TRANSITIONING OUT OF A PRIVATE FOUNDATION

Planning Considerations

INTRODUCTION

Private foundations[1] continue to be one of the most popular charitable giving vehicles in the United States, especially among individuals of significant wealth. According to Candid, a leading source of foundation information, there were nearly 120,000 U.S. independent private foundations as of April 2020 with assets of $948 billion and annual grants totaling $57 billion.[2]

Despite their importance to the philanthropic sector, the growth of private foundations continues to be outpaced by the surge in demand for donor advised funds. From 2015 to 2019, the number of donor advised funds more than tripled from 272,845 to 873,228[3]. During this same period, annual grant distributions from donor advised funds to charities nearly doubled to $27 billion in 2019.[4] And despite some industry criticism that donor advised funds have no minimum annual payout requirement like their private foundation counterparts, the average payout for donor advised funds is approximately 20% compared to private foundations which hovers consistently around their 5% minimum requirement.[5]

There are many possible explanations as to why donors are increasingly choosing to establish donor advised funds over private foundations including their potentially higher tax deductions for lifetime gifts, accessible minimum size requirements (some can be created with as little as $5,000), and the ease and relatively low-cost of establishing and operating one.

For donors trying to decide which vehicle is best for them, this paper provides an overview of both private foundations and donor advised funds while comparing the benefits and limitations of each. For donors considering converting their private foundation to a donor advised fund, this paper offers additional guidance on the process of terminating a private foundation, including tax rules and practical considerations foundation directors or trustees should consider.

1 For the purposes of this article, "Private Foundations" refers to U.S. private non-operating (grantmaking) foundations, and excludes corporate and community foundations.
2 Candid, Key Facts on U.S. Nonprofits and Foundations, April 2020.
3 National Philanthropic Trust Annual Donor Advised Fund Report, 2016-2020 editions
4 Id
5 Id

PRIVATE FOUNDATIONS – AN OVERVIEW

Formation

Private foundations are tax-exempt entities under section 501(c)(3) of the Internal Revenue Code (Code) and can be established either as a nonprofit corporation or as a charitable trust. A private foundation formed as a nonprofit corporation must comply with state laws governing such specialized corporations, including executing articles of incorporation and by-laws that will govern the private foundation's management. Alternatively, a charitable trust is established by executing a trust agreement to govern the foundation's creation, ongoing administration and termination. The differences in form play an important role not only in how a private foundation may be administered, but also determine when and how a private foundation may be terminated.

In order for a private foundation to qualify as a tax-exempt entity under section 501(c)(3) of the Code, it first must obtain tax-exempt status by filing with the IRS a Form 1023 application for exempt status. Form 1023 asks for key information about the nonprofit organization, including charitable purpose/activities, anticipated source(s) of funding, leadership and governance structures. If the IRS approves the application for tax-exempt status, it will issue a "determination letter" confirming the foundation's tax-exempt status as a private foundation. In addition to obtaining initial tax-exempt status from the IRS, a private foundation's board of directors or trustees must comply with ongoing state and federal filing requirements.

Annual Filing Requirements

In order for a private foundation to maintain its tax-exempt status with the IRS and avoid paying penalties, the foundation must file several reports annually. First, a private foundation, whether organized as a corporation or a trust, must file a federal information return, the IRS Form 990-PF ("990-PF"), with the IRS every year. The Internal Revenue Code also requires a foundation to file a copy of the 990-PF with the office of the attorney general in every state that has statutorily defined connections with the foundation.[6] Private foundations organized as corporations generally must file annual reports with the Secretary of State of the state of incorporation, in order to maintain the entity's good standing. Many states also require private foundations to file a separate annual report with the state Attorney General, most commonly required for foundations that solicit contributions from the general public. Failure to comply with federal and/or state filing requirements can result in significant fines. It is incumbent upon a foundation's directors or trustees to ensure that the foundation complies with all administrative requirements.

Grantmaking

A private foundation must distribute at least 5% of its investment assets each year in the form of "qualifying distributions."[7] The distributions most often take the form of a grant to a U.S. public charity. However, private foundations also may satisfy the qualified distribution requirement by making grants to individuals and international organizations if the foundation's directors or trustees conduct the appropriate due diligence and required ongoing oversight.[8]

Investment Oversight

Because grantmaking is the key function of a private foundation, overseeing the private foundation's investments (both to ensure growth and maintain sufficient liquidity to fund the foundation's grants) is a core responsibility of the board of directors or trustees. Although many private foundations, both large and small, choose to have their investments managed by a financial institution, the foundation board ultimately is responsible for ensuring that the assets are stewarded appropriately. For instance, private foundations should avoid "jeopardizing investments" or making investments that are irresponsible or imprudent in providing for a foundation's liquidity needs and/or its long-term financial health.[9] The IRS may levy a tax of 10% of the amount of the jeopardizing investment on the foundation, and an individual foundation director or trustee may be

6 IRC section 6033(c)(2) and Treasury Regulation section 1.6033-3(c) require a foundation to submit a copy of its 990-PF to the Attorney General of a state: 1. in which the foundation maintains its principal office, 2. in which the foundation was created, and 3. which otherwise requires the foundation to file reports. Depending on the circumstances, a foundation may have a duty to send a copy of its 990-PF to several states.

7 IRC section 4942

8 IRC section 4945(h)

9 A detailed discussion of the IRS rules that govern how private foundation assets may or may not be invested is beyond the scope of this paper. However, readers who want more information should look to the IRS rules that pertain to "jeopardizing investments" and "excess business holdings."

personally liable for an excise tax of 10% of the value of the jeopardizing investment if the director or trustee acted knowingly or willingly in making the jeopardizing investment.[10]

There are other investment considerations and concerns facing private foundation directors or trustees. As a result, a foundation's board of directors or trustees should ensure that all board members/trustees are educated about investments and that the foundation maintains an investment policy and reviews the policy at least once each year.

Understanding Your Options – Alternatives to a Private Foundation

The requirements discussed above are not only essential to successfully managing a private foundation, but are time consuming and often expensive. For example, many foundation directors or trustees consider the grantmaking activities to be the most exciting and enjoyable aspect of managing a foundation. But there are tasks associated with grantmaking – collecting post-grant reports, evaluating the impact of the grant, collecting unsolicited requests for funding from potential grantees – which can be burdensome. Moreover, foundation directors or trustees may balk at hiring and paying an employee to manage day-to-day operations, as administrative expenses may reduce the foundation's annual grantmaking funds.

For foundation directors or trustees who find the administrative and operational requirements of managing a private foundation too burdensome, terminating the foundation may be a desirable alternative. For example, transferring the foundation assets to a donor advised fund would enable the foundation's directors or trustees to enjoy the rewards of recommending grants to public charities, but without the fiduciary and compliance duties. On the other hand, the directors or trustees may simply prefer closing down the foundation and distributing the assets to one or more public charities.

The rules governing private foundation termination can be detailed and complex, depending on what type of entity receives the foundation's assets after termination. Foundation directors or trustees should consult with advisors, including an attorney and an accountant, before attempting to terminate a private foundation.

CASE STUDY –
THE MARX FAMILY FOUNDATION

Jerry and Lucy Marx established the Marx Family Foundation with approximately $4 million following the sale of their healthcare consulting business. Jerry and Lucy served on the foundation's board of directors, along with their three adult children: Ben, Samantha and Ann. The foundation's mission focused on supporting environmental and arts/culture organizations in northern California.

Following the deaths of Jerry and Lucy, their children continued to serve as foundation directors although they lived far apart from one another on different coasts. The siblings had each developed charitable interests that differed from the family foundation's mission. They found it increasingly harder to meet and agree on the amounts and recipients of the foundation's grants. Moreover, the siblings felt burdened by their administrative duties, including attending the annual board meeting and ensuring the timely filing of federal and state returns and reports.

After consulting with Northern Trust's Philanthropic Advisory Services team, Ben, Samantha and Ann decided to terminate the Marx Family Foundation and transfer the foundation assets into three separate donor advised fund accounts – one for each sibling. Setting up three donor advised fund accounts allowed the siblings to support their individual charitable interests by recommending grants only to those organizations they each respectively believed in. The Marx siblings were also freed of the administrative duties that came with managing the family foundation.

10 IRC section 4944

TRANSITIONING OUT OF A PRIVATE FOUNDATION

Transitioning out of a private foundation is not a process that can – or should – be completed overnight. Foundation directors, trustees and/or staff members should develop a plan regarding how the foundation will terminate, which organizations or entities will receive the foundation assets, and how the termination process will be communicated to existing grantees. Thoughtful planning not only can make the transition easier for a foundation's board of directors or trustees (and in some cases the foundation's staff), but it also can help avoid unwanted tax penalties and maintain goodwill with external stakeholders, including current and past grantees and other grantmaking organizations.

Avoiding Taxes on the Termination of a Private Foundation

The IRS has specific rules that govern how tax-exempt organizations, including private foundations, can properly terminate their exempt status. One of the most important considerations when terminating a private foundation is the potential for taxes if the termination process runs afoul of IRS rules. Private foundations must follow the provisions listed in section 507 of the Code, or they may be subject to unwanted penalties.

Under Code section 507(a)(1), a private foundation may voluntarily terminate operations by notifying the IRS and paying a termination tax. Additionally, the IRS may terminate a private foundation that violates the Code's private foundation excise tax provisions, and the foundation will also be subject to the termination tax. The taxes resulting from a private foundation's termination, whether voluntarily or involuntarily, can be substantial, including up to 100% of the foundation's net assets.[11]

A private foundation may voluntarily terminate and avoid paying a termination tax in one of three ways. First, the foundation can voluntarily terminate without having to notify the IRS or pay a termination tax if the foundation distributes all of its net assets to one or more organizations, including public charities, defined in Code section 509(a)(1).[12] Recipient organization(s) must be in existence for a continuous period of at least 60 months prior to receiving the foundation's assets in order for the terminating foundation to avoid paying the termination tax.[13]

Second, a private foundation may terminate without having to pay a termination tax by operating as a public charity or supporting organization for a continuous 60-month period after providing proper notice to the IRS.[14]

Third, a private foundation may terminate and transfer all of its assets to another private foundation if the terminating foundation provides the required notice to the IRS in advance of the termination.

It is important for foundation directors or trustees, and their advisors, to understand the rules that pertain to terminating a foundation. Failing to comply with the rules set forth by the IRS may result in the foundation facing unexpected, unwanted taxes or fines from the IRS and/or state authorities.

After making the decision to terminate a private foundation, there are key questions that directors and/or trustees should ask themselves to help ensure a smooth termination process and help protect the foundation's reputation and relationships within the philanthropic community. The following questions will help foundation directors and/or trustees think through some of the key considerations aside from the potential termination tax(es), discussed above.

Is the Foundation a Trust or a Corporation?

A private foundation organized as a nonprofit corporation should follow the applicable state laws that govern the process for dissolving a nonprofit corporation. The Secretary of State and/or Attorney General in the state where the foundation is incorporated may require a final filing or other termination procedure to officially and appropriately wind up the corporation. In addition, foundation directors must abide by the foundation's governing bylaws to determine the appropriate method for dissolution. For example, the by-laws may require either a simple majority vote or a unanimous vote.

11 IRC section 507(c)
12 IRC section 507(b)
13 Id.
14 Id.

For directors or trustees who find the administrative requirements too burdensome, terminating the private foundation and transferring the assets to a donor advised fund would enable them to enjoy the rewards of recommending grants to charities without the fiduciary and compliance duties.

If the foundation is organized as a trust, termination may be more difficult. If the trust terms explicitly permit and outline the process for dissolving the foundation, the trustees will likely have to follow those terms. If the trust terms do not allow for termination, the trustees may have to seek court approval and make the Attorney General of the state in which the trust is resident a party to that petition.

Are there any Outstanding Pledges or Financial Commitments?

In some instances, a private foundation may have outstanding grants/pledges or long-term financial commitments that limit the timing or possibility of termination. For instance, a private foundation's directors or trustees may make a grant to an organization with the intent to pay the gift over several years. If structured properly, a pledge may be binding, meaning it may be enforceable in a court of law, much like a contract. If a foundation is obligated to fulfill a binding pledge, the directors or trustees may need to wait until the pledge is paid up in full before fully terminating the foundation.

Further, if a foundation terminates and the assets are transferred to one or more donor advised funds, the newly created donor advised funds may not be used to satisfy an existing pledge. Before terminating a foundation, its directors or trustees of a foundation should ensure that it has no binding grantmaking commitments.

Have You Communicated with Current/Potential Grantees?

As noted above, it is important for the directors or trustees of a private foundation to choose carefully which organization(s) will receive the foundation assets upon termination in order to avoid unwanted IRS penalties. However, it is equally important to communicate with existing grantees about an anticipated termination, especially if those existing grantees may not receive a portion of the foundation assets upon termination.

For many charitable organizations, especially smaller organizations, budgeting each year and anticipating potential funding sources can be a challenge. If a nonprofit organization receives grants from a private foundation on a consistent basis, that nonprofit organization may come to rely on the foundation's support as part of its annual operating budget. If the directors or trustees of a private foundation plan to terminate, they may want to communicate that intention to current grantees so that those organizations have time to make accommodations to replace the funding from other sources.

Additionally, if a private foundation intends to terminate and distribute its assets to one or more public charities, it is important to communicate that intention to the prospective recipients so that they may plan accordingly. In some instances, receiving a large injection of funds from one source may jeopardize a public charity's tax-exempt status. Under the IRS rules, a public charity must receive a certain percentage of its support from the general public, as measured over a five-year period.[15] If a charity receives a significant amount of its funding from one source in a given year, it may risk violating IRS rules and jeopardizing its status as a public charity. Therefore, foundation directors or trustees should consult with charities and experienced advisors, if necessary, before terminating and making final distributions.

Have You Completed the Final Tax Return and Other Filings?

A private foundation must file a final 990-PF for the year of termination. Section "T" of the 990-PF instructions provides additional guidance and outlines the required documents that must accompany the final return. In the event of termination, the 990-PF preparer must include the following:

- A statement explaining the termination;
- A schedule that lists the names and addresses of all recipients of assets, including date of distribution(s); and
- An explanation of the nature and fair market value of assets distributed to each recipient.

The preparer must check the "final return" box on Item G of the first page of the 990-PF, as well as indicate under which portion of Code section 507 the foundation is terminating.

COMPARISON – PRIVATE FOUNDATIONS AND DONOR ADVISED FUNDS

When a foundation's board of directors or trustees decides it is time to terminate the private foundation, a common recipient of the foundation assets is a donor advised fund (or multiple donor advised funds). For foundation directors or trustees who are considering whether or not to terminate a private foundation and fund a donor advised fund, it is helpful to have a general understanding of the general benefits and/or limitations of donor advised funds.

An Overview of Donor Advised Funds

A donor advised fund is a charitable giving vehicle established and maintained through an existing public charity. An individual or entity (such as a corporation or existing charitable giving vehicle) funds the donor advised fund account by making a contribution to the public charity, known as the "sponsoring charity." The donor may receive an immediate tax benefit in the year of funding. The donor, and other individuals selected by the donor, may act in an advisory capacity by recommending grants from the fund to other qualified charities. The donor may make additional contributions to the fund over time and generally may recommend advisors to manage the fund following the donor's death or incapacity.

CHARITABLE DEDUCTION FOR CONTRIBUTIONS TO A DONOR ADVISED FUND

When a private foundation terminates and distributes assets to one or more charitable organizations, including a donor advised fund, there is no personal federal income tax consequence as a result of the transfer (because the assets are moving from one tax-exempt entity to another tax-exempt entity). However, if a donor intends to make additional contributions to a charitable giving vehicle in the future, a donor advised fund does offer a more advantageous charitable deduction on the donor's personal federal income taxes.

A contribution to a donor advised fund is treated as a contribution to a public charity for the purposes of the federal income tax deduction rules. A donor's income tax charitable deduction is limited by his/her adjusted gross income (AGI) in a given year. If a donor contributes cash to a public charity (including the sponsoring charity of a donor advised fund), the donor may deduct up to 60% of his/her AGI in the year of the donation. Donations of publicly traded securities, including shares of stock and mutual funds, are deductible up to 30% of the donor's AGI.

For contributions to a private foundation, the deduction is limited to 30% of AGI for contributions of cash and 20% of AGI for contributions of publicly traded securities.

If the donor is not able to use all of his/her deduction in a given year, the donor may be able to "carry forward" the unused portion of the deduction for use in subsequent years (for up to five years).

15 IRC sections 509(a)(1) & 170(b)(1)(a)(vi). The rules that relate to the public support requirement are detailed, and public charities should consult with an experienced attorney or accountant to ensure compliance.

For many individuals, one key benefit of a donor advised fund is the ability to make grants anonymously.

Ease of Administration

Unlike the numerous duties imposed on the directors or trustees of a private foundation (including prudent investment, decisions, and meeting deadlines for minimum distributions, as well as for federal and state filings), donor advised funds place few responsibilities on the individuals who act as advisors to the accounts. Although advisors may make investment and distribution suggestions, the sponsoring charity for the donor advised fund program is responsible for any and all compliance duties.

Transparency and Anonymous Giving

For many individuals, one key benefit of a donor advised fund is the ability to make grants anonymously. As previously discussed, all private foundations are required to file an annual federal tax return with the IRS. All 990-PFs that are filed with the IRS are available for public inspection at no cost on the IRS website or through other online databases. The 990-PF includes information about a private foundation's investable assets, names of foundation contributors, names of foundation directors or trustees, any compensation paid to foundation directors or trustees, and recipients of any foundation grants made during its taxable year.

For private foundation directors or trustees interested in making anonymous grants, a donor advised fund may be the best solution. Even though the name of the donor advised funds' sponsoring charity is generally known to the recipient grantee, the name of the advisor recommending the grant does not need to be disclosed. Further, names of donors and advisors will not appear on the sponsoring charity's tax return or other required filings.

Limitations of Donor Advised Funds

A key advantage of a private foundation is the level of control that foundation donors, directors and/or trustees may maintain over the foundation's management, including grantmaking and investment management. For example, donor advised fund programs are generally less flexible in terms of the types of grants that an advisor may recommend. Many donor advised funds do not permit grants to international organizations, nor do they permit grants to individuals. Further, donor advised funds may have requirements based on the type of sponsoring charity that does the actual grantmaking. For example, a donor advised fund with a community foundation may have a requirement that a certain percentage of grants go to organizations in the community where the community foundation is located. Private foundations offer more control over and greater flexibility in the types of grants that can be made. Generally speaking, private foundations may make grants to international organizations and/or individuals, provided that the foundation directors, trustees or staff exercises the necessary due diligence and oversight of the grants.

Private foundations also offer more flexibility in terms of how contributed assets may be invested, assuming that the foundation directors and/or trustees stay within the parameters of the Internal Revenue Code and state fiduciary duties. Donor advised funds were devised to be a type of public charity so as to capture the preferential treatment conferred on its donor (e.g., individuals donating cash to a public charity are entitled to take a deduction of up to 60% of their adjusted gross income, whereas the maximum deduction for the same gift to a foundation is limited to 30% of the donor's adjusted gross income). In order to achieve that intent, the fund's sponsoring public charity must retain complete legal control over the individual funds, leaving less flexibility for the fund's advisor. While an advisor may recommend an investment strategy for assets in the account, the sponsoring charity for the donor advised fund maintains final decision-making authority and responsibility.

The chart on the next page provides insight into each vehicle's relative benefits so that foundation directors or trustees may better understand their options. Of course, foundation directors or trustees should consult with experienced advisors, especially accountants and attorneys who have worked with private foundations, before making a decision about termination.

HAVING A PRIVATE FOUNDATION AND DONOR ADVISED FUND IN TANDEM

Increasingly, individuals are establishing donor advised funds and using them in tandem with their private foundations. Private foundation grants to donor advised funds are included in a foundation's 5% minimum distribution requirement. A donor may distribute an amount from their private foundation to their donor advised fund to make anonymous grants, for example. In other instances, a private foundation may be used to support a family's shared mission, while a donor advised fund can be used to support an individual family member's personal interests.

DONOR ADVISED FUND VS. PRIVATE FOUNDATION COMPARISON

	Northern Trust Charitable Giving Program	Typical Private Foundation
Creating the Fund	Established at The Chicago Community Foundation ("CCF").	Not-for-profit corporation or trust independently organized as a private foundation.
Tax Exempt Status	Shares public charity status of The Chicago Community Foundation.	Not a public charity. Subject to private foundation 1.4% excise tax. Must apply to IRS for tax exempt status.
Costs and Time to Establish	No cost to donor. Can be established within days.	Start-up costs: legal and/or accounting fees to prepare documents, IRS and state registrations, and IRS and state filing fees. IRS approval typically three months or more.
Required Initial Contribution	$50,000	No legal requirement, generally $2,000,000 or more.
Charitable Deduction for Cash Gifts	Tax deduction limited to up to 60% of donor's adjusted gross income.	Tax deduction limited to 30% of donor's adjusted gross income.
Charitable Deduction, Long-term Appreciated Securities	Tax deduction based on full fair market value, up to 30% of donor's adjusted gross income.	Tax deduction based on fair market value limited to 20% of donor's adjusted gross income.
Donor Control	Donor (individual, committee or family) makes advisory grant recommendations, subject to CCF approval.	Donor (individual, company or family) retains complete control over investments and grantmaking.
Duration	Typically two generations.	Generally perpetual life, depending on governing document.
Family Involvement	High.	High.
Mandatory Distributions	None.	Annual 5% distribution required.
Grantmaking Management	Provided by The Chicago Community Foundation.	Must establish internal controls and/or obtain outside services.
Annual Costs	See Program Fees and Expenses.	Administration can be costly.
Annual Taxes	None.	Subject to excise tax of 1.4% on net investment income including net capital gains.
Annual Tax Filings and Administration	Provided by The Chicago Community Foundation.	Form 990-PF must be filed with IRS; additional filings required in some states.
Investments	Program assets are professionally invested through Northern Trust.	Must research and secure its own investment vehicles.

CONCLUSION

Many individual trustees and directors of private foundations discover that the duties of properly managing a private foundation are overly burdensome, and detract from the enjoyment of the foundation's grantmaking activities. For those directors and trustees, there are viable alternatives to maintaining a private foundation, including terminating the foundation and transferring the assets to one or more donor advised funds. Regardless of the chosen alternative, foundation directors or trustees must strictly abide by the rules that govern a private foundation's termination, or run the risk of facing steep penalties from the IRS. Planning well in advance and consulting with trusted counsel along the way should ensure for a smooth termination.

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