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## Maneuvering Through the Minefield of Private Foundation Termination

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### INTRODUCTION

In the world of §501(c)(3) tax-exempt organizations,<sup>1</sup> private foundations encounter more regulation, and enjoy less flexibility, than their public charity counterparts. This is no less true in the area of termination or transitioning to a different tax status, where foundations must step carefully to avoid triggering the private foundation termination tax under §507(c). This article will discuss the different options available to private foundations that are facing changing circumstances and looking to transition their status without incurring the costly tax.

### BACKGROUND ON §501(c)(3)S AND PRIVATE FOUNDATION STATUS

As a starting point, organizations that are exempt from federal income taxation under §501(c)(3) are further classified as either public charities or private foundations. Under §509(a), a §501(c)(3) organization

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<sup>1</sup> Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder.

is presumed to be a private foundation unless it can establish that it falls into one of several categories of public charities.<sup>2</sup> Those public charity categories generally include the following:

- Institutional charities, such as hospitals, churches, and schools, which get public charity status by virtue of the public nature of their activities;<sup>3</sup>
- Publicly supported charities, which must meet one of two public support tests demonstrating that a substantial amount of their support comes from the general public;<sup>4</sup> and
- Supporting organizations, which obtain public charity status by virtue of supporting another public charity (its supported organization).<sup>5</sup>

The issue of public charity versus private foundation status is a key one, because private foundations are far more heavily regulated than public charities. While all §501(c)(3) organizations are subject to requirements and limitations on their activities under the Code, a private foundation must contend with an additional layer of regulations under Chapter 42 of the Code on activities ranging from its investments to foundation transactions with insiders, or “disqualified persons.”<sup>6</sup> More specifically, the private foundation regulations apply in the following manner:

- they impose an excise tax on the private foundation’s net investment income;<sup>7</sup>
- they prohibit acts of self-dealing, direct and indirect, between the foundation and disqualified persons, and in doing so impose penalty taxes on the disqualified person and, in some cases, on certain foundation managers;<sup>8</sup>

<sup>2</sup> §509(a).

<sup>3</sup> §509(a)(1), §170(b)(1)(a)(i)-(iii).

<sup>4</sup> §509(a)(1), §170(b)(1)(a)(iv) and (vi), §509(a)(2).

<sup>5</sup> §509(a)(3).

<sup>6</sup> §4946.

<sup>7</sup> §4940.

<sup>8</sup> §4941.

- they require the foundation to distribute a minimum percentage of its non-exempt-use assets annually;<sup>9</sup>
- they prohibit the foundation from owning more than 20% of a business enterprise, other than a functionally related business or certain passive-income businesses;<sup>10</sup>
- they prohibit the foundation from making any investment that jeopardizes carrying out the foundation's exempt purposes;<sup>11</sup> and
- they prohibit the foundation from making certain types of grants and expenditures known as “taxable expenditures,” which essentially requires a foundation to make grants only for §501(c)(3) purposes and to exercise additional oversight for certain grants.<sup>12</sup>

In addition, private foundations typically are eligible for less favorable charitable giving limits for deductibility purposes.<sup>13</sup>

## OPTIONS FOR TERMINATION OF PRIVATE FOUNDATION STATUS

Organizations that begin as private foundations may not necessarily want to retain that status going forward. However, it is important for foundations and their advisors to be mindful that §507 is the sole avenue for termination of private foundation status—though the section does provide several different options that may be utilized depending on a foundation's particular circumstances.

As background, the Tax Reform Act of 1969<sup>14</sup> built some provisions into the Code that were meant to keep private foundations from receiving tax benefits in exchange for the promise of using assets to carry out charitable purposes, and then avoiding those responsibilities through termination or other means.<sup>15</sup> As such, §507(c) imposes a punitive termination tax when a foundation terminates its private foundation status either (1) involuntarily,<sup>16</sup> where there have been willful, repeated violations of the private foundation rules discussed above; or (2) voluntarily,<sup>17</sup> by notifying the IRS of its intent to terminate, setting forth the

amount of the tax due and perhaps requesting abatement of the tax.<sup>18</sup> The tax is equal to the lesser of 100% of (1) the foundation's net assets, or (2) all income, estate, and gift tax benefits received by the foundation and its substantial contributors.<sup>19</sup>

Given the potential application of this tax, the termination of private foundation status is not something to be taken lightly. Fortunately, foundations looking to terminate their status in a manner that won't trigger the termination tax have several options: (1) operating as a public charity for a continuous 60-month period;<sup>20</sup> (2) transferring net assets to a §509(a)(1) public charity that has been operating for a continuous 60-month period;<sup>21</sup> (3) transferring assets to another private foundation;<sup>22</sup> or (4) transferring net assets to a public charity that is not described in §509(a)(1) or has not been operating for a continuous 60-month period.<sup>23</sup> The requirements for each option are quite different and are described more fully below.

## Operating as a Public Charity — §507(b)(1)(B)

For private foundations that are satisfied that their activities or sources of support can qualify them for public charity status, termination of private foundation status by operation as a public charity under §507(b)(1)(B) is a great option. This does require the organization to take certain steps and satisfy the IRS that it can meet all relevant requirements.

### In General

To begin, the foundation must be prepared to operate as a public charity for a continuous 60-month period beginning with the first day of any taxable year.<sup>24</sup> An organization that is planning to seek public charity status as a publicly supported organization under §509(a)(2), for example, should be comfortable that its current and foreseeable sources of support will allow it to qualify as a public charity under that section.

### Notice and Request for Advance Ruling

Next, the foundation must notify the IRS that it is planning to terminate its private foundation status and operate as a public charity before the beginning of its 60-month period.<sup>25</sup> This notice typically is accomplished through the filing of Form 8940, and checking

<sup>9</sup> §4942.

<sup>10</sup> §4943.

<sup>11</sup> §4944.

<sup>12</sup> §4945.

<sup>13</sup> See generally §170(b).

<sup>14</sup> Pub. L. No. 91-172.

<sup>15</sup> Bruce R. Hopkins & Jody Blazek, *Private Foundations: Tax Law and Compliance* 555 (3rd ed. 2008).

<sup>16</sup> §507(a)(2).

<sup>17</sup> §507(a)(1).

<sup>18</sup> Reg. §1.507-1(b).

<sup>19</sup> §507(c).

<sup>20</sup> §507(b)(1)(B).

<sup>21</sup> §507(b)(1)(A).

<sup>22</sup> §507(b)(2).

<sup>23</sup> Rev. Rul. 2003-13, 2003-1 C.B. 305.

<sup>24</sup> Reg. §1.507-2(b)(1)(i).

<sup>25</sup> Reg. §1.507-2(b)(1)(ii).

option h, “Termination of private foundation status under section 507(b)(1)(B)—advance ruling request.” The foundation will need to provide the following information as part of its notice to the IRS:<sup>26</sup>

- its name and address;
- a statement of its intention to terminate its private foundation status;
- the Code section under which it seeks classification as a public charity, including the particular subsection of §170(b)(1)(A) (if applicable);
- the date its regular taxable year begins; and
- the date of commencement of the 60-month period.

Some of the above information will be covered by Form 8940 itself, while other information will need to be incorporated as an attachment to the form.

Additionally, in order to seek an advance ruling from the IRS that it can be expected to satisfy the requirements of §507(b)(1)(B) during the 60-month period, the foundation will need to provide additional information including:<sup>27</sup>

- a statement that the private foundation is requesting an advance ruling;
- descriptions of the organization’s past, current, and proposed activities, and how it plans to attract public support;
- proposed budgets for the 60-month termination period;
- for foundations looking to reclassify as institutional charities under §170(b)(1)(a)(i), (ii) or (iii), the relevant schedules from Form 1023 (which is the form an organization initially files to obtain recognition of exempt §501(c)(3) status);
- for foundations looking to reclassify as publicly supported organizations under §509(a)(1) and §170(b)(1)(A)(iv) or (vi), Schedule A, Part II of Form 990 (which is the annual informational filing that many §501(c)(3) organizations need to make);
- for foundations looking to reclassify as publicly supported organizations under §509(a)(2), Schedule A, Part III of Form 990; and finally
- for foundations looking to reclassify as supporting organizations under §509(a)(3), a statement requesting a change in foundation classification to a §509(a)(3) supported organization and the re-

<sup>26</sup> Reg. §1.507-2(b)(3); Instructions to Form 8940, Line 8h.

<sup>27</sup> Reg. §1.507-2(d); Instructions to Form 8940, Line 8h.

quested Type (there are Type I, Type II and Type III supporting organizations), as well as a copy of the foundation’s organizing document, bylaws, and Form 990, Schedule A, Parts I and IV–VI, with respect to the most recently completed tax year.

While a private foundation does not technically need to request an advance ruling, doing so provides the additional benefit of obtaining a ruling that donors and grantors can rely on during the 60-month period for purposes such as deductibility under §170 and grantmaking oversight requirements (i.e., expenditure responsibility) under §4945.<sup>28</sup> As such, it is recommended that private foundations take this step — particularly because foundations must continue to file Form 990-PF during the first four years of their 60-month periods.<sup>29</sup> Donors and grantors can be confused by this apparent discrepancy, and the advance ruling can help answer questions and ease reluctance to donate to the foundation during this transition period.

Importantly, the instructions to Form 8940 make clear that an organization that erroneously concluded it was a private foundation but in fact has continuously met a public support test does not need to go through the private foundation termination process. Instead, it can use Form 8940 to request a retroactive reclassification as a public charity, if it can demonstrate that it has continuously operated as a public charity.<sup>30</sup> For foundations that perhaps obtained their tax classification without adequate legal advice or otherwise find themselves in private foundation territory when they would meet the qualifications for public charity status, retroactive reclassification provides an easier process. However, this is not a situation in which most foundations will find themselves.

In addition, the foundation will need to file a consent for statute of limitations purposes, which extends the amount of time that the IRS has to assess deficiencies for the §4940 net investment income tax.<sup>31</sup> This is accomplished through the filing of Form 872-B, which the IRS typically sends to the private foundation to sign after receiving the Form 8940 and any related attachments. Private foundations do not need to pay the net investment income tax during their 60-month period, but if they ultimately do not successfully complete the termination process, such tax

<sup>28</sup> Reg. §1.507-2(d)(3).

<sup>29</sup> A foundation should check Box F at the top of the Form 990-PF that indicates it is in a 60-month termination period.

<sup>30</sup> Instructions to Form 8940, Line 8h.

<sup>31</sup> Reg. §1.507-2(d)(5).

would be due.<sup>32</sup> However, because nonpayment during the 60-month period is due to reasonable cause, no penalties will apply.<sup>33</sup>

### Notice of Completion of Termination Period

In order to complete the termination process, a private foundation needs to establish to the IRS's satisfaction that it met all requirements during the 60-month period.<sup>34</sup> In order to do so, the foundation must file the following information with the IRS using Form 9940 within 90 days after the expiration of its 60-month period:<sup>35</sup>

- a complete description of the foundation's current operations as a public charity, as well as any changes during the 60-month period;
- copies of the foundation's governing document (e.g., articles of incorporation), bylaws, and any amendments (for §170(b)(1)(A)(iii), §170(b)(1)(A)(iv) and §509(a)(3) organizations only);
- Form 990, Schedule A, Part II or III for the 60-month period (for publicly supported organizations under §170(b)(1)(A)(vi) and §509(a)(2) only); and
- Form 990, Schedule A for its most recent tax filing period, details of the relationship between the foundation and its supported organization, and all pertinent information to establish that the foundation did not violate the control requirements described in §509(a)(3)(C) during the 60-month period (for §509(a)(3) supporting organizations only).

Foundations that fail to establish that they successfully met all the requirements during the 60-month period face the potential of being treated as a private foundation for that entire period.<sup>36</sup> However, there are two key exceptions. First, as discussed above, even if a foundation ultimately has to pay the §4940 net investment income tax for years covered under the 60-month period, it will not owe interest or penalties.<sup>37</sup> Second, if a foundation can establish that it did meet all requirements for certain years under the 60-month period, it will be treated as a public charity for those specific years — and grants and contributions made to

the organization during the specific years will be treated as made to a public charity.<sup>38</sup>

Provided that a foundation has submitted the above information to the IRS within the 90-day period, it should file a Form 990 or 990-EZ for the final year of its 60-month period. This is the case even if the IRS has not yet confirmed that the organization has terminated its private foundation status and been reclassified as a public charity.<sup>39</sup>

When the IRS has processed the notice of completion of the 60-month period, and has determined that the organization has met all requirements, it will issue a revised determination letter to that effect. The letter will reflect the organization's specific public charity classification, and will note that the public charity classification is retroactive to the beginning of the 60-month period. In addition, the organization's status will be updated in the IRS business master file extract and IRS Select Check to reflect the applicable public charity status.

### Distributions of Net Assets to a Public Charity — §507(b)(1)(A)

For private foundations that want to cease operations, rather than convert to public charity status, a transfer of all net assets to a certain type of public charity will allow them to terminate their private foundation status without being subject to the termination tax under §507(c). Again, there is a specific process to be followed in undertaking this option.

#### In General

Section 507(b)(1)(A) requires the transfer of all a private foundation's net assets to an organization described in §170(b)(1)(A) (other than clauses (vii) and (viii)) that has been in existence as a public charity for a continuous period of at least 60 calendar months immediately preceding the distribution.<sup>40</sup> In other words, the recipient charity must be an institutional public charity (e.g., a hospital, church, or school), a governmental unit or a publicly supported charity under §170(b)(1)(A)(vi) — it cannot be a §509(a)(2) public charity or a §509(a)(3) supporting organization.<sup>41</sup> Importantly, a transfer to a donor-advised fund held by a sponsoring organization that qualifies under §170(b)(1)(A)(vi) would be allowable under §507(b)(1)(A). This can be a valuable option for foundation founders who perhaps want to maintain some involvement with mission on a smaller scale.

On the foundation's final 990-PF for the year of the transfer, it would check box E, indicating it was ter-

<sup>32</sup> Reg. §1.507-2(d)(4).

<sup>33</sup> *Id.*

<sup>34</sup> Reg. §1.507-2(b)(4).

<sup>35</sup> The foundation should check Part II, Line 8i, and include the applicable required information from the list. Instructions to Form 9940, Line 8i.

<sup>36</sup> Reg. §1.507-2(d)(2)(i).

<sup>37</sup> Reg. §1.507-2(d)(4).

<sup>38</sup> Reg. §1.507-2(e)(2)(ii).

<sup>39</sup> See Instructions to 990-PF, Section U.

<sup>40</sup> Reg. §1.507-1(c)(5).

<sup>41</sup> See Reg. §1.507-2(a)(1), §170(b)(1)(A).

minated under §507(b)(1)(A), mark its return as “Final,” and provide the IRS with details of the transaction on that return.<sup>42</sup> It is not required to provide notice of termination to the IRS and is not liable for tax under §507(c).<sup>43</sup>

### Material Restrictions

In order to transfer all its net assets, a private foundation must transfer all of its right, title, and interest in and to those assets.<sup>44</sup> This means that the private foundation may not impose any material restriction or condition that prevents the recipient charity from freely and effectively employing the transferred assets, or any related income, in furtherance of its exempt purposes.<sup>45</sup>

In determining whether a condition or restriction is material, all facts and circumstances relative to the transfer are considered.<sup>46</sup> The more significant facts and circumstances to be considered include the following:<sup>47</sup>

- whether the recipient public charity is the owner in fee of the assets it receives;
- whether such assets are to be held and administered by the public charity in a manner consistent with its public purposes;
- whether the governing body of the public charity has the ultimate authority and control over the assets and related income; and
- whether, and to what extent, the governing body of the public charity is independent from the transferring private foundation.

The regulations set out certain adverse factors that will indicate the presence of a material restriction on the asset transfer. For instance, a foundation’s retention of the right to direct distributions of the assets on an ongoing basis to a particular organization, or to control the timing of distributions, is a material restriction.<sup>48</sup> In addition, a material restriction is present if there is a requirement that the public charity take action, or refrain from action, with respect to the

transferred assets that is not in furtherance of the charity’s exempt purposes.<sup>49</sup>

Helpfully, the regulations also contain a listing of factors that do not adversely affect the determination of whether there is a material restriction. Specifically, having a name that is the same or similar to that of the private foundation is not problematic.<sup>50</sup> Also, requiring that the assets be used only for one or more specific exempt purposes under §501(c)(3) is not a material restriction.<sup>51</sup> Additionally, it is not a material restriction to require that the transferee public charity retain the assets if that is important to the accomplishment of charitable purposes due to the nature of the property (e.g., if land is transferred that is to serve as a public park for the community, and be maintained by the public charity).<sup>52</sup>

### Distribution of Assets to Another Private Foundation — §507(b)(2)

Alternatively, a private foundation may wish to terminate and distribute its assets to another private foundation. This type of transfer is dealt with separately from the transfer provisions under §507(b)(1)(A), discussed above. Instead, §507(b)(2) addresses all transfers from one private foundation to another pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization.<sup>53</sup> Importantly, this provision does draw in all “significant dispositions of assets” to other private foundations other than transfers for full consideration or out of current income, which is broader than what one would typically consider a termination transaction.<sup>54</sup>

Transfers between private foundations will not trigger the termination tax, and are not treated as terminations of private foundation status under §507(a)(1) — even if the private foundation technically is shutting down and dissolving under state law — unless it gives notice of termination under §507(a)(1).<sup>55</sup> Rather, the transaction results in a carryover of certain tax characteristics and attributes from the transferor

<sup>42</sup> Instructions to 990-PF, General Instructions T and Specific Instructions Item E.

<sup>43</sup> Rev. Rul. 2003-13, 2003-1 C.B. 305.

<sup>44</sup> Reg. §1.507-2(a)(6).

<sup>45</sup> Reg. §1.507-2(a)(7).

<sup>46</sup> Reg. §1.507-2(a)(7).

<sup>47</sup> Reg. §1.507-2(a)(7)(i).

<sup>48</sup> Reg. §1.507-2(a)(7)(iv)(A). However, the regulation is clear that a private foundation can designate *in the transferring document* that the assets should benefit a particular public charity, or that only income should be distributed. *See, e.g.,* Reg. §1.507-2(a)(7)(v) *Ex. 3.*

<sup>49</sup> Reg. §1.507-2(a)(7)(iv)(A)–§1.507-2(a)(7)(iv)(B). *See* Reg. §1.507-2(a)(7)(iv) generally for a full list of adverse factors.

<sup>50</sup> Reg. §1.507-2(a)(7)(iii)(A).

<sup>51</sup> Reg. §1.507-2(a)(7)(iii)(B).

<sup>52</sup> Reg. §1.507-2(a)(7)(iii)(D).

<sup>53</sup> §507(b)(2).

<sup>54</sup> Reg. §1.507-3(a). A “significant disposition of assets” essentially is a transfer of 25% or more of the fair market value of the net assets of the private foundation at the beginning of the taxable year. Reg. §1.507-3(c).

<sup>55</sup> Reg. §1.507-1(b)(6), §1.507-3(d); Rev. Rul. 2002-28, 2002-1 C.B. 941.

foundation to the transferee.<sup>56</sup> The transferee foundation succeeds to the aggregate tax benefit of the transferor foundation, which essentially represents all of the tax savings realized to the foundation and its funders during the foundation's lifetime.<sup>57</sup>

In 2002, in order to discourage unnecessary ruling requests with respect to terminations, the IRS issued a revenue ruling that thoroughly addressed the situation of a private foundation transferring all of its net assets to one or more private foundations under common control.<sup>58</sup> This ruling clarifies, through the use of three examples, the following key points:

- Private foundations transferring their assets to another private foundation are not required to give notice of termination. If they do not do so, the termination tax under §507(c) will not apply. In such circumstances, there is an obligation to file a Form 990-PF for the taxable year of the transfer, but not going forward unless the foundation engages in activities or receives additional assets.
- If the private foundation does give notice of its intent to terminate its private foundation status, the §507(c) tax applies on the date that such notice is given. However, if the foundation had already transferred its assets at least one day before giving notice, the tax due will be zero.
- If a private foundation transfers assets to one or more private foundations effectively controlled by the same persons, the transferee foundation will be treated as though they are the transferor foundation for purposes of §4942, §4943, §4945, and §4946.
- The transferee foundation takes the assets subject to any transferor foundation liabilities under Chapter 42, to the extent the transferor did not previously satisfy those liabilities. Transferee foundations will be responsible for exercising expenditure responsibility on any outstanding grants by the transferor foundation.

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<sup>56</sup> Reg. §1.507-3(a).

<sup>57</sup> Reg. §1.507-5; Bruce R. Hopkins & Jody Blazek, *Private Foundations: Tax Law and Compliance* 574 (3d ed. 2008).

<sup>58</sup> Rev. Rul. 2002-28, 2002-1 C.B. 941.

While this ruling did involve foundations under common control, there are important takeaways for all private foundation transfers to other foundations: (1) the foundation does not have to provide notice of termination under §507(a)(1) to the IRS; (2) if notice of termination under §507(a)(1) is provided, giving notice at least one day after all assets are transferred will result in zero tax liability; and (3) a Form 990-PF will need to be filed for the transfer year, but there is no need to file for subsequent years unless there are activities or additional assets received.

## Distributions of Assets to Other Public Charities — §507(a)(1)

A private foundation that wishes to terminate its private foundation status and transfer its assets to a public charity that is *not* covered by §507(b)(1)(B) will follow a similar process to that described for transactions between private foundations. The IRS issued a revenue ruling<sup>59</sup> covering these types of transfers in conjunction with the one issued with respect to transfers to private foundations, discussed above. This ruling clarifies that a private foundation that distributes all of its net assets to a non-§509(a)(1) public charity, or to a §509(a)(1) public charity that has not been in existence for a continuous 60-month period, gets similar treatment. In other words, it does not terminate under §507(a)(1) and is not subject to tax under §507(c) unless it provides notice of termination; and if it provides such notice, its tax liability will be zero if it has provided notice at least one day after transferring its net assets to the charity.

## CONCLUSION

No matter how careful the planning, circumstances can change over time and mean that the private foundation form is no longer the best fit for a particular organization. Section 507 provides several options for terminating private foundation status without triggering termination tax liability, both for organizations that want to continue operating and those that want to close up shop. It is important to carefully parse each option to choose the appropriate method and ensure that all required steps are taken in proper order, as one misstep could result in significant tax liability.

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<sup>59</sup> Rev. Rul. 2003-13, 2003-1 C.B. 305.