

Terminating a private foundation

Legal guidelines

With more than 1,000 private foundation startups in the United States every year, it's not surprising that a significant number dissolve each year as well. Rather than simply granting all assets or incurring a termination tax, many private foundation boards choose to use assets to create a donor advised fund at a community foundation. A recent IRS ruling makes this shift easier than ever.

Background

A private foundation is a distinct legal entity. As a nonprofit corporation or charitable trust created and governed by state law, it is exempt from most federal taxes under the Internal Revenue Code. In terminating a private foundation, steps must be taken to satisfy both state and federal requirements. Any family foundation considering termination should seek the assistance of expert legal counsel.

State law issues

Governed by the laws of the state in which it was established, a private foundation must be terminated in accordance with these laws. This involves two steps. First, the private foundation governing board must make a decision to terminate the foundation. This may involve filing revised Articles of Incorporation or passing a resolution. Second, the termination must be recognized and approved by the state. This may involve giving adequate notice to the state Attorney General, filing the required termination documents, petitioning a court for approval, and seeking tax waivers or clearance. Procedures vary state to state and will differ depending on whether the foundation is a corporation or a trust.

Federal law issues

Three options allow a private foundation to terminate its status without paying the confiscatory termination tax imposed under Section 507 of the Internal Revenue Code. The private foundation may:

- Distribute private foundation assets to existing public charities, including community foundations
- Convert private foundation to a public charity
- Transfer private foundation assets to another private foundation



Expert counsel

State attorneys general may provide information on their individual state requirements, but a foundation considering termination should seek the advice of expert counsel.



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Distribute private foundation assets to a qualified public charity

Section 507(b)(1)(A) of the Internal Revenue Code

The easiest way to terminate a private foundation is by distributing all of its assets to a public charity, such as a community foundation, that has been in existence for at least five years and is described in section 509(a)(1) of the Internal Revenue Code. Such a distribution automatically terminates the foundation's status with the Internal Revenue Service, without the need to take additional action other than filing the foundation's final Form 990-PF. Revenue Ruling 2003-13, a recent ruling from the Internal Revenue Service, confirms the ease of this form of termination.

Revenue Ruling 2003-13 addresses the process for three less-common situations—terminating distributions by a private foundation to a section 509(a)(1) public charity that has not been in existence five years, distributions to a section 509(a)(2) public charity (an organization that gets most of its income from admissions or sales), and distributions to a section 509(a)(3) public charity (a supporting organization). The Revenue Ruling describes a process to follow in these situations, eliminating the need to secure a private letter ruling (PLR).

Revenue Ruling 2003-13 also makes it easier than ever to use assets to create a community foundation donor advised fund.

- Private foundations distributing assets to a community foundation five years old or older need not notify the IRS.
- With the advice of counsel, private foundations can give their assets to a newer community foundation by following the process laid out in the ruling.
- Private foundations may not impose a material restriction or condition on the recipient charity's use of the funds. It may define a specific charitable purpose or require acknowledgement of the gift, but the recipient's governing body must be independent of the terminating foundation.
- Ensuring that the recipient gains complete ownership and control of both the transferred assets and the income they produce is critical to avoiding characterizing restrictions as material.
- Assets may be used, however, to create a donor advised fund, and the foundation's board members may be named as advisors to the fund.

Convert private foundation to a public charity

Section 507(b)(1)(B)

The most common application of this rule is termination into a supporting organization, often in connection with a community foundation.

- A supporting organization achieves its public charity status by operating to support or benefit a public charity. Rules are complex; competent counsel is a must. The community foundation (or supported organization) must maintain control of the supporting organization. For this reason, the community foundation names at least 51 percent of the supporting organization's board.



A wise investment*

Phillip Lewis and Claudia Moore believe strongly in using their good fortune to strengthen the lives of others. Phillip, a successful real estate investor, and Claudia, a sought-after interior designer, built their fortune by purchasing and renovating houses and commercial buildings in urban neighborhoods. In anticipation of their 60th birthdays, they decided to use one of their properties to add to a private foundation established from the estate of Claudia's parents. As they researched the implications of the real estate gift, they realized their tax deduction would be far greater with a donor advised fund at their community foundation. In addition, they realized they could eliminate the headaches and hassles of maintaining a private foundation by transferring these assets to the donor advised fund. Today, the Lewis Moore Fund is helping to build stronger neighborhoods by buying library books, planting trees and building playgrounds... creating a better community for everyone.

*This article is not intended as legal advice or as constituting a legal opinion.

- This kind of termination takes at least five years. The process begins with a notice to the Internal Revenue Service that the private foundation is terminating into a public charity. The foundation then must continually meet all applicable requirements for public charity status for 60 months from the first day of a taxable year. It is customary to seek an advance ruling from the IRS that the foundation can be expected to successfully complete the termination process.

Transfer private foundation assets to another private foundation

Section 507(b)(2)

This allows a family to consolidate or divide existing private foundations. It can also be used to convert trust-form foundations into corporations. The general rule in the case of these transfers is that the recipient is given the attributes and characteristics of the transferor. For example, a person who was a substantial contributor of the transferor will continue to be a substantial contributor of the transferee.