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TRUSTS & ESTATES
NONPROFIT ORGANIZATIONS
ALERT
2013

Consider a Private Foundation to Fulfill Your Philanthropic Goals

What Is a Private Foundation?

There are a variety of vehicles through which individuals and families can promote their charitable giving goals, and private foundations are often a leading choice. Simply stated, a private foundation is a type of charitable organization that qualifies for tax-exempt status as an organization described under Section 501(c)(3) of the Internal Revenue Code (the "Code").[1]

Why Create a Private Foundation?

Tax Benefits. Contributions to a private foundation are eligible for a charitable deduction on a donor's income tax return during life and on an estate tax return at death if the private foundation is recognized by the Internal Revenue Service ("IRS") as an organization described under Section 501(c)(3) of the Code.[2]

Control. Private foundations maintain a separate legal existence, generally as a trust or a corporation, and are operated by the creator and his or her family or other individuals or entities they select to make grants to charitable organizations within the foundation's mission. The ability to control the mission and direction of a private foundation is often a key component for the donors who choose this form over direct giving or contributions to a donor advised fund or community foundation.

Coordinated Family Giving. Private foundations are particularly attractive to donors who want to create a charitable legacy that extends across multiple generations because they can be used not only to coordinate the family's current philanthropic activities, but also to engage younger generations by fostering an interest in charitable giving.

Grants for Charitable Purposes. While a private foundation's grants must generally be made to public charities, under certain conditions a foundation may make grants for charitable purposes to other organizations, such as international or for-profit entities, providing increased opportunities for a foundation to promote its mission. In those cases, the Code requires foundations to exercise "expenditure responsibility," meaning the foundation must closely monitor the use of the grant funds to ensure that they are used for the intended charitable purposes.

Administrative and Tax Considerations of Private Foundations

Foundation Administration. While not unduly difficult, the administration of a private foundation is more complex than, for example, making contributions directly to a public charity. Because the private foundation maintains a separate legal existence, the foundation must maintain separate bank and investment accounts and must take care not to commingle the assets of the foundation with the assets of individuals who manage or contribute to the foundation. In addition, there are on-going obligations associated with any grant-making program, such as reviewing grant requests, distributing grants, reviewing grantee reports, and making site visits. Depending on the foundation's mission and the involvement of the donor and his or her family, these activities may be more or less complex. In many cases, grant-making is relatively limited and can be handled by the donor and/or members of the donor's family. In some cases, where the scope of activities is sig-

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1. A public charity is another type of charitable organization described under Section 501(c)(3) of the Code. Broadly speaking, the differences between the two types of organizations arise primarily from funding sources and activities. Public charities derive most of their support from the general public through solicitations, fees for services provided, and other fundraising endeavors and generally focus their activities on providing direct services or on conducting tax-exempt activities. Private foundations, on the other hand, are generally funded from a more limited number of sources such as an individual, a family, or a corporation, and tend to focus their activities on making grants to other charitable organizations such as public charities.

2. The Code provides that the deduction available for contributions to private foundations is generally less than the deduction available for contributions to public charities, so donors should consult with their accountant or financial advisor prior to making a contribution to a private foundation.

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nificantly broad, hired staff may be needed to handle the day-to-day administration.

Annual Distributions. Private foundations are required to distribute annually a minimum amount equal to approximately five percent of the fair market value of the foundation's noncharitable assets (the "distributable amount"). In general, distributions that will qualify toward satisfying the annual distributable amount include grants to public charities and administrative expenses of the private foundation related to grant-making. In the event a private foundation distributes less than the distributable amount within the period of time prescribed by the Code, the private foundation may be subject to an excise tax on the amount not distributed.

Restrictions on Foundation Activities. Once assets are transferred to a private foundation, the Code imposes various restrictions on their use and investment. These restrictions are intended to protect the charitable nature of the assets and ensure that they are used to further exempt purposes, rather than private interests. Specifically, certain types of distributions are prohibited, including grants for lobbying, grants to individuals (unless the foundation has received prior approval from the IRS), and grants for noncharitable purposes. In addition, to underscore the fact that the assets are to be used only for charitable purposes, the Code prohibits transactions between the foundation and its donors or managers except under very limited circumstances. Similarly, the Code regulates the extent to which a foundation can control a business entity and prohibits foundation managers from making investments that would jeopardize the foundation's ability to carry out its charitable purposes. There are other rules applicable to private foundations, and foundation managers must be mindful that they comply with all of the rules because violations may result in significant penalties for both the foundation and the individuals involved, including a potential loss of tax-exempt status.

Taxes and Form 990-PF. Private foundations must file annual information returns with the IRS ("Form 990¬PF Return of Private Foundation"). Although private foundations are tax-exempt organizations for income tax purposes, they are subject to an excise tax of one to two percent on their annual net investment income. Because of the complexities involved in filing the annual returns and in complying with the Code's requirements, some of which have been outlined above, private foundations are strongly advised to engage the services of an accountant and an attorney who specialize in advising tax-exempt organizations.

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For many donors, private foundations offer an appropriate vehicle for promoting philanthropic interests, one that affords control while providing a means to establish a family legacy and a tradition of giving. If you would like more information about creating or managing a private foundation, please contact us. ◆

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