Morgan Stanley

PRIVATE WEALTH MANAGEMENT

ESTATE PLANNING STRATEGIES

Private Foundations

Wealth and Estate Planning Strategists
Family Office Resources

A private (non-operating) foundation is a charitable entity, usually controlled by the donor, that makes grants to public charities or, in some cases, other private foundations or individuals. Gifts to private foundations are treated less favorably for income tax purposes than comparable gifts to public charities. Federal tax laws regulate the activities of private foundations.

Structure

A donor can create a private foundation under state law as a not-for-profit corporation or a charitable trust.[1] The donor can designate the members of the private foundation's governing body (directors if a corporation or trustees if a trust) and, accordingly, control the private foundation.

Income Tax

If the donor contributes cash to the private foundation, the donor's income tax deduction is limited to 30% of their adjusted gross income (AGI). If appreciated property is contributed, in general, only the lower of the cost basis or its fair market value may be deducted, subject to a limitation of 20% of the donor's AGI. However, if "qualified appreciated stock" is contributed, then the fair market value can be used to calculate the donor's income tax deduction.

"Qualified appreciated stock" is defined as stock which is tradable on an established securities market on the date of the donation, and which would generate long-term capital gain if sold by the donor. Publicly traded stock will not be qualified appreciated stock if the donor and the donor's family members contribute in the aggregate more than 10% of the outstanding stock of a single company. The special provision may not apply (limiting the deduction to the lower of cost basis or market value) where sale of the stock is restricted under securities laws. Any excess deduction may be carried over for use in the following five years, subject to AGI limitations.

Private Foundation Rules

Private foundations are subject to rules which, generally, may impose excise taxes on the following acts: (i) self-dealing between the private foundation and "disqualified persons" considered related to it (defined, generally, as substantial contributors, substantial owners, related entities, foundation managers and directors, and their family members); (ii) the

[1] While it is beyond the scope of this summary, the choice of entity, although generally neutral, can have securities law and investment implications.

failure to distribute a minimum amount to charity each year (generally, 5% of the market value of the foundation's net asset base, except in the first year); (iii) a 20% limitation on ownership of the voting stock of a corporation or interest in a partnership, reduced by the percentage of voting stock actually or constructively owned by disqualified persons (this percentage is increased to 35% if certain conditions are satisfied); (iv) investment income generated by the entity's assets (a 1.39% excise tax is imposed on the foundation's net investment income, such as dividends, interest, royalties, rents, and capital gains); (v) investments that jeopardize the entity's charitable purpose (closely scrutinized transactions might include trading in securities on margin, trading in commodities futures, investments in working interest in oil and gas wells, trading in options, the purchase of warrants, selling short, etc.); and (vi) certain expenditures or grants deemed inappropriate for tax-exempt purposes (e.g., lobbying and political activities).

Grant-Making

Ordinarily, private foundations meet their grant-making obligations by making grants to public charities. Before making a grant to another private foundation, the private foundation must exercise "expenditure responsibility" by using reasonable efforts and establishing adequate procedures to: (i) see the grant is spent solely for the purpose for which it was made, (ii) obtain full reports from the recipient foundation to see how the funds are spent, and (iii) make detailed reports of such expenditures to the IRS. Before making scholarship or research grants to an individual or awarding prizes for individual achievement, the private foundation must obtain advance approval from the IRS that its procedures are objective and nondiscriminatory.

Disclosure

In general, federal tax law requires a private foundation to make its application for tax exemption and its three most recent annual informational tax returns available to the public. A private foundation must also disclose the names of its contributors. The IRS may impose penalties for noncompliance with these rules.

Advantages

The donor and their family may control the private foundation. The private foundation may employ the donor and their family and pay them reasonable compensation for services rendered in the furtherance of the foundation's goals. The donor can use the private foundation to teach family members fiscal responsibility and encourage philanthropy. The private foundation can memorialize the name of the donor and advance the philanthropic goals of the donor after their death.

Disadvantages

Ongoing administration, including annual tax filings and filings with state charity officials, and monitoring of the activities of the private foundation to avoid violating the private foundation rules can be burdensome and time-consuming (although these responsibilities may be delegated to a third-party service provider). A donor cannot remain anonymous. A private foundation that has net income from a regularly carried-on business unrelated to its charitable purpose (Unrelated Business Taxable Income or UBTI), which includes income generated by the use of borrowed funds, may be taxed on that income, notwithstanding the fact that a private foundation would normally be a tax-exempt entity.

Important Disclosure

Morgan Stanley Smith Barney LLC does not accept appointments, nor will it act as a trustee, but it will provide access to trust services through an appropriate third-party corporate trustee.

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The term "Family Office Resources" is being used as a term of art and not to imply that Morgan Stanley and/or its employees are acting as a family office pursuant to Investment Advisers Act of 1940.

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