

So Your Client is Tired of Operating a Private Foundation

There are several reasons the founders of a private foundation may want to abandon its operation. They may have tired of the process of identifying and evaluating prospective grantees, or they may have decided their children and grandchildren have no interest in that process. They may have decided that the costs of operation exceed the benefit to the community of the separate charity they have created.

The founders have choices about how to terminate the foundation. One of the methods of terminating a private foundation—by having it operate for 60 months as a public charity—is generally not attractive in this situation. Having to raise contributions from enough different sources that the foundation meets a public support test would be difficult to say the least, and would not meet the needs of founders who essentially want to retire. There are, however, several alternatives.

Terminating a Private Foundation

1. General

(a) Notice to IRS

The rules that govern terminations of private foundations are intended to prevent the donors who created it from avoiding the foundation rules by abandoning charitable operations or by creating a new charity and transferring the foundation's assets to it.

The general rules require a private foundation that wishes to cease being a private foundation to notify the IRS and to pay a termination tax.

The termination tax is equal to the benefit of the charitable contribution deductions afforded to all of the donors to the foundation and the tax exemption afforded the foundation during the years of its existence plus interest on those benefits (or the net value of the foundation's assets, if that is lower than the aggregate tax benefit).

If a foundation had to pay such a tax, it would ordinarily be a very substantial sum, but typically a terminating foundation does not pay a tax because it transfers in a way that is not subject to tax or results in no tax because no assets remain.

(b) Notice to AG

The foundation should contact the Attorney General of the state of the foundation's formation and obtain clearance for the termination. Some states have statutes that require the AG's approval, but even where there is no such statute, the AG is likely to have an interest. If the foundation was created as a trust, court approval for the termination will ordinarily be required.

2. Methods of Termination

(a) Transfer of assets to a 509(a)(1) (i.e. “donative”) public charity that has been in existence as a public charity for a continuous period of at least 60 months. This transfer does not require notification of the IRS and there is no termination tax.

- adopt a plan of dissolution and distribute assets
- file a final Form 990-PF (attach a certified copy of the plan of dissolution, the names of the recipient charities and a description of the assets transferred)
- dissolve under state law

(b) Transfer of assets to a 509(a)(1) public charity in existence less than 60 months, to a 509(a)(2) (i.e. “fee for service”) public charity, or to a 509(a)(3) supporting organization to a public charity. If done properly this avoids termination tax.

- adopt a plan of dissolution and distribute assets
- give notice to the IRS of intent to terminate at least one day after distribution of assets
- file a final Form 990-PF (attach a certified copy of the plan of dissolution, the names of the recipient charities and a description of the assets transferred)
- dissolve under state law

In Rev. Rul. 2003-13, the IRS approved transfers in the (a) and (b) categories subject to eight assumptions, including the following:

the transferee is not controlled, directly or indirectly, by the foundation or one or more of the foundation’s disqualified persons

the transferee retains its public charity status for at least three years following the distribution

the foundation retains sufficient assets to pay its regular excise taxes for the portion of the year prior to the distribution

the foundation does not impose any material restrictions on the transferred assets

The revenue ruling holds that there is no termination tax. It also holds that the distributions: do not result in net investment income to the foundation; do not constitute self-dealing; are qualifying distributions; do not result in excess business holdings; and are not jeopardizing investments or taxable expenditures.

- (c) Operate as a supporting organization to one or more public charities for 60 months

This is a subset of having the foundation operate for 60 months as a public charity, but does not require raising contributions to meet a public support test or operating a grant program.

- amend the governing instruments so that the majority of the foundation's board is appointed by one of the supported organizations (if the foundation is a trust, this will generally require court approval)
- give notice to the IRS before the beginning of the 60 month period of intent to operate as a 509(a)(3) supporting organization
- file Form 990-PF for each year in the 60 month period except the final year
- within 90 days after the end of the 60 month period file the information required by the IRS to establish that the foundation met the requirements for being a 509(a)(3)

Note: disqualified persons with respect to the private foundation cannot directly or indirectly control the 509(a)(3)

(d) Transfer assets to one or more private foundations

An extremely complicated set of rules applies when a private foundation transfers 25% or more of its assets to one or more other private foundations. Generally, any excise taxes due from or other tax attributed to the transferor foundation carry over to the transferee(s). The application of the private foundation excise tax rules to the transfer itself differs depending on whether the transferor and transferee(s) are commonly controlled.

This kind of transfer occurs when a number of small family foundations are consolidated or, more often, when the second or third generation of a family foundation divides the foundation's assets in order to pursue different charitable interests.

(e) Transfer to a donor advised fund

This is a subset of method (a), because the sponsoring organization of the DAF will typically be a 509(a)(1) public charity in existence as such for at least 60 months.

sponsoring organization will not be controlled by disqualified persons to the foundation

the sponsoring organization will maintain its public charity status

given rules that govern DAFs, the material restriction rules should not be an issue

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