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The Private Foundation Life Cycle: A Compliance Overview

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THE PRIVATE FOUNDATION LIFE CYCLE: A COMPLIANCE OVERVIEW

I. ORGANIZATIONAL MATTERS

A. Choice of Entity: Texas State Law

The beginning point for a discussion of any new private foundation is the selection of the proper legal structure for such a foundation. Based on personal experience, nonprofit corporations are by far the most common choice of legal structure for a private foundation in Texas, with charitable trusts a distant second. The same is true on a national level.¹ Although other legal structures exist (unincorporated associations and limited liability companies), such organizational structures are rarely used.

When evaluating whether to form a new private foundation as a nonprofit corporation or a charitable trust, it is important to identify the donor's specific long-term goals. Importantly, the donor should consider the significant start-up financial cost and ongoing compliance obligations of a private foundation. Other issues for the donor to consider include: (a) ease of formation; (b) type and amount of assets to be held; (c) type and scale of planned activities; (d) liability protections for directors; (e) expected amount of unrelated business taxable income; (f) governance structure; and (g) permanence of mission statement.

1. Non-Profit Corporations

Subsection 22.001(5) of the Texas Business Organizations Code defines a nonprofit corporation as a corporation no part of the income of which is distributable to a member, director, or officer of the corporation, except as provided by Section 22.054. A nonprofit corporation may be formed for any lawful purpose or purposes not expressly prohibited by the Texas Business Organizations Code.²

A nonprofit corporation can be member managed or managed by a board of directors. The management of a nonprofit corporation is governed by the Certificate of Formation filed with the Texas Secretary of State. The Certificate of Formation will typically state the name of the nonprofit corporation, the duration (i.e., perpetual or a number of years), the

purpose of the nonprofit corporation, the name and address of the registered agent, the management of the nonprofit corporation, the names and addresses of the members and/or directors, and restrictions on distributions or upon dissolution. The Certificate of Formation also typically contains others provisions including limitations of liability and indemnification provisions for directors and officers. Once the Certificate of Formation is accepted by the Secretary of State, the nonprofit corporation becomes incorporated. However, the Certificate of Formation – which includes the purpose of the nonprofit corporation – can easily be amended by a vote of the board of directors. Judicial approval is not required. In some circumstances, the ease at which the purpose of a nonprofit corporation can be changed is seen as a negative.

In addition to the Certificate of Formation, Bylaws for the nonprofit corporation must be prepared. The Bylaws may contain provisions for the regulation and management of the affairs of the nonprofit corporation that are consistent with law and the Certificate of Formation.³ If the Bylaws are inconsistent with the Certificate of Formation, the Certificate of Formation typically controls, with some exceptions.⁴ In order to become effective, the Bylaws must be adopted by the nonprofit corporation's board of directors or members.⁵ Bylaws typically contain provisions regarding the election of directors and officers, annual and regular meetings, duties of directors and officers and committees of directors, compensation, fiscal year, and procedures for amending the Bylaws, among other provisions.

The Texas Business Organizations Code requires at least three directors of a nonprofit corporation.⁶ A majority of the board of directors is necessary to transact the business of the nonprofit corporation, unless the Certificate of Formation or Bylaws set a different quorum requirement.⁷ The board of directors must conduct at least one meeting annually and should keep minutes at all board meetings. The election of officers of the nonprofit corporation, which is required to include a president and a secretary and are responsible for the day to day management of the corporation, is determined by the Certificate of Formation, the Bylaws, or by the directors.⁸

¹ See Evelyn Brody, *Charity Governance: What's Trust Law Got to Do with It?*, 80 Chicago-Kent L. Rev. 641 (2005), which estimated that in 2005 only 12,422 of the 650,000 recognized charities in the U.S. were organized as trusts.

² Texas Business Organizations Code ("TBOC") § 22.051.

³ TBOC § 22.102.

⁴ TBOC § 22.103.

⁵ TBOC § 22.102.

⁶ TBOC § 22.204.

⁷ TBOC § 22.213.

⁸ TBOC § 22.232.

The Certificate of Formation and Bylaws trump any default provisions of the Texas Business Organizations Code, except for those certain provisions that cannot be waived.⁹

2. Charitable Trusts

Section 123.001 of the Texas Property Code defines a charitable trust as (1) a charitable entity, (2) a trust the stated purpose of which is to benefit a charitable entity, or (3) an inter vivos or testamentary gift to a charitable entity. Section 123.001 then specifically defines a “charitable entity” as a corporation, trust, community chest, fund, foundation, or other entity organized for scientific, educational, philanthropic, or environmental purposes, social welfare, the arts and humanities, or another civic or public purpose described by Section 501(c)(3) of the Internal Revenue Code of 1986 (the “Code”). Or, in plain English, a charitable trust is a fiduciary relationship created by a person (the trustee) holding property that has been dedicated to a charitable purpose.

Unlike a nonprofit corporation, a charitable trust may be governed by a single trustee (including a corporate trustee), neither annual meetings nor minutes are required, and title to the assets is held in the name of the trustee(s). Since title is held in the name of the trustee(s), conveyance of trust assets generally requires the signature of all trustees. When more than one trustee is serving, any other decisions (excluding conveyance of assets) typically only require a majority of the trustees serving.¹⁰

A charitable trust is created by a written trust agreement that allows the trustee to make distributions for charitable purposes described in Section 501(c)(3) of the Code. The assets contributed to a charitable trust must be irrevocably dedicated to a charitable purpose. The trust agreement does not need to be filed with the Secretary of State in order for the trust to legally exist. As a result, the trust agreement can be signed quickly, any name can be used for the trust (e.g., there is no need to predetermine name availability with the Secretary of State), no filing fee needs to be paid, and the trust agreement is confidential from a state law perspective (although it is still subject to inspection under IRS rules).

⁹ The following provisions of the TBOC cannot be waived by a nonprofit corporation: 22.053; 22.102; 22.104; 22.153; 22.156; 22.204; 22.216; 22.218; 22.225-226; 22.231; 22.251-253; 22.256-257; 22.302; 22.351-353. Thanks to Hayden Harms, an associate at Fizer Beck, for compiling this list.

¹⁰ Texas Trust Code § 113.085.

A donor has wide latitude in limiting or restricting the purposes of the charitable trust, as described in the trust agreement. The donor may require distributions be made to certain causes (i.e., 60% of distributions must be made to Jewish causes) or restrict distributions to certain causes (i.e., no distributions may be made to support religious organizations). However, any limitation, restriction, or mission statement should be included in the trust agreement itself.

Although it is possible to change the purpose of a charitable trust (as contained in the trust agreement and organizational documents), it is much more challenging with a charitable trust than with a nonprofit corporation. Under the doctrine of cy pres, which has been codified in Section 112.054 of the Texas Trust Code, a charitable trust may be judicially reformed in order to prevent the trust from failing. However, this provision only allows the judicial modification of trust (whether private or charitable) for the following purposes: (1) the purposes of the trust have been fulfilled or have become illegal or impossible to fulfill; (2) because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust; (3) modification of administrative, non-dispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration; (4) the order is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intentions; or (5) subject to the requirement that all beneficiaries consent, (a) continuance of the trust is not necessary to achieve any material purpose of the trust or (b) the order is not inconsistent with a material purpose of the trust. The burden is on the trustee or beneficiary of the charitable trust bringing the action to “prove up” the purpose of the modification, as the court has no obligation to approve the petition for judicial modification. In addition, the Office of the Texas Attorney General must be given notice of the judicial modification and an opportunity to intervene, as described in Chapter 123 of the Texas Property Code.

Charitable trusts are governed by the Texas Trust Code, which applies to both charitable trusts and private trusts. However, the trust agreement is the governing instrument for a charitable trust provided that the trust agreement does not limit the applicability of the provisions of the Texas Trust Code outlined in Section 111.0035(b).

B. Choice of Entity: Federal Law

After the donor (and their attorney) agrees on the type of state law entity, a preliminary decision regarding federal tax status should be made, subject to IRS review. There are currently over twenty-five

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