

# Trusts & Estates

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## Committee Report: Philanthropy

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### Breaking Up Is (Not So) Hard to Do

Getting out of a bad relationship with a private foundation is easier than you might imagine. Here are the five steps

**S**ometimes even the best relationships go sour. But getting out of a private foundation doesn't need to be fraught with confusion about an uncertain future. By following a straightforward, step-by-step process, you can extricate your clients from a foundation relationship that's no longer working.

Attorneys and wealth managers who ask the right questions when their clients are first considering a private foundation can avoid sending them on a path to the foundation's early termination. (See Mark E. Powell, "Would They Do It Anyway?" p. 45.) Advisors' failure to identify clients' tolerance for complexity and costs, their need for privacy and the level of commitment of the spouse and subsequent generations can result in a client being mismatched with a private foundation solution. A fair number of private foundations decide voluntarily to terminate each year.<sup>1</sup> You could find yourself having to guide a client through this process.

#### What Went Wrong?

First, you need to identify the source of dissatisfaction with the private foundation. While the vast majority of complaints are driven by the cost, complexity, commit-

ment required or privacy issues, some foundations have even more complicated issues to resolve.

For example, when there's infighting among directors, the answer might be to collapse the foundation and distribute its assets among several private foundations, each managed independently by the original foundation's directors. If the client wants to donate an asset that would not be appropriate for a private foundation, but would be appropriate for a supporting organization (SO), the answer might be to collapse the private foundation into an SO. In some rare circumstances, foundation directors might reorganize the foundation as a public charity to fundraise from the general public, which is necessary to meet the public support test. All of these are complex solutions to very specific needs.

Far more often, the directors' complaints stem from the basic headaches of running a foundation. In these cases, there is typically one seemingly straightforward course of action: Terminate the foundation and distribute the assets to one or more public charities.

Still, there are some specifics to consider when a foundation distributes its assets to public charities:

- Is the charity categorized as an Internal Revenue Code Section 509(a)(1) or a 509(a)(2) organization?<sup>2</sup> Section 509(a)(1) public charities are traditional charitable organizations, such as churches, hospitals, schools and other charities that are supported by donations from the general public. Section 509(a)(2) public charities are those supported by a combination of public support and income earned from their charitable programs



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(such as a non-profit symphony that derives revenue from membership fees and admissions charges).

• **If the charity is a 509(a)(1) public charity, how long has it been in existence?** Section 509(a)(1) public charities that have been in existence for at least 60 months (“qualified distributees”) are not subject to the same level of Internal Revenue Service scrutiny applied for distributions to other charitable organizations. Distributions from a private foundation to established, traditional charities are very straightforward. But if the recipient public charities are 509(a)(1) organizations that were established within the previous 60 months, or if they’re 509(a)(2) organizations (regardless of when they were established), the process for correctly terminating the foundation is more complex and the tax implications of doing it incorrectly are onerous.

Given the complexity of distributions to non-qualified distributees, the majority of private foundations that terminate choose to distribute their assets to 509(a)(1) organizations that are at least 60 months old.

### Before Calling it Quits

When a foundation’s directors are frustrated with a private foundation due to its complexity, time commitment or lack of privacy, they may incorrectly assume that their only course of action is to close the foundation, distribute the assets to charity, and move on. **It is often worth taking a step back to ascertain whether the directors have any interest in continuing their philanthropic activities.** Would they maintain the foundation if their stated concerns were alleviated? If foundation directors are interested in ongoing philanthropic engagement but have strong concerns about complexity and/or privacy, they don’t have to throw the baby out with the bathwater. Charitable vehicles like donor-advised funds (DAFs) can offer a simple solution.

**DAFs are endowed grant-making vehicles, much like private foundations, that offer a simpler, lower cost solution, with greater control over privacy or recognition, and none of the demands of board involvement.** DAFs do not offer the same level of

control as private foundations (for example, control over granting to individuals and hiring staff), but for directors frustrated with a private foundation, this loss is probably not an issue.

Because DAFs are 509(a)(1) public charities, they are considered qualified distributees as long as they have been operating for more than 60 months. Distributing a private foundation to one or more DAFs follows the same simple steps as distributing to any other qualified distributee.

### No Need for Confusion

We’ve spoken with a number of estate-planning attorneys and wealth managers who have expressed concerns about terminating a foundation and transferring all the assets to charity. It’s easy to understand this reluctance because the tax rules for some types of foundation terminations are complex, the excise tax on foundations that terminate improperly is onerous and, in the past,

In the early 2000s, we saw two revenue rulings that simplified and clarified many of the issues that previously made terminating a private foundation such a headache.

many terminations required a private letter ruling from the IRS. But, advisors should be aware that terminations into qualified distributees are relatively easy, and the IRS recently has simplified the process for other types of terminations as well.

**IRC Section 507 outlines the requirements for voluntary termination of a private foundation.** But the gray areas lead to frequent questions and the need for PLRs in certain situations once placed an unnecessary burden on both directors and the IRS.

Thankfully, the early 2000s saw Revenue Ruling 2002-28 and Rev. Rul. 2003-13, which simplified and

clarified many of the issues that previously made terminating a private foundation such a headache. **Rev. Rul. 2002-28 focuses on clarifying the requirements and tax treatment of terminations in which the recipient is one or more private foundations that are related to the terminating foundation. Rev. Rul. 2003-12 largely confirmed the conventional wisdom—that non-qualified distributees that are public charities may take advantage of a simplified process.** It also provided guidance for how these organizations could avoid the termination tax.

While these revenue rulings dramatically simplified the process and reduced the tax burden on terminations when the recipient is a non-qualified distributee, these forms of termination still are more complicated than those in which the recipient is a qualified distributee.

Of course, each state has its own procedural particularities, but the general process of terminating a private foundation and distributing its assets to qualified distributees remains much the same, regardless of the state in which the foundation is incorporated.

### Five Steps

Here's the five-step process for terminating a private foundation and distributing its assets to qualified distributees, be they traditional charities or DAFs<sup>3</sup>:

- (1) **Adopt a plan of dissolution and (if necessary) notify state authorities.**

The foundation's directors must first adopt a plan of dissolution in accordance with the laws of the state in which the foundation was established. In many states, the foundation's counsel must also notify the state's attorney general or other state authorities of the directors' intent to distribute the assets and dissolve the foundation. In most of the situations we've seen, directors were able to notify the state's attorney general and then distribute the assets to charity while waiting for approval to dissolve the foundation. The distribution was simply treated as any other grant to a public charity. But it's important to consult with experienced counsel to determine the requirements for dissolution in a particular state.

- (2) **Distribute the assets of the foundation.**

As noted above, the easiest way for a private foundation to terminate is by transferring all of its assets to one or more 509(a)(1) public charities that have been in existence for at least 60 months. This type of termination requires no notification to the IRS of the foundation's intent to terminate and the foundation is not liable for a termination tax.

- (3) **Notify the state's secretary.**

Following any necessary approvals of the state attorney general or other state authorities, the directors follow their state's process for dissolving a corporation. Many states provide a form to accomplish this and may require a resolution of the directors.

- (4) **File the final 990-PF.**

The foundation will need to file a Form 990-PF for the taxable year in which the final distribution was made. Notifying the IRS that this is the final return is as simple as checking the box at the top of the form which says "final return" and completing the form consistent with a 507(b)(1)(A) termination.

- (5) **Submit the final 990-PF to the state's attorney general's office.**

This step varies by state, but typically the state's attorney general will require a copy of the final 990-PF to be on file as a part of the termination paperwork.

It's that simple.

By asking the right questions ahead of time,<sup>4</sup> you may be able to avoid a situation in which your clients' private foundation no longer suits them. But even if you follow all the best practices, your clients' circumstances and concerns may change. Family dynamics and commitment to the foundation's mission can change over time, particularly as the founding directors retire. The availability of the foundation's 990-PF online may give rise to family security concerns resulting from the perception of wealth and the burden of unsolicited grant requests. Privacy concerns also may come about in response to an

unwanted change in the family's reputation or relationships born from the transparency of the philanthropic activities of the foundation. Given that 65 percent of private foundations are family-managed,<sup>5</sup> 95 percent do not have professional staff,<sup>6</sup> and 43 percent are worth less than \$250,000,<sup>7</sup> an increasing number of foundation directors will find themselves asking whether the burdens of administration are greater than the benefits of continuing the foundation.

For those who decide it's time to move on, the process of terminating a private foundation doesn't need to be difficult. Sometimes the end of one relationship is the start of an even better one. **TE**

#### Endnotes

1. Roughly 6 percent of private foundations terminate each year. See Association

of Small Foundations, 2002.

2. Internal Revenue Code Section 509(a)(3) public charities (supporting organizations (SOs)) also are eligible, but SOs are a complex solution that wouldn't address the directors' concerns.
3. Note that this process addresses voluntary terminations of private foundations organized as corporations. Foundations organized as trusts are relatively rare and the process for terminating them is very different.
4. See Mark E. Powell, "Would They Do It Anyway?" *Trusts & Estates*, June 2008 at p. 45, and Bonnie B. Hartley and Michael T. Hartley, "Passing Down the Foundation," *Trusts & Estates*, April, 2008 at p. 39.
5. Council on Foundations, 2002, [www.cof.org/learn/content.cfm?ItemNumber=740#f](http://www.cof.org/learn/content.cfm?ItemNumber=740#f).
6. Katherine Fulton and Andrew Blau, "Looking Out for the Future, An Orientation for Twenty-First Century Philanthropists," Monitor Company Group, LLP, 2005. Available at [www.futureofphilanthropy.org/files/finalreport.pdf](http://www.futureofphilanthropy.org/files/finalreport.pdf).
7. Foundation Source, 2008.

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