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Subchapter S Corporations Can Do Good For Others And Themselves Through Private Non-Operating Foundations

By John J. Hess

Suppose a client owns a substantial interest in a successful Subchapter S corporation ("S corporation"). An S corporation is generally a closely held corporation whose shareholders elect on behalf of the corporation to be treated for most tax purposes as a partnership so that income earned by the corporation is taxed only to the shareholders in the year it is earned. On the other hand, the income earned by a regular corporation ("C corporation") is taxed to the C corporation in the year it is earned and taxed again to the shareholders in the year dividends are paid to them.

The client wishes to establish a program of charitable giving but does not want to generate publicity for himself. One way this could be accomplished would be for the S corporation to establish a private non-operating foundation under section 501(c)(3) of the Internal Revenue Code ("Code"). A private non-operating foundation (a "PNF") is a tax-exempt organization that is not publicly supported and which limits its activities to making contributions to other tax-exempt entities. Because of various administrative requirements imposed by the law, such a foundation will generally limit its contributions to publicly supported charities. A PNF can either be a not-for-profit corporation or a trust.

In our situation, it is preferable for the S corporation to make the contributions to the PNF. The IRS has ruled that the deductibility of contributions to a charity by an S corporation will pass through to the shareholders and be subject to the individual limitations on deductibility (Rev. Rul. 2000-43). The annual deduction limit for individuals who contribute to a PNF is generally 30% of their adjusted gross income ("AGI"). The annual deduction limit for C corporations is only 10% of its adjusted taxable income ("ATI"). Thus, our client can get the significant tax benefit of making charitable contributions and, at the same time, maintain his privacy. However, it should be noted that a direct contribution by the client, individually, to a public charity would generally be subject to an annual deduction limit of 50% of AGI. Privacy is maintained through the use of a PNF, but at a certain cost.

A PNF must obtain recognition from the IRS that it is exempt from income tax under section 501(c)(3) of the Code by filing a Form 1023 with the IRS. In order to get retroactive recognition from the date of its formation, a Form 1023 must be filed with the IRS within 27 months after the end of the month in which the PNF was formed. Annual filings with the IRS and the state where the PNF is maintained are required.

It must be noted that a PNF is generally subject to a 2% excise tax on its net investment income, must distribute at least 5% of the value of its net

ANDERSON KILL & OLICK, P.C.
1251 Avenue of the Americas
New York, NY 10020-1182
(212) 278-1000
Fax: (212) 278-1733

ANDERSON KILL & OLICK, P.C.
1600 Market Street
Philadelphia, PA 19103
(215) 568-4202
Fax: (215) 568-4573

ANDERSON KILL & OLICK, P.C.
One Gateway Center
Suite 1510
Newark, NJ 07102
(973) 642-5858
Fax: (973) 621-6361

ANDERSON KILL & OLICK, L.L.P.
2100 M Street, N.W.
Suite 650
Washington, DC 20037
(202) 218-0040
Fax: (202) 218-0055

ANDERSON KILL & OLICK (Illinois), P.C.
230 West Monroe Street
Suite 2540
Chicago, IL 60606
(312) 201-9516
Fax: (312) 201-9548

ANDERSON KILL & OLICK, P.C.
Two Sound View Drive
Suite 100
Greenwich, CT 06830
(203) 622-7668
Fax: (203) 622-0321

www.andersonkill.com

John J. Hess

who's who

John J. Hess is a shareholder in the New York office of Anderson Kill & Olick, P.C. whose practice concentrates in the areas of tax law, employee benefits and ERISA. Mr. Hess is a member of the Association of the Bar of the City of New York, the New York State Bar Association (and its Section on Taxation), and the American Bar Association. Mr. Hess can be reached at (212) 278-1811 or jhess@andersonkill.com.

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Member's Listing

Phillip J. Benoit, CPA (212) 278-1348
pbenoit@andersonkill.com
James G. Clements (212) 278-1244
jclements@andersonkill.com
Phillip England (212) 278-1483
pengland@andersonkill.com
Abbe I. Herbst, Editor (212) 278-1781
aherbst@andersonkill.com
John J. Hess (212) 278-1811
jhess@andersonkill.com
Mary E. McGuire, EA (212) 278-1801
mmcguire@andersonkill.com
C. William Tanzi (212) 278-1384
wtanzi@andersonkill.com

investment assets every year and is subject to a number of special rules and restrictions that generally do not apply to public charities. As a result, the governing instrument of a PNF must prohibit the directors or trustees of the PNF from (i) engaging in any act of self-dealing, (ii) retaining any excess business holdings, (iii) making any investments that jeopardize the charitable purpose of the PNF or (iv) making any taxable expenditures. "Taxable expenditures" include payments to influence legislation or an election and grants to another PNF unless expenditure responsibility is exercised by the grantor.

Notwithstanding the restrictions, having the client's S corporation establish a PNF can have a number of advantages to the client, the company and its employees:

(1) Contributions to the PNF by the company would preserve the anonymity of the client while accomplishing his program for charitable giving when the PNF makes contributions to various public charities.

(2) The client and/or members of his family could administer the PNF and receive reasonable compensation for managing the PNF.

(3) Contributions by the PNF could provide favorable publicity to the company (i.e., the PNF could use the company's name and logo).

(4) Contributions made by the company to the PNF would be deductible by the client subject to the 30% of AGI annual limit rather than the C corporation limit of 10% of ATI.

(5) A matching contribution program by the PNF for the employees of the company would provide an indirect benefit to these employees. For example, a matching contribution to a museum could result in a higher membership classification for the employee with increased membership benefits, such as eligibility to attend special events or increased discounts for purchases at the museum gift shop.

Thus, there are a number of advantages for a closely held business to establish a PNF. This is particularly true if the business entity is an S corporation or partnership. The attorneys and accountants at AKO can assist your closely held business in establishing and administering a PNF.

Helpful Tip: *A PNF could establish, with the consent of the IRS, a limited college scholarship program for the children of the company's employees. In view of the rising costs of higher education, this would constitute a significant benefit to those employees of the company whose children receive the scholarships.*

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