The Pros and Cons of Establishing a Not-for-Profit Corporation Versus a Charitable Trust in New York

By Andrew S. Katzenberg

High net worth clients often have philanthropic desires and objectives, and one method to achieve these goals is to establish a private charity, also known as a private foundation. Instead of giving to a public charity, clients can establish their own private foundation. Foundations provide several advantages that clients may not have considered when deciding to make charitable gifts.

First, most gifts to a private foundation will be tax deductible to a similar extent as gifts to a public charity.[1] This allows the client to make larger current gifts which result in a larger tax deduction, even though he or she does not plan on distributing those funds in that same year to other charities. In other words, clients can take a deduction up front and make distributions to the client's preferred charities over time. Second, the client can be a director or trustee and / or can appoint directors and trustees, giving him or her control over the foundation's investments and charitable grants. Third, family members can participate in the foundation, which can be used to educate younger generations about the importance and benefits of philanthropy. Finally, a client can secure his or her legacy through the benevolent acts of the foundation for decades after the client's death.

Once a client has decided to create a foundation, it then falls to the attorney to recommend which type of entity to establish based on the client's objectives. This article will focus on the advantages and disadvantages of establishing not-for-profit corporations and charitable trusts in New York.

I. Not-for-Profit Corporations

Not-for-Profit Corporations, also known as charitable corporations, can be formed under New York's Not-for-Profit Corporations Law (NPCL).[2] To qualify as a Not-for-Profit Corporation, a corporation must meet specific and rigid requirements,[3] including, but not limited to, the following.

Like all New York corporations, it must file for incorporation with the New York State Department of State.[4] The certificate of incorporation must state the specific purpose or purposes for its creation.[5] The purpose cannot be too vague or broad[6] such as using Section 501(c)(3)'s tax exempt purpose language[7] alone as the description of the purposes.[8] The purpose or purposes article should identify (i) what the corporation intends to accomplish, (ii) who will benefit and (iii) how it will accomplish its purposes.[9]

A corporation is also required to have a minimum of three directors.[10] The directors' names and addresses need to be listed in the certificate of incorporation.[11]

The name of the corporation usually must include the word "corporation," "incorporated," "limited," or their abbreviations to identify the corporate nature of the entity.[12] There are several exceptions to this rule, but they are limited in focus.[13] One exception to the name requirement is for corporations that are created solely for charitable or religious purposes.[14] However, if the purpose article includes any other purposes, then it is not exempt and must use one of the identifying words or abbreviations in its name. For instance if the corporation had both charitable and educational purposes, it would not qualify for the exception.[15] However, a corporation could request permission from New York's Department of State to do business under an "assumed name," rather than its legal name.[16]

Foundations with certain purposes, such as education or operation of hospital or health services, are also required to obtain consent from other corresponding governmental agencies or offices to qualify for incorporation (*i.e.*, Department of Education and Department of Health respectively).[17] Foundations with purposes that include business purposes must include an additional statement explaining the public and quasi-public objectives its business purpose will achieve.[18]

One cannot avoid New York's difficult incorporation laws by incorporating in another jurisdiction such as Delaware. These charitable corporations are considered foreign charitable corporations[19] and are required to file an "application for authority" with New York's Department of State if they intend to "conduct business"[20] in New York.[21] Though a foreign charitable corporation does not have to satisfy as many requirements as a charitable corporation incorporated in New York, it must still define the specific purposes of the charitable corporation in the application for authority.[22]

II. Charitable Trusts

Charitable trusts are governed under Article 8 of New York's Estate, Powers & Trusts Law (EPTL).[23] The statutes governing charitable trusts are not as rigid as the Not-for-Profit Corporations Law.

When establishing a charitable trust under New York law, one should follow the same rules as creating any other lifetime trust, which merely requires the signatures of the creator and one of the trustees, all of which are witnessed by two individuals or notarized.[24]

A bigger advantage of a charitable trust is that a trust does not need to have as specific a charitable purpose(s) as a charitable corporation.[25] This means the trust can have several broad charitable purposes (*e.g.*, religious, charitable, educational, or benevolent purposes) and could use Section 501(c)(3)'s tax exempt language alone as the description of the purposes. This is helpful when a client does not have a specific purpose in mind or has multiple purposes in mind.

Further, a trust only needs one trustee instead of three directors,[26] and a trust can always allow for additional trustees to be appointed at a later date.[27] A client may not have three people he or she wants to manage the charity, and this would simplify the initial decision.

There are no requirements for a trust's name. It can be called the "John Doe Foundation," the "Lucky Day Trust," or any other name a client cares to use. It also does not need consent of any New York governmental agency to be established such as the Department of Education or the Department of Health (except it must register with the New York Charities Bureau the same as a charitable corporation[28]).

Another advantage of a charitable trust is that the creator can make the purposes irrevocable whereas a charitable corporation's certificate of incorporation can always be amended by the board of directors.[29] If the purpose of the charitable trust becomes impractical after the creator's death, the trustee may petition the court to change the specific purpose to accomplish the general purpose of the trust.[30]

Despite these advantages, the scale is not completely tipped in favor of charitable trusts over charitable corporations. First, under New York's Surrogate's Court Procedure Act, trustee compensation is limited to six percent (6%) of income and none of the principal of the trust.[31] Directors of corporations, on the other hand, are limited to "reasonable compensation" without any firm caps.[32]

Second, charitable trusts can be subject to higher taxes than charitable corporations. "Unrelated business taxable income" (UBTI) is subject to tax at the normal tax rates for corporations and trusts.[33] A trust's highest tax rate is 39.6% and reaches this amount at $11,950 (adjusted for inflation) of UBTI[34] whereas a corporation's highest bracket is 35%,[35] which takes effect at $10 million of UBTI.[36]

III. Liability of Directors and Trustees

The biggest disadvantage of a charitable trust is that the trustee is exposed to greater personal liability then a corporate director. Directors and officers of corporations owe a duty of care,[37] loyalty and obedience[38] to the corporation, which opens them up to personal liability. However, there are specific laws that protect directors and officers of charitable corporations from liability, such as mandatory indemnification,[39] in addition to broader indemnification that may be granted or authorized by the certificate of incorporation or by-laws.[40] Directors and officers are also protected by the business judgment rule, which protects them from liability as long as their actions are "taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes."[41]

Directors may also delegate investment authority to officers or employees without being held liable for those individuals' actions.[42] Essentially, the directors can insulate themselves from liability on investment decisions by delegating authority.

On the other hand, trustees have a fiduciary duty to exercise reasonable care, diligence and prudence.[43] This is analogous to a corporation's director's duty of care. Additionally, trustees' investment and management actions are also governed by the Prudent Investor Rule, which does not apply to directors, resulting in a higher fiduciary duty.[44] Under this rule, the trustees' investment and management actions are judged based on all circumstances and facts at the time of their decisions to determine if they acted in accord with a prudent investor.[45]

Though the Prudent Investor Rule allows for the delegation of investment authority by the trustee, the trustee must exercise "care, skill and caution" in such delegation and must periodically review delegee's exercise of authority.[46] In addition, the trustee may still be liable for negligent acts of the delegee, unlike a corporate director.[47]

As mentioned above, the NPCL specifically protects the acts of the directors and officers, whereas the EPTL is silent on the issue.[48] The trustee is also not protected by the business judgment rule.[49] However, the flexibility of the trust instrument allows one to build in limited liability and indemnification for the trustee, though not to the same extent as provided to directors and officers.

IV. Conclusion

Charitable trusts are easy to form in New York and are amenable to expanded charitable purposes, while charitable corporations provide greater protection from liability for their directors and officers and lower taxes on UBTI. Greater protection from liability in itself does not further the client's charitable goals; this is merely an ancillary benefit for the individuals managing the charitable organization.

Therefore, when initially setting up a charitable organization in New York for high net worth clients, a

charitable trust is normally the best starting point. As your client's foundation grows and his or her objectives become clearer, he or she can always create a charitable corporation at a later point to receive the funds of the charitable trust. This strategy will allow the foundation to get up and running sooner while providing the additional benefits of a corprate structure in the future.

Endnotes

1. The maximum amount of gifts to a public charity that may be deducted in a year is 50% of one's adjusted gross income, and this amount is further reduced to 30% for appreciated property. The maximum amount of gifts to a private foundation that may be deducted in a year is 30% of one's adjusted gross income, and this amount is further reduced to 20% for appreciated property, though gifts made to private operating foundations and, in rare cases, private foundations can qualify for a deduction amount of up to 50% of one's adjusted gross income. IRC 170(b) (2013); *see also* I.R.S., *Publication 526: Charitable Contributions* 13-14 (Jan. 18, 2013), *available at* http://www.irs.gov/pub/irs-pdf/p526.pdf (last visited July 29, 2013).
2. N.Y. Not-for-Profit Corporations Law § 402(a)(2) (NPCL).
3. NPCL § 402(a) (listing several requirements for the corporation's certificate of incorporation).
4. NPCL § 403 ("Upon the filing of the certificate of incorporation by the department of state, the corporate existence shall begin, and such certificate shall be conclusive evidence that all conditions precedent have been fulfilled and that the corporation has been formed under this chapter…").
5. NPCL § 402(a)(2); *see also* NPCL § 201 (establishing the purposes for which a corporation may be formed under the NPCL).
6. *See In re Council for Small Bus., Inc.*, 155 N.Y.S.2d 530, 530 (Sup. Ct., Kings Co. 1956) (denying an application for incorporation because "[t]he purposes outlined in the proposed certificate of incorporation are too generalized and vague"). *See also, In re Aid Found., Inc.*, 27 Misc. 2d 314, 315, 210 N.Y.S.2d 165, 167 (Sup. Ct., Kings Co. 1960) (denying application for incorporation of a corporation, which claimed "exclusively charitable" purposes, but provided only "vague" and "unclear" description of the charity's scope and proposed activities). If a certificate of incorporation does not specify the charitable organization's purpose(s), it will not qualify as a Not-for-Profit Corporation.
7. "[O]rganized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals." IRC § 501(c)(3).
8. *See* N.Y. Dep't of State, *Not-for-Profit Incorporation Guide* (January 2012), *available at* http://www.dos.ny.gov/forms/corporations/1511-f-l_instructions.pdf (last visited September 16, 2013).
9. *Id.*
10. NPCL § 702(a).
11. NPCL § 402(a)(4). However, type D corporations need not list names and addresses of initial directors. *Id.*
12. NPCL § 301(a)(1). Abbreviations include "Inc.," "Corp.," or "Ltd."
13. A corporation falls within the exception if (i) it is formed for charitable or religious purposes, (ii) it is formed for purposes that require approval by the commissioner of social services or the public health and health planning council, or (iii) it is a bar association. NPCL § 301(a)(1).
14. NPCL § 301(a)(1).
15. *See* NPCL § 301(a)(1) (failing to exempt corporations with educational purposes from the name requirement).
16. N.Y. General Business Law § 130 (GBL). For the link to Department of State, *see* N.Y. Dep't of State, Div. of Corps., State Records & UCC, *Certificate of Assumed Name*, http://www.dos.ny.gov/corps/assdnmins.html (last visited July 29, 2013) (providing instructions for how to file a certificate for assumed name with the Department of State).
17. NPCL § 404. Some of the agencies whose consent is required include Office of the Attorney General, Office of Children & Family Services, Department of Health, Department of Education, Office of Mental Health and Office of Alcoholism and Substance Abuse Services. *Id.*
18. NPCL § 402(a)(2).
19. NPCL § 102(a)(7).
20. *See* N.Y. Dep't of State, *"Doing Business" In New York: An Introduction To Qualification General Guidelines* (February 2000), *available at* http://www.dos.ny.gov/cnsl/do_bus.html (last visited October 6, 2013). It is not entirely clear what constitutes doing business in New York but NPCL § 1301 does have a nonexclusive list of acts which do not constitute doing business in New York such as maintaining bank accounts or granting funds.
21. NPCL Article 13. For the link to Department of State, *see* N.Y. Dep't of State, Div. of Corps., State Records & UCC, *Application for Authority*, http://www.dos.ny.gov/forms/corporations/1555-f-l-a.pdf (last visited October 10, 2013).
22. NPCL § 1304.
23. The provisions under EPTL Article 7 governing trusts should also be considered when dealing with a charitable trust and should be used when the provisions of EPTL Article 8 do not provide guidance. *See generally* EPTL 7-1.1–7-8.1.
24. EPTL 7-1.17(a). This Section refers to "every lifetime trust," which would include charitable lifetime trusts, since they are not excluded from the definition of lifetime trust under EPTL 1-2.20. However, prior to 1997, there was no formal requirement for the execution of lifetime trusts (except for pour-over trusts). Turano, McKinney's Practice Commentary, EPTL 7-1.17 (2012).
25. *Cf.* NPCL § 201 (requiring not-for-profit corporations to specify a charitable purpose, unlike trusts).
26. *Compare* EPTL 7-1.17(a) (providing that trust must be executed "by at least one trustee"), *with* NPCL § 702(a) ("The number of directors constituting the entire board shall be not less than three.").
27. *See* EPTL 7-1.17(b) (outlining the requirements governing amendments to a trust).
28. EPTL 8-1.4.
29. NPCL § 801.
30. EPTL 8-1.1(c).
31. N.Y. Surrogate's Court Procedure Act 2309(5) (SCPA).
32. 26 C.F.R. § 53.4958-4(b).
33. IRC § 511(a)(2) and (b)(2).
34. IRC § 1(e).
35. However, any amount UBTI between $100,000 and $335,000 is taxed at a 39% rate and any amount UBTI between $15,000,000 and $18,333,333 is taxed at a 38% rate. IRC § 11(b)(1)(D). *See also*, Form 1120 Instructions for 2012 page 17, *available at* http://www.irs.gov/pub/irs-pdf/i1120.pdf (last visited October 8, 2013).
36. IRC § 11.
37. NPCL § 717.

38. *See* N.Y. Dep't of State, Charities Bureau, *The Regulatory Role of the Attorney General's Charities Bureau* 4 (July 15, 2003), *available at* http://www.courts.state.ny.us/reporter/webdocs/role.pdf (last visited July 29, 2013); *see also Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 186 Misc. 2d 126, 152, 715 N.Y.S.2d 575 (Sup. Ct., New York Co. 1999).

39. NPCL § 723(a). Indemnification is mandatory if a director is successful on the merits of a case. *Id.*

40. NPCL § 721 (providing that the indemnification and advancement of expenses under the NPCL are non-exclusive remedies).

41. *Consumers Union of US, Inc. v. States*, 5 N.Y.3d 327, 360, 806 N.Y.S.2d 99, 118, 840 N.E.2d 68, 87 (2005) (suggesting that the business judgment rule would operate in a nonprofit context as well to bar judicial inquiry when good faith and judgment is used in making a business decision); *see Spitzer v. Grasso*, 11 N.Y.3d 64, 71, 862 N.Y.S.2d 828, 832, 893 N.E.2d 105, 109 (2008); *Macnish-Lenox v. Simpson*, 17 Misc. 3d 1118(A), 851 N.Y.S.2d 64, *12-15 (Sup. Ct., Kings Co. 2007).

42. NPCL § 514. The directors must exercise the standard of care required under NPCL § 717 when delegating investment authority. NPCL § 514(b).

43. EPTL 11-1.7 (providing that it is contrary to public policy to limit a fiduciary's liability for "failure to exercise reasonable care, diligence and prudence").

44. EPTL 11-2.3.

45. EPTL 11-2.3(b)(2).

46. EPTL 11-2.3(c)(1).

47. *See In re HSBC Bank USA, N.A.*, 30 Misc. 3d 1201(A), 958 N.Y.S.2d 646 (Sur. Ct., Erie Co. 2010), *aff'd as modified*, 96 A.D.3d 1655, 947 N.Y.S.2d 288 (4th Dep't 2012) (finding a trustee negligent for purchasing "improper" investments at the direction of a non-trustee).

48. *Compare* NPCL § 723(a), *and* NPCL § 721, *with* EPTL 11-1.7.

49. *See In re Estate of Schulman*, 165 A.D.2d 499, 502, 568 N.Y.S.2d 660, 662 (3d Dep't 1991) (holding that trustee standards, not the business judgment rule, applied to the trustee).

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