Morgan Stanley

Private Foundations

Charitable Giving Strategies

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.

Wealth and Estate Planning Strategists
Family Office Resources

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, his or her income tax deduction is limited to 30% of his or her adjusted gross income (AGI). In general, only the lower of the cost or the fair market value of long-term appreciated property contributed to a private foundation may be deducted subject to a limitation of 20% of the individual's AGI. However, individuals can deduct the fair market

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

value of “qualified appreciated stock” contributed to a private foundation. “Qualified appreciated stock” is defined as stock which is tradable on an established securities market on the date of the gift 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 his or her 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 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 the AGI limitations.

Private Foundation Rules

Private foundations are subject to the private foundation rules which generally may impose excise taxes on the following acts: (i) self-dealing between the private foundation and persons considered related to it (“disqualified persons”); (ii) the failure to distribute a minimum amount to charity each year (generally 5% of the market value of the foundation’s assets); (iii) a 20% limitation on ownership of the stock of a corporation or interest in a partnership (this percentage is increased to 35% if certain conditions are satisfied); (iv) investment income generated by the entity’s assets (under current law, a 2% tax which can be reduced to 1% if certain distribution requirements are met); (v) investments that jeopardize the entity’s charitable purpose; and (vi) certain expenditures or grants deemed inappropriate for tax-exempt purposes.

Grant-Making

Ordinarily, 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 disclose the names of contributors. The IRS may impose penalties for noncompliance with these rules.

Advantages

The donor and his or her family may control the private foundation. The private foundation may employ the donor and his or her family and pay them reasonable compensation. 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 forever. The private foundation can advance the philanthropic goals of the donor after his or her death.

Disadvantages

Paperwork, including annual tax filings and filings with state charity officials, and ongoing monitoring of the activities of the private foundation to avoid violating the private foundation rules, can be burdensome and time-consuming (but can 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) may be taxed on that income, notwithstanding the fact that a private foundation would normally be a tax exempt entity. UBTI includes income generated by the use of borrowed funds.

Important Disclosure

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