Private Foundations: Trust or Corporation? Choosing the Right Fit

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It has been estimated that over the next 50 years $41 trillion will pass to charity. The forms donors will use to make these charitable contributions will have a wide range, from outright gifts to testamentary trusts to more sophisticated giving techniques. One sophisticated giving technique that continues to increase in popularity is the organization of private foundations. Private foundations are subject to a number of complicated rules that prohibit and tax various forms of self-dealing. In addition, contributions to private foundations are subject to a number of restrictions relating to the income tax deductibility of contributions. Because of these complicated rules, it was used to be that private foundations were considered to be a charitable giving technique only used by the wealthy. However, that is not the case anymore. Today many donors are organizing private foundations with initial contributions of less than $1 million.

With the increase in the amount of private foundations that are being organized, donors and their advisors continue to focus on the complicated self-dealing and income tax deductibility rules. Although those rules are important and should be given much attention, the donors and their advisors must not overlook one fundamental issue: What is the appropriate legal entity to use in structuring the private foundation? When in the process of organizing a private foundation, donors and their advisors should consider a number of important factors to determine which structure of the private foundation is most preferable. The appropriate choice of legal entity will be a significant step in furthering the donor’s goals.

Private Foundation Basics

Every charitable organization exempt under Section 501(c)(3) is assumed to be a private foundation. In order not to be a private foundation, the organization must fit into one of the categories of public charities specifically excluded from the definition of a private foundation under IRC §501(c)(3). Despite whether a private foundation is organized as a trust or a corporation, each private foundation will qualify as one of the three basic types of private foundations, a private operating foundation, an exempt operating foundation, or a grant-making foundation.

In general, a private operating foundation is a private foundation that devotes most of its resources to the active conduct of its exempt activities. These foundations are still subject to the tax on net investment income and to the other requirements and restrictions that generally apply to private foundation activity. However, private operating foundations are not subject to the excise tax on failure to distribute income. Also, contributions to private operating foundations described in §4942(j)(3) are deductible by the donors to the extent of 50% of the donor’s adjusted gross income, whereas contributions generally to most other private foundations are generally limited to 30% of the donor’s adjusted gross income.

In general, an exempt operating foundation is a private foundation that has been (1) publicly supported for 10 years; (2) whose governing body consists of individuals less than 25% of whom are disqualified individuals and is broadly representative of the general public; and (3) has no officer who is a disqualified individual during the year. A private operating foundation is not subject to the tax on net investment income if it is an exempt operating foundation. In addition, private foundations may make grants to exempt operating foundations without complying with the expenditure responsibility requirements.

A private foundation that is neither a private operating foundation nor an exempt operating foundation is classified as a grant-making foundation (also often referred to as private nonoperating foundations). The majority of private foundations are labeled “grant-making foundations.” A grant-making foundation generally does not carry out any charitable activity. Instead, a grant-making foundation is designed to hold assets for charitable purposes, usually being for the distribution to public §501(c)(3) organizations.

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Donor’s Intent/Objective

Private foundations have become a significant part of many donors’ philanthropy-focused estate plan. A reason for the increase in the organization of private foundations among all types of donors is that private foundations allow donors with different objectives and motivations to accomplish similar goals. This results because private foundations can be structured as trusts, not-for-profit corporations, or a hybrid of both entities. Because private foundations can be structured differently, donors are presented with more options that will allow them to achieve their philanthropic objectives.

Because there are advantages and disadvantages to each type of structure for a private foundation, the donor’s objectives and motivations for organizing the private foundation must be understood before the private foundation is organized. It is likely that one type of structure is a better “fit” for the donor’s objectives.

For example, a donor may want to organize a private foundation as a means to benefit a very specific charitable purpose. If this is the case, it is likely that one of the donor’s objectives is to limit the ability of future generations to deviate from that specific charitable purpose. Therefore, a more restrictive structure may be appropriate.

In a different situation, a donor may want to use the private foundation as a means for his or her descendants to be involved in the family’s charitable giving. If this is the case, it is likely that the donor’s objectives are for his or her descendants to play a major role in the administration of the private foundation and in the grant-making process. Therefore, the structure that may be most appropriate is one that will allow the future generations to be part of the management of the private foundation yet be subjected to the least liability.

Many donors decide late in December that they want to organize a private foundation prior to year-end. If this is the case, the donor’s objective is likely to provide the donor with a means to make a charitable contribution to the private foundation before year-end so that the donor will receive an income tax deduction for the current year. Thus, the ease of setting up the private foundation may be of primary concern to the donor.

Donors will often have many different reasons for wanting to organize a private foundation. However, once the donor’s primary objectives for organizing the private foundation have been established, it will be easier to match the donor’s objective with the factors described in the following sections and to decide on the appropriate structure for the donor’s private foundation.

Flexibility

In most situations donors will know whether they want to give those individuals or entities that will manage the private foundation flexibility. A private foundation that is organized as a not-for-profit corporation rather than a trust will provide greater flexibility to the managers of the private foundation. This often results because state statutes and the corporate bylaws provide corporate directors with greater flexibility than that provided to a trustee by state statute and the trust instrument.

Directors of a not-for-profit corporation (unless specifically limited by the articles of incorporation or bylaws) will generally be able to alter the governing structure of the corporation by corporate resolution. Because of this flexibility, it will be easier for a board of directors to address circumstances that may affect how the private foundation is managed.

A donor may see both advantages and disadvantages to the flexibility to alter the management structure of the not-for-profit corporation. For example, the flexibility may be advantageous if a donor wants his descendants to be directors of the private foundation. In that situation, the corporate bylaws may allow a board to increase its size to accommodate members of the donor’s family who have reached the age of majority. However, a donor may find the flexibility of the corporate structure to be a disadvantage because the foundation’s directors can change on a frequent basis with new elections. In that case, the donor will have less control over who manages the corporation. In comparison, a less flexible charitable trust will allow the donor to designate who acts as trustee and successor trustees of the trust. Thus, the donor will effectively choose who will manage the private foundation.

A not-for-profit corporation will also provide greater flexibility to the board of directors with regard to the foundation’s charitable purpose. State law generally allows the charitable purpose set forth in the articles of incorporation to be amended by corporate resolution (unless specifically prescribed in the articles). Thus, the board or directors are given a means to amend the corporate purpose to adapt to the societal changes. However, depending on state law, the private foundation may need to obtain approval from state officials before a corporate purpose may be amended.

All donors may not find the flexibility to alter the charitable purpose associated with the corporate structure appealing. Many donors are concerned that the philanthropic purpose for which the foundation was organized may too easily be changed by a board of directors to a purpose that was not intended by the donor.

In comparison to the corporate structure, if a private foundation is organized as a charitable trust, the trust instrument must be irrevocable. Therefore, the donor, the trustee, or a third party will likely be unable to modify the terms of the trust instrument. Although this will allow the charitable purpose of the trust to remain unchanged, the trustee may find the trust’s charitable purpose either limited or no longer workable should societal circumstances change. In recent years, the inability to change a trust’s limited charitable purpose has been the subject of much charitable litigation. It is important to note that a trust instrument may be drafted to grant the trustee a broad flexibility; however, a donor will not be able to anticipate all the changed circumstances that may occur in the future.

To amend a charitable trust, most state’s cy pres and equitable deviation doctrines will require that the charitable trust cannot be amended without a court proceeding or prior approval of the state’s attorney general. The court proceeding will require the state’s attorney general to be a party. Further, to be successful in modifying the charitable purpose, the trustee will likely have to show that the existing charitable purpose is impossible or impractical to fulfill.

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Standard of Care

The standard of care applicable to corporate directors as opposed to trustees is very different and must be considered when determining the legal entity of the private foundation. Because of the potential risk of personal liability associated with the position, many individuals are unwilling to be board members or trustees of private foundations. For those individuals who will consider acting as a board member or trustee, their focus before accepting the position is often on the foundation’s ability to indemnify the individual from personal liability.

Generally, directors of a not-for-profit corporation will be subject to less personal liability than trustees of a charitable trust. The business judgment rule will be the standard of care applied to the directors of a not-for-profit corporation. 10 The business judgment rule generally provides that a director is liable only for acts of self-dealing, willful misconduct, and gross negligence. 11

In the case of a charitable trust, the trustee will likely be held to a more rigorous standard and a higher level of responsibility than a director. While a director of a not-for-profit corporation will generally only be liable for gross negligence, a trustee of a charitable trust may be held liable for acts of simple negligence. 12 Therefore, even if a trustee acts in good faith, the trustee may still be personally liable for the negligent act.

In addition, most states have either formally adopted the Uniform Prudent Investor Rule or some form of that rule. The prudent investor rules apply to trustees of charitable trusts and not directors of not-for-profit corporations. The prudent investor rules of most states generally allow a trustee to delegate investment authority to a third party; however, as with many states’ prudent investor rules, the trustee may be liable for negligent acts of the individual or entity to whom the trustee delegated investment authority. 13 In comparison to a not-for-profit corporation, certain state’s statutes, provide that a director of a not-for-profit corporation will not be liable for the negligent acts of those individuals or entities to whom they have delegated investment authority. 14

If a donor feels that a trust is the best structure for a foundation but is concerned about personal liability for the trustee, the trust instrument may either lessen the standard of care applicable to the trustee or provide a broad indemnification within the trust agreement. A court, however, may narrowly construe such a broad indemnification in a charitable trust due to public policy concerns.

Ease of Organization and Fees

Is a not-for-profit or a trust easier to establish and is either entity less expensive to organize or maintain? Generally a private foundation structured as a trust can be more quickly organized than a corporation. The initial work associated with the trust structure involves drafting the trust instrument and having it executed by the settlor and the trustee.

In the case of a corporate structure, there are often more filings and initial preparation work. To structure the private foundation as not-for-profit corporation, articles of incorporation must be filed with and approved by the applicable state’s secretary of state.

In addition, the name of a not-for-profit corporation must be approved by the applicable secretary of state. Many states corporation should be drafted and approved by the board of directors. The corporation will also have to name a registered agent within the state of incorporation. This may result in additional work and fees if the private foundation is being incorporated in a state other than the donor’s domicile.

There are two main maintenance fees generally associated with a charitable trust: (1) the fee associated with drafting the trust instrument, and (2) the administration fee to the trustee, if any. On the other hand, the not-for-profit corporation will pay a fee to the secretary of state upon organization and will be required to file an annual report with the secretary of state. Although the annual report generally is not substantial, an annual filing fee is generally required.

There are other additional formalities required with the corporate structure. State law generally requires that a not-for-profit corporation hold annual meetings and keep detailed minutes of such meetings. There are no such formalities required for a charitable trust.

Accounting

The need to prepare and send annual accountings to the beneficiaries of a private foundation are another factor to be

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researched before a charitable trust structure is chosen.

Under a corporate structure, an accounting requirement to the beneficiaries is generally not required by not-for-profit corporation statutes and a not-for-profit corporation’s bylaws. Despite this fact, annually accounting to the beneficiaries of a not-for-profit corporation may minimize the corporation’s potential liability. It will be difficult for a beneficiary to argue that the private foundation’s funds have been mismanaged where a beneficiary has been provided with and has approved annual accountings on behalf of the private foundation.

**Unrelated Business Taxable Income**

Before organizing the foundation, donors and their advisors should determine if there is a possibility that the foundation will be subjected to tax on unrelated business taxable income (UBTI). While a private foundation should take steps to avoid UBTI, if the foundation is organized as a corporation the UBTI will tax at the corporate rate.\(^{16}\)

If, however, the foundation is structured as a trust, the UBTI will be taxed as trust rates.\(^{17}\)

**Contributions for International Organizations**

One factor that favors the corporate structure is if the private foundation intends to make contributions for use outside the United States. Section 170(c)(2) provides that contributions by a corporation to a private foundation organized as a trust are deductible only if the contribution is used for a charitable purpose within the United States.\(^{18}\) However this restriction does not apply to contributions to private foundations that have been structured as not-for-profit corporations. Although this issue is generally not a factor with most private foundations, it must be considered if the foundation intends to use its contributions for charitable purposes outside the United States.

**Hybrid Entity**

After examining all the advantages and disadvantages of the corporate and trust structures for a private foundation, a donor may still have a difficult time deciding which entity to use. The donor may want limited liability for those individuals or entities managing the private foundation but may be concerned that the charitable purpose could easily be changed. In that situation, it may be possible to structure the private foundation as a hybrid type of entity.\(^{19}\) Using this approach, the donor would organize the private foundation as a not-for-profit corporation. The corporation, however, would have a sole member, being a trust. Many states’ not-for-profit laws allow not-for-profit corporations to have members.\(^{20}\)

By using the hybrid approach, the member (as the trustee of the trust) would be given exclusive authority to make key decisions regarding amendments to the corporate purpose. This can be accomplished by requiring the consent of the member to make any changes to the articles of incorporation. The trust instrument that governs the trustee should then prohibit any changes to the philanthropic purpose of the corporation.

Essentially, by using the hybrid structure, the directors of the foundation would be held to a standard of care applicable to corporations. However, the directors would not have the flexibility to change the philanthropic purpose as would generally be the case with a foundation organized solely as a not-for-profit corporation.

**Making the Choice**

There are several matters to consider when determining what legal entity to use for a private foundation. Most practitioners will probably argue that the not-for-profit corporation is the structure used the majority of the time. Although this may be the case, it would be inappropriate not to have an open mind at each meeting with the prospective donor who would like to organize a private foundation. The starting point in choosing the legal entity should be to understand the donor’s objectives and motivations for organizing the foundation. Once those goals and motivations are determined, it will likely be easier to choose the right “fit.”

**Endnotes**

2. IRC §501(c)(3); I.R.C. §509(a).
3. IRC §4942(j)(3).
4. IRC §4942(j)(3); Treas. Reg. §53.4942(c)-1(c).
7. Id.
8. Id.
16. IRC §511.
17. Id.
18. IRC §170(c)(2).