GivingOutlook

Making the Transition Out of a Private Foundation

By Deborah L. Jacobs

Many people who set up private foundations hope that they will continue for generations. Yet a variety of factors conspire against that, ranging from the death of the original founder to a desire for greater privacy in charitable affairs. A popular solution is to dissolve the foundation and distribute its assets to a public charity, such as one offering a donor-advised fund. Advisors to high-net-worth individuals need at least a working knowledge of the issues involved in shutting down these entities, and should be able to recommend other charitable tools to their clients.

"During the past several years, we've had more and more clients inquire about terminating private foundations," says David Scott Sloan, a Boston-based lawyer who heads the National Private Wealth Services group at Holland & Knight. "For some founders the administrative burden and cost of running a foundation ultimately outweighs the initial thrill of giving like a Carnegie. It's easy to get bogged down with day-to-day details, like overseeing investments, monitoring income and expenditures, and making the required distribution of at least 5% of the entity's assets each year," Sloan notes.

Plus, foundations must file an annual tax return and comply with complex rules. The Internal Revenue Code regulates everything from the types of investments and grants a private foundation can make to transactions with officers, directors, trustees, and substantial contributors (most are off-limits). Those who violate the law -- even inadvertently -- risk stiff penalties. Increased government oversight in recent years has created heightened scrutiny and potential expense for foundations and their officers.

Wrapping Things Up

"Running a private foundation is similar to operating a small business in many ways, including the process of shutting the foundation down," says David Scott Sloan, a Boston-based lawyer who heads the National Private Wealth Services group at Holland & Knight in Boston. The following checklist can help you guide clients through the necessary stages -- and in the most logical order:

- Check the document that created the foundation to be sure you are complying with all the provisions that affect dissolution.
- Select the 501(c)(3) IRS-qualified public charity that will receive the assets, and verify that it has been in existence for at least five years.
- Satisfy any contractual commitments, such as pledges, that the foundation has made.
- Calculate the legal and accounting costs of dissolution, and pay these fees before you distribute the endowment to charity.
- Make sure your last transfer is to charity. This includes the required 5% payout for the year of dissolution.
- Indicate, on the next tax return, that this is the foundation's final return.
- Take all the necessary steps required by state law to dissolve the foundation. (The division of public charities at the attorney general's office can be a valuable resource.)

One entrepreneur was in his 60s when he set up a foundation and funded it with $10 million worth of post-IPO stock. During the first few years, he was actively involved in grantmaking, but as he lost his verve for the enterprise he nearly missed the annual deadline for distributions.

At Sloan's suggestion, he established a donor-advised fund at the *Fidelity*® Charitable Gift Fund℠ (a qualified public charity) to use in conjunction with his foundation. "With a donor-advised fund, he could make grant recommendations on his own timetable and now, 10 years after creating the foundation, this client is in the process of dissolving the entity altogether and having the remaining $5 million endowment go into his donor-advised fund account," Sloan says.

Successive generations may have additional reasons for not wanting to continue the foundation. Perhaps descendants don't share the founders' passion for the organization's mission. As family members scatter geographically, the difficulty of building a consensus can hinder grantmaking. Siblings who don't get along may be unwilling to work together toward a charitable goal. Private foundations also dissolve because there is no succession plan in place, or asset values have declined to the point where the expense of running the operation is disproportionate to the endowment.

Some clients, especially those who are contemplating gifts of appreciated assets other than cash or publicly traded securities (for example, real estate or private C-Corp shares) may decide to change the format of their charitable vehicle for tax reasons. With a private foundation, the deduction is generally limited to cost basis. In contrast, if the same assets are donated to a public charity, the donors could deduct the fair-market value.

"Donors concerned about privacy might also want to opt out of a private foundation," says Victoria B. Bjorklund, a lawyer with Simpson Thacher & Bartlett in New York. The foundation's yearly tax filing, IRS Form 990-PF, is a public record that shows assets, gifts, grants, and the names and addresses of trustees, directors, and officers. "The average citizen does not consider that fact unless they become aware of it through their own personal experience."

Donors who give through a public charity with a donor-advised fund can keep a lower profile -- or remain anonymous, if they wish. All the grant recipient will know is that the donation came from an individual donor-advised fund of the sponsoring charity. This might appeal to people who don't want credit for their generosity, are trying not to call attention to their wealth, or wish to avoid solicitations from other charities.

Regardless of why a private foundation shuts down, it can distribute its assets in various ways, or even divide them into several different pots, says Laura Peebles, a tax director at Deloitte & Touche in Washington, D.C. One possibility is to split the foundation into multiple entities -- perhaps along branches of a family tree. This might be appropriate when family members are committed to having a private foundation but, for whatever reason (for example, divorce or ideological differences), can't operate as a cohesive group.

"A simpler solution is to give all the money to a public charity and wind down the private foundation," Peebles says. The recipient may be a single institution, such as a hospital or school.

The most flexible alternative of all is to transfer the funds to a public charity with a donor-advised fund program, which is also a public charity. That way, multiple charities can receive grants from the donor-advised fund account. Donors can make these recommendations on their own timetable -- it's not necessary to choose the specific recipients when dissolving the foundation. The administrative burden is greatly reduced as well. (For example, the sponsoring charity, rather than the donor, among other grant recipient diligence, verifies that the organizations receiving the grants are IRS-qualified public charities.)

"Clients who previously might have carved up one foundation now express an interest in distributing the entire endowment to a charity with a donor-advised fund program, with each family member serving as an advisor of a separate fund," says Bjorklund. This avoids the duplicate administrative expenses of running multiple foundations, such as preparing and filing an IRS Form 990-PF for each.

Instead, the public charity sponsoring the donor-advised fund files one IRS Form 990 for all of its assets. "People are more green today, and that kind of consciousness about avoiding duplication means a donor-advised fund is perceived as a cost-effective way to do your philanthropy," Bjorklund says.

In addition, donor-advised funds have many of the benefits of a private foundation without the burdens. Donors can choose a name for the fund, provide advice on how the fund assets are invested (or rely on the fund's own investment experts), and favor charities that reflect their values.

Like a private foundation, however, a donor-advised fund can be used to train children and grandchildren in philanthropy. One way to do that is to name one or two advisors on the account while involving other family members in the process of recommending grants. Another is to establish multiple accounts, each with one family member as advisor.

There are no setup fees for these accounts, and the annual operating costs are lower than those of a private foundation. Organizations with donor-advised fund programs include public charities, such as the Fidelity Charitable Gift Fund, religious entities, universities, and community foundations.

Although the mechanics of foundation dissolution aren't that difficult, Section 507 of the tax code imposes a stiff penalty for doing it incorrectly. This dissolution tax equals 100% of the foundation's net assets or all the tax benefits that resulted from the organization's exempt status, whichever is less.

Until recently, the standard practice was to get a private letter ruling from the Internal Revenue Service ensuring that the contemplated transaction wouldn't generate a dissolution tax under Section 507 of the Internal Revenue Code. However, that became unnecessary in most cases after the IRS issued two key revenue rulings: Ruling 2002-28, which involves transferal of assets to other foundations, and Ruling 2003-13, which deals with transformation into a public charity.

Under Ruling 2003-13, when assets are distributed to a public charity that has been in existence for at least five years there is no requirement to notify the IRS. The foundation simply indicates on its tax return, the 990-PF, that this is the organization's final return.

"The foundation does need to follow other legal formalities, however," says Peebles. "It must pass resolutions regarding the distribution of the assets and the dissolution of the organization, transfer the funds, and then file appropriate dissolution documents under state law."

"Whether the foundation was initially formed as a trust or a corporation makes a difference in the dissolution procedures," Peebles says. While corporate board members can pass a resolution to dissolve, trustees will need to refer to the trust agreement (which is basically a contract) to determine how the trust can be terminated -- or even whether it can be terminated at all. Depending on what the trust agreement says, it may be necessary to get the court's permission to formally dissolve the foundation.

"There are several pitfalls in this area. One is overlooking the requirement that a foundation distribute at least 5% of its assets each year. Organizations that don't satisfy the payout requirement before dissolution could be subject to excise tax in the year of dissolution," says Peebles. "Since the last distribution should go to charity, it's a good idea to prepay legal and accounting expenses. And don't dissolve the entity before filing the last tax return, or you will have no one legally authorized to sign it," she warns.

In addition to complying with federal requirements for dissolution, foundations must observe state law formalities, which vary widely. For example, in some states (including California and New York) the foundation must give notice to the state attorney general, whose duties include making sure that the distribution of the foundation's assets are consistent with the original donor's intent. "New York's rules are especially complex, requiring a multistep process of various court approvals in addition to the attorney general's okay," Bjorklund notes. "Even spending down the assets of a foundation requires this approval," she says. From start to finish, the whole process can easily take six months.

To avoid family friction and the soul-searching that can surround dissolution, a growing number of donors are designing foundations with a limited life span, rather than thinking of them as something that will last forever. Wealth creators who take this approach might include a sunset provision providing that the entity will terminate when a specific event occurs, such as when the last of the founders dies. For example, the Bill & Melinda Gates Foundation is scheduled to close within 50 years after its current trustees have died. Among other things, this avoids the threat that grants will stray from the donor's intent with each succeeding generation.

"Existing foundations can amend their governing documents to include sunset terms, and, if they wish, specify the charity that will get the assets at that point," Bjorklund says. That enables the form of a donor's philanthropy to keep pace with new family circumstances and changing times.

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