

Philanthropic Estate Planning

By Janet Nava Bandera

Terminating Outdated Charitable Vehicles

Charitable giving has been on the rise for many years. This brings up the question: What do you do with the charitable vehicles that seemed like a good idea at the time, but have outlived their usefulness either financially or emotionally? This column discusses options for those that thought they were stuck with something mom or dad put in place or that they implemented years ago at a different time in their own lives.

Private Foundations

The number of private foundations, and correspondingly the number of families wishing to terminate them, has increased dramatically over the past several years. Between 1990 and 2000, the number of foundations increased by 75 percent according to the Foundation Center, a provider of information and research about philanthropy in the United States. The number shutting down was six percent per year, according to the Association of Small Foundations.

An article in Bloomberg Wealth Manager picked up the trend, sparking much interest in the philanthropic and advisor communities.¹ The article suggested that advisors educate themselves and have a basic understanding of the relevant compliance issues of termination and the alternatives.

Why Foundations Terminate

Family foundations terminate for three primary reasons: (1) cost, including the cost of experts and the personal time commitment, (2) a lack of interest, or (3) a lack of funds.

Whether a foundation has \$10 million or \$30 million in assets, the most common motivation for



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termination is the family's lack of commitment. The original donor is getting older or is deceased, the descendants either don't share the same values or don't have the time required to run the foundation. For individuals that inherited the job or are simply busy with their outside lives, the work can become a burden rather than a joy, particularly where family members disagree on the direction of their philanthropy. Family friction—whether over each other's choice of charities or facing long-standing family dynamics—can cause a communication meltdown.

Without internal expertise, the legal and administrative aspects for which outside experts are paid, often become an expensive burden. These costs often average \$5,000 or more per year. Add to that the personal time involved in researching charities, educating younger family members, reading grant proposals and disbursing grants and the time commitment is simply too great for many.

Solutions

Terminate the Foundation

Terminating a foundation is fairly simple. The foundation can simply make grants en masse or transfer its assets in bulk to another foundation or charity, including a donor advised fund. The charity can then file a final 990-PF and fade away. Some states may require that the foundation take additional steps to terminate its existence as a nonprofit corporation or trust, but these steps are not overly burdensome.

Transfer the Assets to Another Foundation

Code Sec. 507(b)(1)(A) permits a private foundation that has not engaged in willful, repeated acts that would subject it to excise tax under the private foundation excise tax rules to terminate its private foundation status by transferring all of its assets to one or more tax-exempt public charities described in Code Sec. 509(a)(1) that have been in continuous operation for at least 60 consecutive months prior to the foundation's termination transfer.

This Code section was the basis for the conclusion in LTR 200543060,² in which the IRS ruled that a private foundation's transfer of all its assets to another private foundation will not cause the transferor's private foundation status to terminate, will not subject the foundation to termination tax

and will not result in net investment income to the transferor (each requirement set out above was met).

If the facts vary slightly (the transferee has been in existence less than 60 months or the transferee is a 509(a)(2) organization or 509(a)(3) entity—a supporting organization), the foundation must provide notice to the IRS if it intends to terminate. If it provides notice and terminates, it is subject to a termination tax, but if there are no assets the day it provides the notice (because the assets were already transferred), there will be no tax.

Transfer the Assets to a Donor Advised Fund

Rather than distribute the assets to another charity, the foundation board may wish to retain a less burdensome form of continued involvement. Thus, a donor advised fund that will allow the donors to recommend how the funds should be distributed without the administrative burden is desirable. When a private foundation terminates its status and distributes its assets to a qualifying Code Sec. 509(a)(1) charity, it may not place material restrictions on the receiving charity's use of the assets that would prevent it from using them for its exempt purpose. According to Reg. §1.507-2(a)(8)(iii), transferring those assets to a donor advised fund would not constitute a material restriction because the recommendations of the representatives of the terminating private foundation are advisory only.

Thus, if the donor advised fund has been in continuous operation for at least 60 months and the foundation has not engaged in any willful acts, the foundation can transfer the assets and terminate without termination tax or investment income.

Charitable Remainder Trusts

A charitable remainder trust may have become unattractive because the investments have been mismanaged, the payout rate is too large or too small or the donor no longer wishes to deal with or pay for the administration of the trust.

Terminating a CRT

Not every CRT is a candidate for an early termination. If the trust document prohibits a beneficiary from assigning his or her income interest or expressly

prohibits early termination, then an early termination is not feasible. If not prohibited, the next step is to examine the past administration of the trust.

Administration of a CRT is often difficult for the lay person. At any moment in time there may be unresolved issues with the investment portfolio, distributions to the income beneficiaries, or tax filings may not be current. Before entering into a termination transaction, the administration of the CRT should be cleaned up and any unresolved issues resolved.

Terminations generally take one of two forms: (1) the assignment of the income interest to the charitable remainder beneficiaries (an “assignment termination”); or (2) division of the trust assets between the income and remainder beneficiaries based upon the actuarial present value of their respective interests (an “actuarial split”). A third option is to trade the income interest for a charitable gift annuity. The IRS has ruled that such terminations are not prohibited self dealing.³

Assignment of Income Interest

In LTR 7949035,⁴ the IRS concluded that the assignment of the entire income interest to the remainder beneficiary and subsequent termination of the trust would not cause the trust to retroactively fail to qualify as a CRT within the meaning of Code Sec. 664. One determining factor was that the assignment of the income interest was permitted under state law. Later rulings in LTR 200208039, LTR 200304025 and LTR 200324035 continued this line of reasoning.⁵

Of particular interest to most donors is that the IRS has consistently determined that a gift tax charitable deduction is allowed in an assignment termination.⁶ The amount of the income tax deduction is computed using the formula prescribed in the regulations for computing the present value of an income and remainder interest in a trust.

Because an income interest in a CRT is neither cash nor a marketable security, many practitioners feel the charitable contribution substantiation rules found in Reg. §1.170A-13(c)(3) require that the computation of the present value of the income interest must follow the qualified appraisal rules.

Dividing the Trust Assets

In LTR 200127023,⁷ the proposed termination of the CRT was not prohibited by state law; it was to

be made pursuant to a court order resulting from a proceeding to which the state attorney general was a party; and the amounts distributed to the income beneficiary were to be determined and distributed pursuant to the valuation rules set forth in Code Sec. 7520 and the distribution of assets in kind be made (to all beneficiaries) in a pro rata manner. Based upon this fact pattern, upon termination, the income beneficiary (with respect to his life income interest value), recognizes zero-basis, long-term capital gain income in the amount of the property realized by him.

In any case, state law should be followed as to whether a court proceeding is necessary, who must consent to the termination and whether the attorney general must be included (the IRS has shown a preference for having the Attorney General as a consenting signatory to the termination⁸).

Trading the Income Interest for a Charitable Gift Annuity

In LTR 200152018,⁹ the IRS approved the assignment of an income interest in exchange for a charitable gift annuity issued by the charitable remainder beneficiary. This transaction preserved an income stream for the income beneficiary and allowed an additional income and gift tax charitable deduction. Most importantly, the income beneficiary was permitted to defer the recognition of the capital gain on the exchange by recognizing a portion with each annuity payment.

Conclusion

Where a family has outgrown the benefits of a charitable giving vehicle they are not stuck; there are solutions. There is sufficient guidance from the IRS to make finding a suitable solution easier than ever.

Author's Note: More on this subject, including a digest on published rulings, can be found in the IRS manual at its Web site www.irs.gov/irm/part7/ch11s07.html#d0e103963 and in Changing the Grant Making Entity, a presentation by Frank Minton to the American Bar Association Section on Real Property, Probate and Trust Law, given in Seattle Washington, May 2004 found at: www.abanet.org/rppt/meetings_cle/spring2004/pt/communityfoundations/minton.pdf#search=terminating%20private%20foundation%20frank%20minton.

¹ Deborah L. Jacobs, Meltdown, Bloomberg Wealth Manager, Oct. 2004.
² LTR 200543060 (Aug. 2, 2005)
³ See LTR 200127023 (Apr. 4, 2001).
⁴ LTR 7949035 (Sept. 5, 1979).

⁵ LTR 200208039 (Nov. 29, 2001); LTR 200304025 (Oct. 23, 2002); LTR 200324035 (Mar. 4, 2003).
⁶ See Rev. Rul. 86-60, 1986-1 CB 302 and LTR 7949035 (Sept. 5, 1979).

⁷ *Supra* note 3.
⁸ See LTR 200127023, *supra* note 3, and LTR 200208039, *supra* note 5.
⁹ LTR 200152018 (Sept. 26, 2001).

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