



## The Mechanics of Terminating a Private Foundation

*What to do if you client has already formed a Private Foundation and would like to switch to a Community Foundation Fund.*

*Experts review the advantages—and mechanics—of converting a private foundation to a public charity or donor advised fund.*

Many families start private foundations with great enthusiasm, eager to research their favorite charities and involve their families. However, "private foundations can unify the goals of a family, but they can also become divisive as enthusiasm wanes," says Susan C. Kaplan, MBA, CFP, of Kaplan Financial in Newton, Mass.

Beyond family dynamics, the cost and hassle of managing private foundations can become onerous over time, especially for smaller foundations, says Andrew Kyriacou, JD, tax attorney, and partner with Ernst & Young in Boston, Mass. Fortunately, two recent IRS rulings (2002-28 and 2003-13) have clarified IRS intent and simplified the termination process, Kyriacou says.

These considerations, along with the surge in the number of donor advised funds over the past decade, have prompted many families to convert private foundations to public charities or donor advised funds.

### **Distributing the Foundation Assets**

Private foundations that wish to terminate can distribute their assets in a number of ways. They can turn over their money to a public charity, such as a hospital, school, or community foundation, become a supporting organization to a public charity, or transfer their assets into a donor advised fund.

But not all distribution options are equal. Some private foundations give their assets in a lump sum to a public charity, sometimes to create an endowment to help pay the cost of one of the charity's activities. But many experts feel donor advised funds can be a better option. For one thing, some public charities go through so many personnel and leadership changes that records may get lost, and money earmarked for one cause might end up being used for other purposes. Donor advised funds place control of the assets in another charity, which can offer effective stewardship, while allowing donors to recommend annual grants to the charities they seek to support.

"Fortunately, voluntary termination is simple," says Brad Britton, JD, director of planned giving and general counsel at The Columbus Foundation in Columbus, Ohio, particularly when the recipient charity has been in existence at least five years, as is true for most community foundations. Britton notes that private foundations simply give their assets to the community foundation and file the final

990-PF to the IRS afterwards. State law may require additional steps to terminate the foundation's legal existence as a nonprofit corporation or charitable trust. As far as the community foundation is concerned, paperwork is simple, often consisting of no more than a one-page Fund Agreement spelling out the donor's intent.

In terms of the mechanics of transferring assets, foundations can cash out any way they like. "The money can be wired from multiple banks, brokerages, or written on a private foundation's personal check," says Britton.

Typically the family's tax advisors handle IRS reporting. Financial advisors do not play the lead role in the mechanics of termination, but focus instead on clients' philanthropic goals and how best to meet them. Because clients speak more often to their financial advisors than their lawyers or accountants, the advisor is often in the best position to propose giving solutions.

### **Beware Involuntary Termination**

Financial advisors should be aware of the big, bad wolf: involuntary termination, in which the IRS shuts down the foundation for willful, flagrant, and repeated violations of its tax-exempt status. The penalty for failing to terminate properly (Sec. 507 of the tax code) consists of a confiscatory tax equal to either 100 percent of the foundation's assets, or all income, estate, and income tax benefits received by the foundation and its substantial contributors, whichever is less.

The penalty is rarely applied, however, Kyriacou says, because most private foundations know what the IRS considers flagrant transactions, such as not paying income tax on investments (Code Section 4940); self-dealing (4941); failing to distribute at least five percent of its assets each year (4942); involvements in unrelated business (4943); jeopardizing their exempt status by failing to exercise reasonable care and prudence (4944); and engaging in lobbying and other prohibited expenditures (4945).

Even when there has not been any wrongdoing, certain kinds of transfers require special treatment to avoid penalty taxes. These are transfers to charities that have been in existence less than five years, and the conversion of the private foundation into a supporting organization. Foundations considering these options should get help from an attorney with experience in handling this kind of transaction.

### **Simplifying a Giving Plan**

While technically giving up control of the money, families can still recommend grants to a wide range of charities, and set up their donor advised fund to reflect their family's values. "Typically clients want to stay involved, and can choose their level of participation," Britton says. They may decide to select field-of-interest funds, which support favored causes, or opt for more control in the form of a designated fund, which further circumscribes a field of interest through specific donor directives. Many clients choose a combination of both.

For their part, many advisors appreciate the simplicity of donor advised funds for their clients.

For one thing, community foundations and public charities have more leeway with the IRS in the disbursement of grants. "Community foundations can more easily handle unusual requests, which may include grants to individuals, small schools, or scholarships," says Judy Shine, CFP, president of Shine Investment Advisory Services in Englewood, Colo.

In addition to simplified grant making, donors may also find it easier—and more tax-efficient—to gift unusual assets to public charities. "We recently accepted a closely held engineering firm," Britton says, "We have a lot of experience handling real estate, partnership interests, and other unusual assets."

Private foundations may accept such assets, too, but under less favorable tax conditions. The deduction for lifetime gifts of appreciated assets, other than stocks to private foundations, is limited to the asset's cost basis. If the same asset is donated to a public charity, donors can deduct its fair market value.

Donors—and many advisors—appreciate being involved in their local community foundations, which have a long history of researching, assessing, and benchmarking the performance of local charities. Donors enjoy the personal attention they receive from a local staff eager to serve. Financial advisors sit on CF boards, and, in some cases, continue to manage their client's assets within the foundation.

There are solid arguments in favor of private foundations, but the liabilities of administration and tax compliance can make them more of a burden than a joy. "People like the concept of the private foundation, but in truth something like a charitable remainder trust or a donor advised fund gives you just as much for less money and fewer headaches," Kaplan says.

*For more information on how to work with the Community Foundation on your charitable giving, please contact us.*

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