Do Private Foundations Work Best in Trust or Corporation Form? How to Choose the Right Fit

by Kenneth A. Goldstein

Private foundations are subject to a number of complicated rules that prohibit and tax various forms of self-dealing. Additionally, contributions to private foundations during the donor’s lifetime are subject to a number of restrictions relating to the income tax deductibility of contributions. Because of these complicated rules, it 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. A majority of foundations hold assets with fair market values of less than $1 million.

With the increase in the number 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 these rules are important and should be given much attention, donors and their Advisors should not overlook another critical question: What is the appropriate legal entity to use in forming a particular private foundation?

Matching Available Options to Donor Goals

When organizing a private foundation, donors and their Advisors should consider a number of important factors to determine whether to structure the private foundation as a corporation or a trust. The appropriate choice of legal entity will be a significant step in furthering the donor’s goals.

Private foundations have become a significant part of many donors’ philanthropy-focused estate plans. A reason for the increase in the organization of private foundations among all types of donors is that private foundations allow donors with differing 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. Thus, donors are presented with more options that will allow them to achieve their philanthropic objectives. (Regardless of which form is chosen, all the assets of the entity must be used for charitable purposes.)

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

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

State Law Requirements

Choice of Domicile and Initial Filing. Corporations are subject to state law requirements for formation such as filing the articles of incorporation with the applicable state’s secretary of state for approval. The amount of time that the Secretary of State takes to approve the filing of the articles of incorporation varies by state. In some states, it is possible to file the articles on an expedited basis and receive the filed articles of incorporation back the same day or the following day. Other states may take as long as three or four weeks to form the corporation.

The corporation does not need to be filed in the state where the donor is domiciled. As with for-profit corporations, there may be qualified state’s secretary of state for approval. The amount of time that the Secretary of State takes to approve the filing of the articles of incorporation varies by state. In some states, it is possible to file the articles on an expedited basis and receive the filed articles of incorporation back the same day or the following day. Other states may take as long as three or four weeks to form the corporation.

The corporation does not need to be filed in the state where the donor is domiciled. As with for-profit corporations, there may be qualified
be advantages to forming the foundation as a Delaware corporation. For example, Delaware corporate law is well developed, Delaware law permits foundations to have a single director, and under Delaware law, only the Delaware attorney general may sue a Delaware foundation.4 However, the articles of incorporation will 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.

In addition, the name of a not-for-profit corporation must be approved by the applicable secretary of state. Many states have informal requirements that must be included in a private foundation’s name that is organized as a not-for-profit corporation such as “NFP” or some other abbreviation or language that identifies the corporation as a not-for-profit.

For the foregoing reasons, it is possible that a private foundation structured as a trust may be organized more quickly than a corporation. The initial formation of a foundation as a trust usually requires merely the execution of the trust agreement by the grantor and the trustee. Furthermore, the existence of the trust does not usually require any filings or filing fees with the secretary of state.

Trusts generally require fewer formalities than corporations such as not requiring director’s meetings. In addition, trusts usually place both day-to-day control of the entity and the supervisory role in the hands of the trustees, whereas a corporation typically separates these roles between the officers and directors. In some states, a single individual may not serve in multiple roles. For example, a corporation formed under New York law prohibits the same person from acting as both president and secretary.5 The laws of some states also require a minimum number of directors.

Corporate Formalities. Once the articles of incorporation have been filed and approved, bylaws for the corporation should be drafted and approved by the board of directors. In addition, 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.

Annual Filings. Most states also require that an annual filing for a corporation be filed with the state. The work required to prepare and file the annual report is generally not substantial, but an annual filing fee is usually required. Trusts often have no such filing requirement to maintain the trust’s existence.

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 generate a current charitable contribution deduction for the amounts contributed to the private foundation before year-end. Therefore, the ease of setting up the private foundation may be of primary concern to the donor.

Flexibility

Corporations Generally More Flexible Than Trusts. 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 generally provide greater flexibility because state statutes and the corporate bylaws provide corporate directors with greater flexibility than what is 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 by-laws) 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.

Pros and Cons of Flexibility. A donor may see both advantages and disadvantages to the ability to alter the management structure of the not-for-profit corporation.

Control Issues. Such 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 family members 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 may lose control over who manages the corporation. In comparison, a charitable trust will allow the donor to designate who acts as trustee and successor trustees of the trust. Thus, the donor may effectively choose who will manage the private foundation.

Charitable Purpose. 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 will generally allow 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 of directors is given the means to amend the corporate purpose to adapt to societal or other changes.

Some 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 not intended by the donor.

On the other hand, a private foundation organized as a charitable trust is an irrevocable instrument that generally cannot be amended, absent a court order (unless the trust instrument provides otherwise) or other approval permitted under state law. Even though it is possible that the terms could be modified by a court order, this is a cumbersome and expensive process with an uncertain result. In addition, depending on state law and/or the trust instrument, the private foundation may need to obtain approval from state officials before a charitable purpose may be amended.

If the donor is concerned about “mission drift,” the trust instrument should specify the purpose of the foundation. The purpose of the foundation should clearly specify the donor’s intended uses of the foundation’s assets. The purpose may also include a secondary purpose in the event that the original purpose can no longer be pursued. For example, if the purpose of the foundation is to give funds to charities that help AIDS patients, what happens to

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the foundation if and when a cure to AIDS is discovered? A carefully crafted purpose may deter a court from permitting the foundation to act in a manner that is contrary to the express wishes of the foundation documents. In recent years, the inability to change a trust’s limited charitable purpose has been the subject of much litigation. It is important to note, 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.

In order 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 (unless the trust instrument provides otherwise). 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.

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.

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.

Example—Mission Drift: The Ford Foundation is an often cited example of a foundation diverting from the principles of the donor. Henry Ford and Edsel Ford created the Ford Foundation but the foundation did not contain any instructions regarding its purposes. While the governing documents of the Ford Foundation did not contain any instructions, Henry Ford had a fairly well-articulated philosophy of giving, both in his writings and in interviews—e.g., “I do not believe in giving folks things. I do believe in giving them a chance to make things for themselves.”

It is these beliefs that most likely caused Henry’s grandson, Henry Ford II, to resign in 1977 as a trustee of the Ford Foundation over his perceived disgust with how the foundation and most of its trustees had drifted so far from his father’s and grandfather’s beliefs.

In a different situation, a donor may want to use the private foundation as 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 grantmaking process. Therefore, the structure that may be most appropriate is one that contains the flexibility to allow future generations to be part of the management of the private foundation yet be subjected to the least liability.

However, see the case of In re Barnes Foundation, a noteworthy example of a court’s ultimate authority to change a donor’s plan. In Barnes, the donor, Albert C. Barnes, specifically mandated in the governing instrument of his foundation that his art collection remain on display in his Merion, Pennsylvania, residence in perpetuity.

After a long court battle between the foundation, members of the community, and other charitable organizations, the court permitted the foundation to move the artwork held by the foundation to a new facility in Philadelphia. While the lack of flexibility ensured that the foundation would continue to satisfy the donor’s wishes, it is this lack of flexibility that may have prompted the court to allow the modification to the foundation’s purpose. It is possible that this case may not have made it to court had Mr. Barnes granted a family member or group of family members, as trust protectors, with the express authority to amend the document.

Standard of Care and Potential Liability

The standard of care applicable to corporate directors as opposed to trustees is very different. If the foundation is a non-operating foundation and is merely making distributions to other charitable organizations, these concerns may not be that great. If, on the other hand, the foundation will actually be engaging in charitable activities, this factor should be considered when determining the legal structure. Because of the potential risk of personal liability associated with the position, some individuals may be hesitant to act as a director or trustee of a private foundation. An individual who will consider acting as a director or trustee will often focus, before accepting the position, on the foundation’s ability to indemnify the individual from personal liability.

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

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. Therefore, even if a trustee acts in good faith, the trustee may still be personally liable for the negligent act.

Applicability of Uniform Prudent Investor Rule. In addition, most states have formally adopted either the Uniform Prudent Investor Rule or some form of that rule. The prudent investor rules apply to trustees of charitable trusts and not to 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. In comparison to a not-for-profit corporation, certain state statutes provide that a director of a not-for-profit corporation will not be liable for the negligent acts of those indi-
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individuals or entities to which they have delegated investment authority.16

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.

Unrelated Business Taxable Income

Before organizing the foundation, donors and their advisors should determine if there is a possibility that the foundation will be subject 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 be taxed at the federal income tax rate for corporations.17 If, however, the foundation is structured as a trust, the UBTI will be taxed at the federal income tax rate for trusts.18 UBTI may also be subject to state income tax as well.

The tax rates for a foundation reach the highest marginal rate of 39.6% at a tax level threshold.

Any gain or loss from the sale or disposition of property used for the exempt purposes of a foundation is not included in figuring a foundation’s tax on net investment income, nor is it subject to UBTI. However, capital gains that result from the sale or other disposition of property held for investment purposes or for the production of income not related to the foundation’s purpose must be included in net investment income to the extent that those gains are not subject to UBTI. Generally, capital gains that result from the sale or other disposition of property not used for the exempt purpose of the foundation are considered to be UBTI and are taxed at UBTI rates—determined by whether the foundation is a trust or corporation.19

The UBTI tax rate on capital gains of a foundation organized as a trust can be vastly different from the UBTI tax rate of one organized as a corporation. This may occur because trusts pay tax on capital gains at the preferential capital gains tax rate20 (currently 20%) whereas a corporation is not subject to the preferential capital gains tax rate.21 Therefore, a foundation organized as a trust could pay UBTI on capital gains at a much lower tax rate than a foundation organized as a corporation. A further benefit to the trust foundation as opposed to the corporate foundation is that the trust can take a deduction for income distributed, including the 5% annual minimum distribution threshold. The income distribution deduction allowable to the trust foundation will likely make the gap between the UBTI tax rate on capital gains between a trust and corporation even larger.

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. IRC §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, whereas, if the corporate gift is made to a corporation (as opposed to a trust) there is no such restriction.22 Although this issue will generally not be 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.

When a Hybrid Entity Makes Sense

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.23 Many states’ not-for-profit laws allow not-for-profit corporations to have members.24 Using this approach, the donor would organize the private foundation as a not-for-profit corporation. The corporation would have a sole member, which is a trust established by the donor. The donor would be the trustee of this trust. The trust instrument would name successor trustees of the trust.

By using the hybrid approach, the donor, as trustee, 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 and would give the member the right to add or remove any director. The trust instrument that governs the trust should either grant the member the power to make any changes to the philanthropic purpose of the corporation or if the donor prefers, prohibit any changes entirely.

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

Accordingly, as discussed previously, there are several issues to consider when determining what legal entity to use for 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

1. An earlier version of this article, written by Richard Horwood and John Wiktor, was published in the July/August 2006 issue of the Family Foundation Advisor.


3. Often, the state charges an additional fee for such service.


5. N.Y. Not for Profit Corp. L. §713 (2012).

6. New York and Illinois both require three or more directors. See N.Y. Not for Profit Corp. L. §702 (2012) and Ill. General Not for Profit Corp.

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10. Lincoln University had the authority under Dr. Barnes’s 1952 trust indenture, as amended, to nominate four of the five members of the foundation’s board of trustees. Id.
16. IRC §511.
17. Id.
18. Id.
19. IRC §§1(e), 1(h).
20. IRC §11.
21. IRC §170(c)(2).
22. See Reg. §1.170A-11(a) and Rev Rul. 69-80.