foundations, the 990-PF is seriously flawed. Its modernization could yield many benefits to the sector and, more important, to the hundreds of thousands of nonprofit organizations that foundations serve.

This essay traces the history of the 990-PF to reveal how its current structure and content came to be. It then analyzes the return's shortcomings and discusses how the 990-PF could be transformed into a more effective instrument for promoting accountability and best practices in the foundation sector. Although it will not be possible to implement all of the recommendations, in the debate over reform and simplification of our federal tax code, modernizing Form 990-PF should be given serious consideration.

## Evolution of Form 990-PF

In a seminal article from 2000 in the *Exempt Organization Tax Review*, distinguished attorney and foundation expert Thomas A. Troyer traced the history of congressional legislation on, and IRS regulation of, private foundations, providing history-in-the-making insights of which every foundation official should be aware.<sup>5</sup> Troyer explains how the IRS regulatory filing requirement for foundations originated in the early 1940s, when Congress sought to

address the then-serious issue of foundations and other tax-exempt organizations holding and controlling businesses unrelated to their charitable purposes and using assets for the benefit of trustees and managers.

Beginning in 1941, a Form 990 information return became required of all organizations, including foundations, that were exempt from income tax. The Commonwealth Fund's return for that year reveals that it consisted of two pages, the first requiring very brief information on charitable activities and any potentially improper distributions to board members or officers, and the second, a summary of receipts and disbursements and of assets and liabilities.<sup>6</sup>

Succeeding versions of the tax-exempt organization/foundation filing over the next 33 years reflect further efforts by Congress to address abuses in the foundation sector. By 1949, Form 990 was a three-page return requesting additional information on the nonprofit's affiliations with other organizations, including for-profit concerns, on business relationships with trustees and managers, and on political activities. In addition, from 1950 onwards, nonprofits with income unrelated to their charitable purpose were required to file Form 990-T (Exempt Organization Business Tax Return).

Following federal legislation in 1950, the 990 was replaced with Form 990-A, a four-page document that moved the question concerning charitable activities of the nonprofit from the beginning of the form to a later section. The new form led off with a revenues-and-expenses statement focused on business activities of charitable organizations—the aim being to identify such activities that were not charitable in purpose. On the second page were questions on issues of considerable concern to Congress at the time: foundations' holdings

of controlling interests in for-profit corporations; whether those businesses paid dividends; conflicted business dealings between foundations and donors or foundation-controlled for-profit corporations; lobbying activities intended to influence specific legislation; and participation in political campaigns. For the first time, it was required that the financial statement parts of the return (income and expenses and balance sheet) be made available to the public.

The federal Revenue Act of 1964, which limited the tax-deductibility of gifts to foundations, was preceded by congressional hearings in which the Department of the Treasury agreed to conduct a major study of foundations' activities. In 1965, Treasury produced the first data-based set of findings on the foundation field—relying, notably, not on the limited information produced by the 990-A return, but on a survey of 1,300 foundations. This key report debunked the then-current view that foundations exercised inordinate economic power in the U.S. economy, though it did identify serious abuses among a minority of foundations and recommended legislative action to combat them.

In his article, Troyer describes how a series of missteps by a few foundations in the highly charged political environment of the late 1960s led to action on Treasury's recommendations for further regulatory action. The result was the inclusion in the Tax Reform Act of 1969 of the basic provisions for foundation regulation and IRS tax return filing that remain in place to this day. These include: proscriptions against self-dealing activities by foundation trustees and officers; for the first time, a required annual minimum payout for private foundations; prohibitions against holding controlling interests in for-profit concerns; restrictions on select programmatic activities (specifically, grants to individuals and the expenditure responsibility requirement for grants made to organizations other than nonprofits);

restrictions on lobbying and prohibitions on participation in political campaigns and voter registration drives; penalties on expenditures for noncharitable purposes; an excise tax, also for the first time, on foundations' net investment income; and reduction of the charitable deduction for contributions of appreciated property to private foundations.

As a result of the 1969 tax legislation, the 990-A that was required of all tax-exempt organizations was revised in 1970 (and renamed simply "Form 990") to include sections for foundations for computing the new excise tax on investment income and information on any activities or conditions prohibited or regulated in the legislation. For purposes of the excise tax calculation, foundations were now also required to submit detailed schedules on realized capital gains and losses arising from their endowment investments. Further, foundations were required to list all of the securities in their portfolios and all grants and contributions paid or approved for future payment during the year.

In addition to this three-page return, foundations were required to submit a three-page Form 990-AR, "Annual Report of Private Foundation," which requested information on foundation managers and their business dealings with the foundation or with corporations in which the foundation had substantial holdings. Foundations were also required to file Form 4720, Return of Certain Excise Taxes, if they engaged in self-dealing, political, or other prohibited practices (for example, investments jeopardizing their charitable purposes) on which tax penalties could be levied.<sup>7</sup> In the following year, Form 990 was further revised to include the calculation of taxes on excess business holdings and sections listing the compensation of officers, directors, and trustees, the compensation of the five highest-paid employees, and the five highest-paid persons providing professional services.



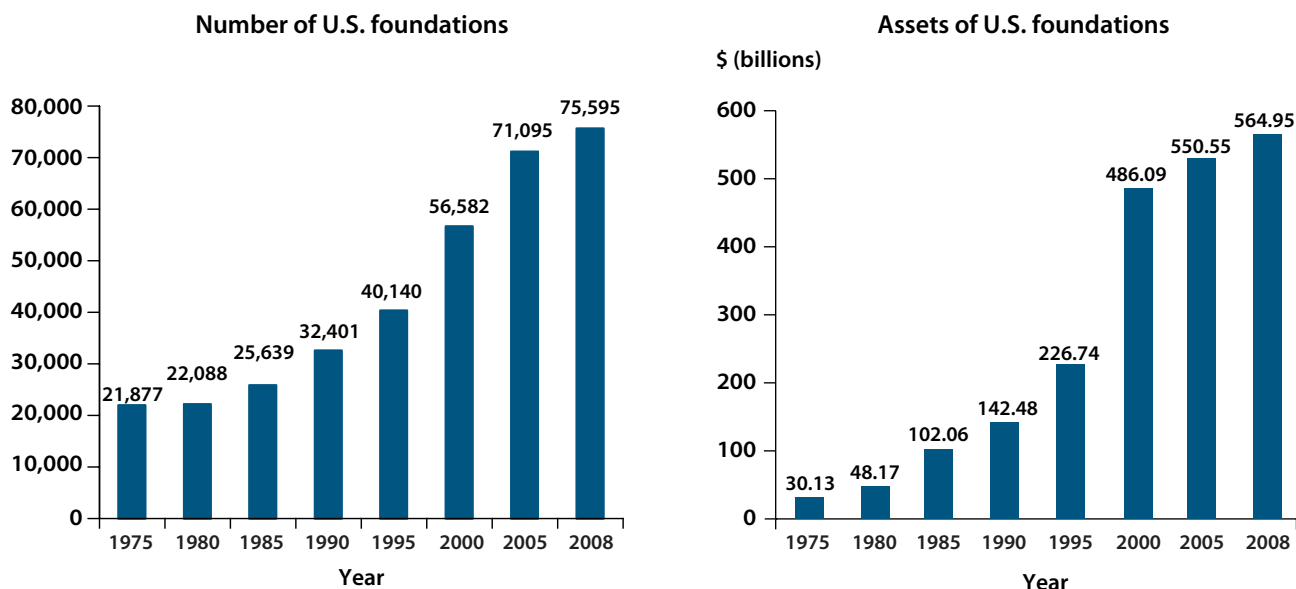
By 1974, all of the regulatory and tax ramifications of the 1969 tax legislation had been incorporated into a separate, seven-page, annual tax return for foundations, which at that time was renamed Form 990-PF, “Return of Private Foundation.” This form, with relatively minor revisions that have expanded the form’s length to 13 pages, plus 32 pages of instructions, remains in place to this day.<sup>8</sup>

To their enormous credit, the 1969 regulations on foundations and the resulting 990-PF, along with strong self-regulatory activities such as the 1969–70 Peterson Commission on Foundations and Private Philanthropy and the 1973–77 Filer Commission on Philanthropy and Private Needs, have eliminated most of the abuses that were targeted in 1969. Foundations no longer control businesses for noncharitable purposes; they more than meet the annual payout requirement;<sup>9</sup> instances of self-dealing, at least among larger organizations,

are few and far between; and continuing progress is being made in identifying best practices for non-profits (including foundations) and promoting their spread throughout the sector.<sup>10</sup> A measure of the extent to which the abuses of 42 years ago have disappeared is the negligible annual revenue from all 75,000 foundations produced by the Form 4720 penalty taxes in 2006: \$2.1 million from self-dealing taxes; \$3.0 million from undistributed income penalties; \$146,000 from taxable expenditures; and \$66,000 from excess business holdings penalties.<sup>11</sup>

This chronicle of how the current 990-PF came to be demonstrates, however, that it is, like all tax returns, the product of accretion—not a modern document carefully constructed to efficiently regulate a sector dramatically different in both size and activities from what it was in 1974. After all, the census of foundations has grown almost 250 percent since 1975, and the assets of foundations, by 395 percent (Exhibit 3). As the following section

**Exhibit 3. The number of U.S. foundations has grown by 246 percent and the total assets of U.S. foundations by 395 percent since 1975—while the 990-PF regulatory structure has remained static.**



Source: The Foundation Center.

will demonstrate, the 37-year-old filing form, the components of which were built up over an earlier 33-year period dating back to 1941, falls considerably short in addressing efficiently the current regulatory needs of the IRS and state attorneys general and the accountability and best-practice needs of the foundation sector.

### Shortcomings of the Current 990-PF

The shortcomings of the current 990-PF are a serious concern not only because of the additional filing costs that result, but also because the form is the only one universally filed by foundations. In addition to its regulatory and tax collection use by the IRS, the form is widely used by:

- foundation trustees, who are counseled by Independent Sector that they have a fiduciary responsibility to review the return before it is filed;
- nonprofits, which use it for fundraising purposes;
- researchers, who use it to assess the work of the sector and promote best practices;
- the Foundation Center, the Council on Foundations, Guidestar, and other such organizations, which use it to promote accountability;
- journalists, who use it in their reporting on the foundation sector; and
- members of the general public, who use the return to help assess local or regional foundations' accountability.

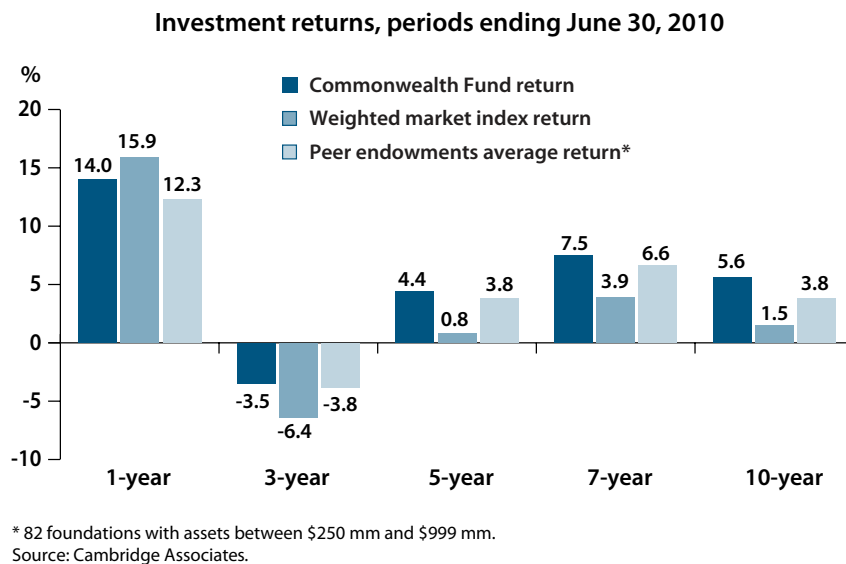
Yet, the 990-PF is not well designed for the uses to which it is put.

**Misstated administrative expenses.** The information requested in Part I, “Operating and Administrative Expenses” (lines 13–26) is particularly problematic for value-adding foundations like The Commonwealth Fund that both make grants and conduct their own research programs and communications activities, and whose staff is extensively involved in developing, monitoring, and disseminating the results of grant-funded work. The absence of a functional allocation of foundation expenses in this section results in most of the intramural expenses of such foundations being mislabeled as “administrative” by those who do not appreciate that an increasing number of foundations do much more than write checks, but in fact work in partnership with their grantees and operate programs directly.

Additionally, the failure of this section to request a functional breakdown of expenses according to whether they are for grants, the administration of grants, the foundation’s own direct charitable activities (such as operating museums, running service programs, research, or communications), endowment management, or general administration has confounded efforts to establish benchmarks for administration ratios.<sup>12</sup> The latter are not only of great interest to foundation trustees and managers, but also to congressional overseers, researchers, and journalists.

**Missed opportunities to shed light on endowment performance.** Information on the investment performance of the foundation’s endowment is solicited nowhere in the 990-PF. Since the endowment is the only source of income for most foundations, this is an egregious omission—equivalent to not requiring for-profit corporations

**Exhibit 4. Requiring foundations to report the quarterly investment performance of their endowments would produce the comprehensive database needed for benchmarking and improving endowment management.**



to report their earnings in their tax returns and financial statements.

Effective oversight and management of foundation endowments are a source of great concern for any experienced observer and practitioner in the field. Too many foundations still do not track their investment performance at all, or relative to market and peer benchmarks, fail to attract qualified trustees to serve on their investment committees, and lack the sophisticated skills needed to manage their endowment effectively on their own, yet persist in trying to do so. Moreover, the risks of conflicts-of-interest involving investment committee members and money managers are substantial.<sup>13</sup>

Peer comparisons of investment returns like those in Exhibit 4 can be very helpful to investment committees of foundation boards in assessing and improving their performance. But the 990-PF provides no help in this regard; consequently, groups of foundations and consultants undertake separate, costly efforts to compile performance databases that

are very limited in scope and unlikely to be truly representative of the sector.

**Unwieldy format and poorly targeted content.**

Reflecting the numerous additions over time, the 990-PF is unnecessarily long, complicated, and poorly organized, with little attention to the needs and priorities of its users. In contrast to corporations and many nonprofits, most foundations are fundamentally simple organizations, typically with a single source of income (their endowment) and a single product line (their grants). The IRS's major concerns are that foundations meet the required annual payout, pay the required excise tax (and in a limited number of cases, an unrelated business income tax), not have controlling interests in for-profit businesses, and avoid practices that involve conflicts of interest (self-dealing) or that stray outside their philanthropic purpose. But the content and structure of the return do not reflect these realities.

- The determination of the all-important annual payout requirement, comparison with actual payout, and calculation of any necessary catch-up payout that must be made in the following year are spread over four sections (Parts X–XIII) and two pages and do not appear until near the end of the return. As a result, it is likely that only sophisticated readers are able to discern readily and accurately whether the foundation is meeting its payout obligations.
- Part I, “Analysis of Revenue and Expenses,” requires in four columns different presentations of this information, with column totals that do not correspond to each other and that are confusing to users. A single column presenting revenues and expenses in an accounting method consistent with the foundation’s books would be more useful to the interested audience.
- The Part II requirement that foundations attach schedules showing individual securities in their endowment portfolios at fiscal year-end serves little purpose. Most portfolios are actively traded and a snapshot is therefore of limited use. More significant is that even small foundations have dozens of securities in their portfolios, and large ones, hundreds or thousands; clearly, summative information revealing any untoward concentration of holdings in individual companies would better serve the IRS’s regulatory needs.
- Part II, “Balance Sheets,” is more disaggregated than necessary, and the requirement to show columns with book values for the beginning and end of the fiscal year and the market value for the end of the year is anachronistic, dating back to an earlier time when foundations’ balance sheets used book values. Foundations’ balance sheets now routinely use market values, and the balance sheet part of the 990-PF could easily and appropriately be consolidated into a dozen or so lines, compared with 31, and two columns, rather than three, showing beginning and end-of-year market values.
- A considerable amount of the information requests apply to only a few foundations or to only particular types of foundations (for example, operating foundations). Rather than complicating the basic form, such information should be solicited, when applicable, in separate schedules.
- Sections such as Part XIII (Exhibit 5) that consist largely of shaded boxes not to be filled in could obviously be tightened up.
- Parts VII-A and VII-B, which deal with regulated, prohibited, or taxable activities, consist of some 50 yes/no questions that are unnecessarily long and, disconcertingly, not always up-to-date with regard to current law or best practices. For example, there are no questions about the two Sarbanes–Oxley requirements for nonprofits, whistleblower and records-retention policies, or the requirement for written investment and spending policies under states’ Uniform Prudent Management of Institutional Funds Act legislation.
- Some sections of the return are a carryover from earlier IRS corporate tax returns that have little relevance in the foundation field—for example, Part III, “Analysis of Changes in Net Assets or Fund Balance.” Such vestigial information requirements could be removed from the return with no loss to users.

**Exhibit 5. The Form 990-PF is unnecessarily long, complex, and confusing—adding to the costs of filing it and diminishing its value to users.**

- Misrepresents foundations’ administrative expenses
- No information on endowment performance
- Unwieldy format and poorly targeted content
- Major challenges to e-filing
- Poor functionality as a research database
- Misleading or indecipherable terms
- Missing focus on the foundation’s purpose

Source: Internal Revenue Service.

**Costliness of e-filing.** Like other nonprofits, foundations filing more than 250 IRS forms (for example, W-2 income tax withholding forms and 1099-Miscellaneous Income forms) are now required to file the 990-PF electronically, but only a small number of foundations currently meet this threshold. Because of the potential efficiencies in both submitting data and creating researchable databases on foundations’ tax returns, requiring electronic filing is a desirable aim for the administration of the 990-PF. But realization of this goal is greatly hampered by the complexity of the existing form. Those that do file electronically find it to be a costly undertaking, and review of the small number of

e-filed 990-PFs reveals the results in some cases to be less than satisfactory.

**Poor functionality as a database.** As the only mandatory information filing required of all foundations, the 990-PF—like other tax returns—should provide the ancillary function of generating a valuable database for researchers, journalists, and policymakers. Efforts to use it for such purposes reveal its deep flaws: too often, the information requested is of little current relevance; major gaps such as those noted above on endowment performance and functional allocation of expenditures limit its utility; and

the complexity of the return make it a researcher's nightmare.

**Lack of disclosure of relationships with service providers.** The return also requests information on compensation and fees paid to foundations' trustees, managers, higher-paid staff, and contractors, and it asks about potentially inappropriate transactions that could trigger the filing of Form 4720 and payment of self-dealing penalty taxes. But it does not require disclosure of names of individuals involved in interlocking relationships between foundation trustees/managers and institutions or individuals that provide services to the foundation.

**Lack of clarity on "jeopardizing investments."** The 990-PF has yes/no questions on investments that could jeopardize the foundation's charitable purpose, and requires filing Form 4720 if tax penalties must be paid on such investments. What constitutes a jeopardizing investment, however, is not clear-cut, and on Form 4720, only a brief description—not explanation—of such an investment is required. The engulfment of a number of foundations in the Madoff scandal demonstrates the need for disclosure of significant endowment losses arising from excessive concentrations in holdings, unusual leverage through derivatives or borrowing, or fraud—not only in the interest of public accountability, but as a means of alerting other foundations to hazardous kinds of investing to be avoided.<sup>14</sup>

**Missing focus on the foundation's purpose.** Not until Part IX-A, "Summary of Direct Charitable Activities" (page 7), is any information requested on what the foundation actually does to justify its tax

exemption. More important, the result of the broad latitude that foundations are given in answering an open-ended question about their activities and performance, combined with the rigidities of a tax return, is that the form does little to promote understanding of what foundations do and the extent to which they are accomplishing their missions and making a difference in society.

**Misleading or indecipherable terms.** Because of its reliance on tax code terminology, much of the language in the form is unintelligible to the many lay readers, including trustees and journalists, who use it—leading to harmful misinterpretations. For example:

- "Minimum Required Payout" would be a much clearer title for Part X than the current "Minimum Investment Return";
- "Adjusted Required Payout" (Part XI) would be more informative than "Distributable Amount"; and
- "Actual Current Year Payout" (Part XII) would be less mystifying than "Qualifying Distributions."<sup>15</sup>

**Weakness in promoting best practices.** The 990-PF has served a very useful role in weeding out "worst practices" in the foundation field, but it plays a very limited role in prodding for best practices. As discussed below, there are significant limitations on the extent to which the 990-PF can be expected to play the latter role, but in key areas like requiring reporting on endowment investment returns, the foundation's work and overall performance, and adherence to certain legally required best practices, it falls short.

## Modernizing the 990-PF

### Recommended Guidelines

This limited review of the shortcomings of the existing 990-PF suggests guidelines for its modernization.

**Reporting of expenses should be disaggregated functionally.** Doing so would enable users to readily identify which parts of the foundation's expenses are devoted to grants and direct charitable activities, grants administration, endowment management costs, unrelated business costs, and general administration.

**The major missing gap of endowment investment performance should be filled.** Requiring all foundations with assets of \$10 million or more to report the net investment returns on their endowments for each of the last four calendar quarters would quickly produce a comprehensive time series on endowment returns that could be parsed by foundation size, intended life expectancy, and other variables to enable reliable peer benchmarking.

Many foundations will, doubtless, object to this new requirement on grounds that it is burdensome and could be misused by critics who do not understand the vagaries of financial markets, acceptable variations in risk tolerance for different foundations, and the need for perpetual foundations to take a long-term view with respect to endowment management. The burden argument does not hold up, however, as any foundation investment committee doing its job properly should have readily on-hand data on quarterly investment returns, and should use such data to compare results over multiyear periods to market benchmark and peer-institution returns. The burden of this proposed requirement would also be reduced by exempting from it the nearly 70,000

foundations with less than \$10 million in assets. While very large in number, these foundations account for only 14 percent of foundation assets, and they have a wide variety of investment objectives and risk profiles that are generally quite different from those of larger foundations.

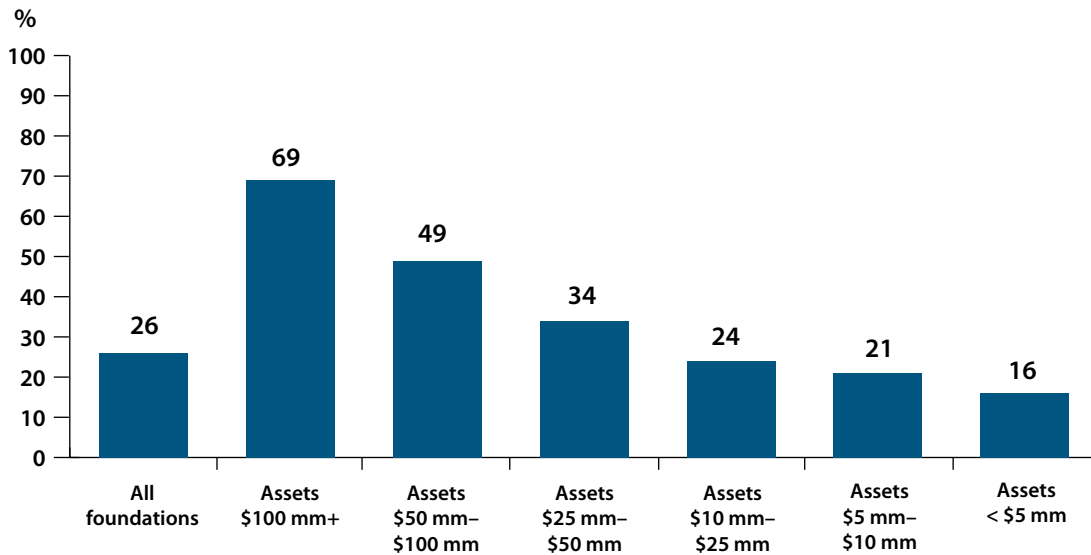
It is indeed likely that, once investment returns of foundation endowments are public, they will be the subject of commentary from the media and foundation observers. University endowment managers have long been subject to such scrutiny, and the foundation community would benefit from similar accountability.

**The return should be used to prod foundations to use Web sites to report information on their programs and performance that cannot be readily conveyed on a tax return—thereby also enabling more rapid adoption of e-filing of returns.**

- The 990-PF should add a question on whether the foundation maintains a Web site and solicit the address. The Foundation Center reports that only 26 percent of foundations currently have a Web site, although the trend is distinctly upward (Exhibit 6).<sup>16</sup> Even among foundations with assets of \$100 million or more, 31 percent do not have a Web site, and among foundations with assets between \$50 million and \$100 million, the shortfall is 51 percent. Only 16 percent of foundations with less than \$5 million in assets have an online presence.

Surely in the Internet age, maintenance of a Web site that discloses basic information on the foundation's activities, governance, and management should be a fundamental test of accountability. The burden of this expectation has been greatly reduced by the

**Exhibit 6. Only 26 percent of foundations have Web sites informing the public and grantseekers of their missions, activities, and performance. A modernized Form 990-PF could spur foundations to develop Web sites to report programmatic information not easily reported on a tax return.**



Source: Foundation Center, [www.glasspockets.org](http://www.glasspockets.org), 2009 survey.

Foundation Center's willingness to develop a basic Web site at no cost for any requesting foundation, and its willingness to develop more sophisticated sites for very reasonable fees.

- Greater emphasis—upfront—should be placed on foundations reporting their missions, goals, strategies, and results. To facilitate e-filing and to encourage foundations to take full advantage of the Internet in carrying out their missions, organizations should be permitted to meet the informational requests of this section of the return with a link to their Web site. Allowing this would enable far more comprehensive, timely, and accessible reporting of the information than a tax return could ever achieve. The 990-PF should push foundation communications in this direction.
- One of the biggest obstacles to e-filing is the return's Part XV requirement to list detailed

information on all grants. A foundation that reports this information on their Web site should be able to meet the requirement by providing a link and by participating in the Foundation Center's Web-based Grantsfire and eGrant Reporter system, which allows foundations to post information on grants nearly in real time.

By taking this step, the 990-PF would no longer serve as a print repository for lists of grants made by individual foundations. Instead, raw data on grants by individual foundations would be available on their Web sites, while cleaned and structured data would be available through the Foundation Center's electronic databases. Foundation transparency would be enhanced, while the currency of data provided to the Foundation Center would be greatly improved. This would also have the salutary effect of ensuring that the research



and trend studies produced by the Foundation Center and others are based on current-year data—something that is not possible with the current 990-PF grants-reporting system, with its time lags and variable fiscal years for foundations.

**The basic return should be as short and uncomplicated as possible and written in plain English.**

Essential tax code terminology should be provided parenthetically. The return should have a logical progression that guides users to sound conclusions on the foundation's compliance with regulations and adherence to fundamental, recognized best practices for the sector.

- The calculations of the required payout, payout shortfall, and excise tax on investment income should be concise and presented in a format easily followed by lay users.
- Secondary information should be requested in supplemental schedules, to be supplied by foundations as appropriate.
- The requirement to list individual securities in the endowment portfolio should be replaced with one to list securities of any one company constituting more than 5 percent of the endowment, or that amount to 20 percent or more of a portfolio company's net assets.

**The yes/no questions on foundation compliance with regulations should be updated to include legally required best practices in governance and management.** Among these should be questions on whether the foundation has written endowment investment, spending, whistle-blower, and records-retention policies. Consideration should also be given to adding questions on key best

practices recommended by Independent Sector on conflicts-of-interest and travel reimbursement policies. Such questions, with explanations required for negative responses, would be as productive a prod for the widespread adoption of basic best practices as the existing questions on business holdings and political activities have been. The burden of these additions could be alleviated by tightening up the existing regulatory compliance questions.

**Separate schedules should be required for reporting payments to related parties and by commonly controlled organizations.**

Close relationships between foundation trustees and managers and institutions or individuals providing services to the foundation should be disclosed. Most such relationships are likely to be innocuous—for example, a grant for a project conducted by a researcher within a large university whose president is a trustee of the foundation. But requiring disclosure would promote accountability.

**Foundations should be required to disclose and explain instances of material investment losses (more than 5 percent of assets) arising from excessive investment concentration or leverage (greater than 5 percent of assets), or fraud.** In addition to serving as a monitor of stewardship, this requirement would foster the exchange of information on endowment management hazards to be avoided.

**Modern foundation accounting practices should be followed throughout the return, especially in the financial statements sections.** The 990-PF should be updated regularly to keep pace with generally accepted accounting practices for foundations.

## First Steps in Revising the 990-PF

Working groups of Independent Sector's 2005–06 Panel on the Nonprofit Sector recommended modernizing the 990-PF, and follow-up work by a leading group of foundation financial officers and tax experts has resulted, fortunately, in a prototype revised 990-PF incorporating many of the above guidelines.<sup>17</sup> Indeed, the principal items proposed above that are not in the prototype are the requirements for reporting endowment investment returns, the existence of a foundation Web site, and occurrence of a material endowment loss arising from excessive concentration, excessive leverage, or fraud.<sup>18</sup> In stark contrast with the existing 990-PF, the prototype revised basic form is four pages, rather than 13. The Commonwealth Fund estimates that its costs for preparing the modernized return would be approximately \$10,000, compared with current costs of \$18,000.

The IRS began a process for revising the Form 990 for nonprofits that are not foundations ("Return of Organizations Exempt from Income Tax") in 2005, and the new Revised Form 990 went into effect in the 2008 tax year. It was expected that the Service would move forward with modernization of the 990-PF once the work on the return required of other nonprofits was completed. Regrettably, the IRS has not seized on the opportunity provided by the work of foundation accounting and tax experts.<sup>19</sup>

The IRS should be encouraged not to delay revision of the 990-PF, for the following reasons:

- The shortcomings of the existing form are manifest, and the filing falls well short of its potential for advancing both the Service's foundation regulatory functions and the foundation sector's self-regulatory efforts.
- The annual excise tax on investment income collected from foundations has never been used for the original intended purpose of strengthening regulation of the sector; instead, these taxes are added to the general federal revenue pool.<sup>20</sup> Surely, channeling a very small portion of the excise tax revenues, for a few years, for the purpose of revising the 990-PF would advance the public interest.
- Tax return revisions are normally laborious and involve weighing many competing interests and issues, such as data discontinuities and taxpayer burdens resulting from revisions of an established form. This is not the case for the private foundation return: a workable prototype already exists; the sector is able to afford any short-term costs that arise from implementing a new form; and because of its shortcomings, the data currently collected on the 990-PF are rarely used for research or analysis.
- How well implementation of the Revised Form 990 for other nonprofits works out has little or no bearing on what should be done about the 990-PF. Since 1972, Congress and the IRS have recognized that the foundation sector is quite distinct from the general nonprofit sector and requires more regulation and specialized tax-form reporting.

## Whither the Excise Tax on Foundations' Net Investment Income?

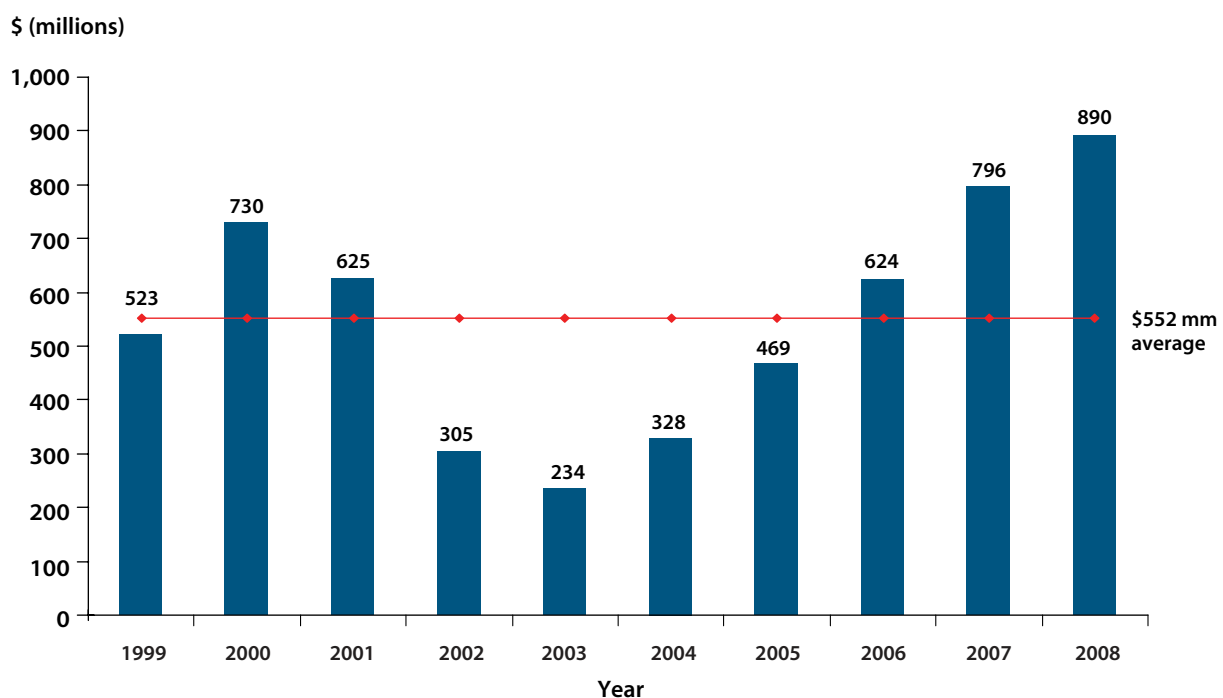
Approximately two pages of the 990-PF are devoted to the calculation of the 2 percent excise tax that must be paid on net investment income (income from interest, dividends, other sources, and net realized capital gains). The computation is complicated

by the provision that the tax rate is lowered to 1 percent periodically for foundations that pay out more than the required annual minimum charitable distribution for a certain period. The argument for replacing the dual excise tax rate structure with a single rate generating the same amount of revenue—1.39 percent, as proposed in legislation introduced by U.S. Senator Charles Schumer (S. 676), or 1.35 percent, as proposed in President Obama’s federal budget for fiscal 2012—is sound. A single rate would advance the goal of tax simplification, reduce filing preparation costs, and obviate the unproductive gaming of the current system in which some foundations engage.

Should Congress entertain simplifying the excise tax, it should also take under consideration an alternative approach that would advance simplification even further, while also reducing the

pronounced variability in revenues produced by the tax (Exhibit 7): replacing the excise tax on net investment income altogether with a flat tax on foundation assets that, on average over a defined period, would produce the same amount of revenue. As shown in Exhibit 8, using The Commonwealth Fund as an example, a flat assets tax of 0.14 percent would have produced the same \$12 million in revenues over the 1994–2008 period as the actual excise tax—but with much less volatility and more predictability. This simplified alternative excise tax method, requiring only a few lines in the return, offers multiple benefits: foundations could more reliably predict their annual tax bills; the IRS could more reliably predict revenues from this source; and foundations would have no incentive, as they do under the current method, to vary their grant activities in order to minimize their tax bill.<sup>21</sup>

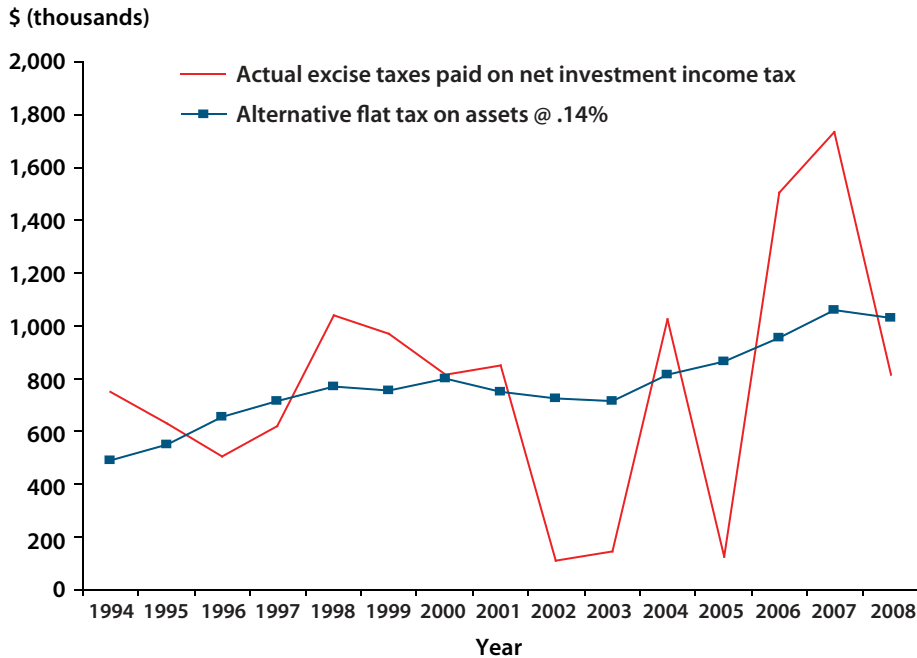
**Exhibit 7. Excise taxes on net investment income paid by foundations average \$552 million annually, with large fluctuations from year to year.**



Source: [www.irs.gov/taxstats/charitablestats](http://www.irs.gov/taxstats/charitablestats), IRS data files.

**Exhibit 8. A flat excise tax on foundations' assets could produce the same revenues as the current excise tax on net investment income, but with much less annual volatility and unpredictability—and would be a much simpler computation on the Form 990-PF.**

Commonwealth Fund: Actual excise tax paid vs. tax that would have been paid at a rate of .14% on assets, 1994–2008—with same cumulative total



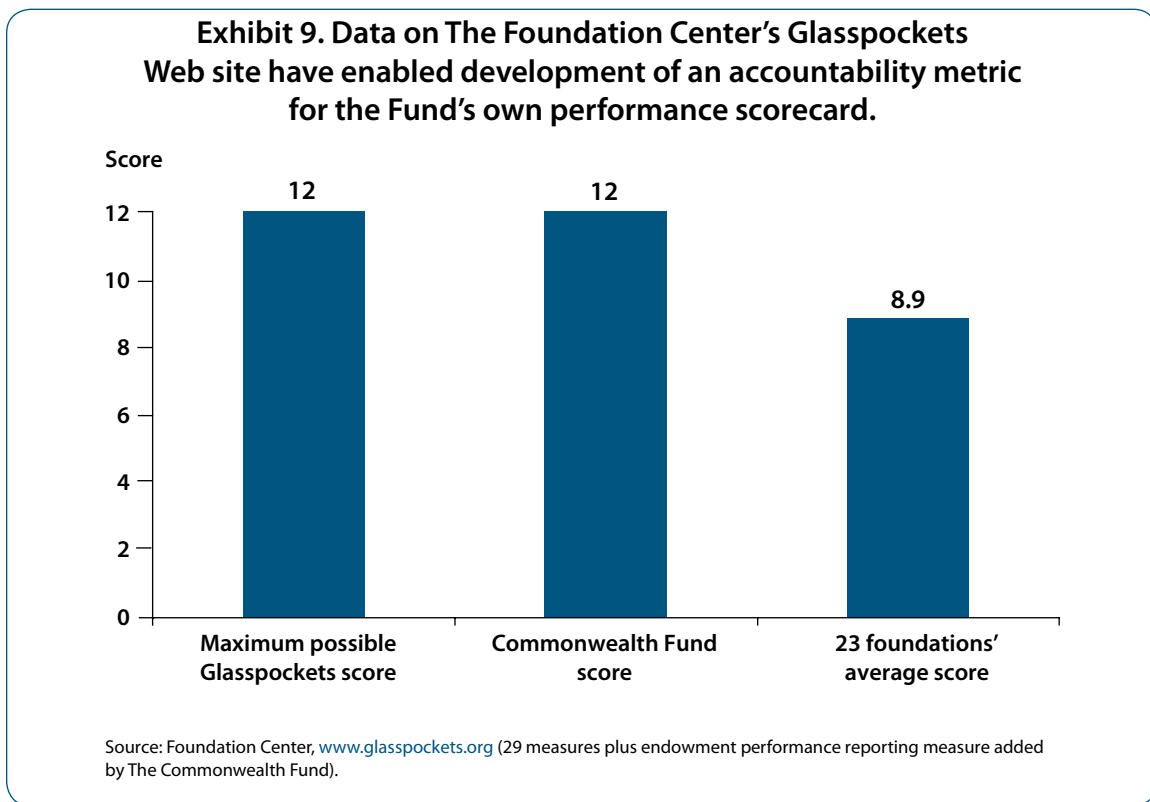
Source: The Commonwealth Fund.

## Advancing Transparency, Accountability, and Best Practices

These recommendations for modernizing the 990-PF recognize the limitations on the extent to which the tax filing can ever serve as a guide for the foundation sector on transparency, accountability, and best practices. The IRS will always see the main purpose of the return to be determining compliance of foundations with the U.S. tax code and Treasury regulations. A revised return would improve the principal databases for monitoring foundation activities and encourage the adoption of legally required or widely agreed-upon best practices. But the size and diversity of the sector, the perils of the IRS attempting to use a limited amount of data for promulgating performance benchmarks, and serious

IRS resource constraints lead to the conclusion that the foundation community itself should take the primary responsibility for ensuring that transparency, accountability, and best-practice adoption are a cultural norm for the sector.

In response to concerns of the U.S. Senate Finance Committee about misconduct by some nonprofits, Independent Sector's Panel on Nonprofits promulgated in 2007 *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations*. These guidelines, together with work by the Center for Effective Philanthropy and groups like Grantmakers for Effective Philanthropy, efforts of the Council on Foundations and regional associations of grantmakers, and the CFA Institute's recently issued code of



conduct for endowment management, demonstrate a strong sectoral response to the need for robust self-regulation.<sup>22</sup>

Among the most promising approaches for encouraging foundations to assess and improve their practices and to expose themselves to helpful public scrutiny is the Foundation Center's Web-based Glasspockets project.<sup>23</sup> Aimed at bringing transparency to the philanthropic community, Glasspockets is increasing understanding of best practices in foundation transparency and accountability, drawing on information available on institutions' Web sites. The Center has identified 29 indicators of transparency and best practices across six domains: basic contact information, governance policies and information, human resources/staffing policies and information, financial information, grantmaking information, and performance measurement. It asks foundations to voluntarily submit profiles indicating the extent to which their Web sites demonstrate pursuit of best practices.

As of February 2011, 24 foundations, including The Commonwealth Fund, have placed their profiles on Glasspockets. In a continuing effort to improve its own performance scorecard, the Fund has used these data to develop a new accountability metric (Exhibit 9).<sup>24</sup> The metric uses weights appropriate to the Fund's own values for each indicator in the Glasspockets profile to arrive at a weighted average accountability score for itself, the other participating foundations, and the group as a whole.<sup>25</sup>

Brad Smith, President of the Foundation Center, argues that greater transparency is the best means to protect the freedom that philanthropies need to pursue their missions.<sup>26</sup> The 990-PF is a major tool for ensuring basic transparency on the part of all foundations. Modernization would make it even more valuable and would strengthen the sector's own self-regulatory efforts to ensure effective use of the nation's philanthropic resources.

## NOTES

- <sup>1</sup> *Foundation Yearbook, 2010 Edition*, (New York: The Foundation Center), [foundationcenter.org](http://foundationcenter.org). Data are for 2008.
- <sup>2</sup> The privately funded and nonprofit Foundation Center maintains the most comprehensive database on U.S. and, increasingly, global grantmakers and their grants and operates research, education, and training programs to advance knowledge of philanthropy.
- <sup>3</sup> Based on IRS estimates of average time requirements for different aspects of the filing process, in Internal Revenue Service, *2010 Instructions for Form 990-PF*, p. 30, Paperwork Reduction Act Notice. Using the IRS's time calculations and estimated hourly preparer rates, the average cost of filing the return is \$9,000. Costs for individual foundations, of course, vary widely, depending on their size and complexity of operations. With a \$650 million endowment, The Commonwealth Fund, for example, spends about \$18,000 in preparing its annual tax return. The author thanks Commonwealth Fund controller Jeffrey Haber for these estimates and for his other contributions to this paper.
- <sup>4</sup> See [www.irs.gov/taxstats/charitablestats](http://www.irs.gov/taxstats/charitablestats), IRS data files, average for the 1998–2008 filing years.
- <sup>5</sup> Thomas A. Troyer, “The 1969 Private Foundation Law: Historical Perspective on Its Origins and Underpinnings,” *Exempt Organization Tax Review*, Jan. 2000 27(1):52–65. This brief history of the evolution of Form 990-PF is based on Troyer's article and review of the archived 990-PF filings of The Commonwealth Fund. Another valuable historical perspective is in Paul Arnsberger et al., “A History of the Tax-Exempt Sector: An SOI Perspective,” *Statistics of Income Bulletin*, Winter 2008, [www.irs.gov/taxstats/charitablestats](http://www.irs.gov/taxstats/charitablestats).
- <sup>6</sup> Troyer dates the first 990 information return back to 1943, but the first filing of the 990 in the records of The Commonwealth Fund is for the 1940–41 fiscal year.
- <sup>7</sup> Form 4720, much expanded, must still be filed by foundations to pay penalty taxes for self-dealing, failure to meet the payout requirement, excess business holdings, jeopardizing investments, and taxable expenditures.
- <sup>8</sup> The requirement for detailed schedules on the sources of realized capital gains and losses has been dropped along the way, after proving to be of little value to regulators. Foundations were no longer required to file Form 990-AR after 1975.
- <sup>9</sup> According to IRS data, the average payout of private foundations in 2007–08 was 7.9 percent, ranging from 27 percent for foundations with less than \$1 million in net assets to 6.3 percent for foundations with \$100 million or more in net assets. The payout rate is cyclical, rising in years of market decline, and falling somewhat in years of market upswing—but the average is routinely greater than the required minimum. See [www.irs.gov/taxstats/charitablestats](http://www.irs.gov/taxstats/charitablestats).
- <sup>10</sup> Eleanor L. Brilliant, *Charity and Public Inquiry: A History of the Filer and Peterson Commissions* (Bloomington, Ind.: Indiana University Press, 2000).
- <sup>11</sup> Arnsberger, “A History of the Tax-Exempt Sector,” p. 133.
- <sup>12</sup> Elizabeth T. Boris et al., *Foundation Expenses and Compensation: How Operating Characteristics Influence Spending* (Washington, D.C.: The Urban Institute, The Foundation Center, and Philanthropic Research, Inc., 2006).
- <sup>13</sup> John E. Craig, “Rethinking the Management of Foundation Endowments,” *The Commonwealth Fund 2009 Annual Report* (New York: The Commonwealth Fund, March 2010); and David F. Swenson, *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment* (New York: Free Press, 2009).
- <sup>14</sup> Alan Leibman, “The Madoff Aftermath and Charities: The IRS Forms 990-PF of the Shapiro and Wilpon Foundations—a Contrast in Transparency—Installment 27,” *White Collar Defense & Compliance*, Fox Rothschild, LLP, 6-1-10.
- <sup>15</sup> In each case, the tax code terminology could be retained parenthetically following the plain language title.
- <sup>16</sup> See [www.foundationcenter.org/findfunders/statistics](http://www.foundationcenter.org/findfunders/statistics).
- <sup>17</sup> *Strengthening Transparency, Governance Accountability of Charitable Organizations: a Final Report to Congress and the Nonprofit Sector*. June 2005. [www.nonprofitpanel.org](http://www.nonprofitpanel.org).

Conversation with Ana Thompson of the Charles and Helen Schwab Foundation and Gwen Sherman of the Bill and Melinda Gates Foundation, Jan. 14, 2011. Jody Blazek of Blazek and Vetterling LLP, a past chair of the American Institute of Certified Public Accountants' Tax-Exempt Organizations Resource Panel and member of its task forces on IRS Forms 990 and 1023, has provided expert advice to the group.

- <sup>18</sup> The prototype also does not envision enabling foundations to meet the requirements for information on their charitable activities and grants with links to their Web sites and data submission to the Foundation Center.
- <sup>19</sup> ABA Section of Taxation, Comments on Form 990-PF and Related Instructions, Sept. 28, 2010, American Bar Association (contact Victoria B. Bjorklund at [vbjorklund@stblaw.com](mailto:vbjorklund@stblaw.com) for more information); <http://www.improveirs.org/annualreports/2008%20Recommendations%208-5-2009.pdf/>.
- <sup>20</sup> Troyer, "The 1969 Private Foundation Law," p. 64.
- <sup>21</sup> Losers under a switch to an assets tax would be foundations with large more-or-less permanently held holdings—especially in situations where such holdings have low dividends. Endowments with these characteristics produce little realized gains or income subject to the current tax on net investment income.
- <sup>22</sup> *Investment Management Code of Conduct for Endowments, Foundations, and Charitable Organizations*, CFA Institute, Aug. 2010.
- <sup>23</sup> The Foundation Center, [www.glasspockets.org](http://www.glasspockets.org).
- <sup>24</sup> John E. Craig, "The Commonwealth Fund Performance Scorecard," *The Commonwealth Fund 2006 Annual Report* (New York: The Commonwealth Fund, March 2007).
- <sup>25</sup> The Fund's metric includes a 30th test of accountability not currently in Glasspockets: whether the foundation reports its endowment returns, compared to benchmarks, over multiple years.
- <sup>26</sup> Brad Smith, "Foundations Need to Be More Transparent," PhilanTopic blog, [www.foundationcenter.org](http://www.foundationcenter.org), Jan. 26, 2010.

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