

WHAT IS LOST WHEN PHILANTHROPY AVOIDS PHILANTHROPY LAW?

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Professor Dana Brakman Reiser has once again produced work that invites us all to look at philanthropy and philanthropy law in a fresh way. In *Disruptive Philanthropy: Chan-Zuckerberg, the Limited Liability Company, and the Millionaire Next Door*,¹ Professor Reiser provides what she calls, “the definitive explanation” for a trend in philanthropy: the “seemingly bizarre choice” by some charitable donors to do philanthropy using a for-profit vehicle, like a limited liability company, rather than a traditional non-profit charitable entity, like a private foundation.² Professor Reiser uses as her case-study the Chan-Zuckerberg Initiative (CZI), which was created when the founder of Facebook and his wife publicly committed 99% of their net worth to social causes, but notably did not contribute any of it to a private foundation.³ Professor Reiser explains that Chan and Zuckerberg, and other philanthropists who have chosen to forego tax-exempt status, have done so both because they found certain restrictions on tax-exempt organizations too constraining and because they found the benefits (especially tax benefits) of contributing to a traditional tax-exempt organization insufficiently beneficial.⁴ She argues that this trend is likely to grow, and increasingly more charitable donors are likely to make use of the “philanthropy LLC,” thus avoiding any regulatory function that the current legal regime provides.⁵

But the key to understanding the philanthropy LLC—at least as exemplified by CZI—is that it is not so much used as a *substitute* for traditional charitable contributions as a *delay* in making them. While Professor Reiser does describe some activities of CZI that will never involve a traditional charity,⁶ most of what CZI does is choose charitable recipients and then make contributions to them. In that way, Chan and Zuckerberg do take advantage of the charitable tax deduction. The deduction is especially valuable for philanthropists like them because their wealth consists almost entirely of extremely highly appreciated stock (in their case, stock in Facebook, the company Zuckerberg founded). When a donor makes a charitable contribution of appreciated property, they get a *double* tax benefit—they avoid paying capital gains

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1. Dana Brakman Reiser, *Disruptive Philanthropy: Chan-Zuckerberg, the Limited Liability Company, and the Millionaire Next Door*, 70 FLA. L. REV. 921 (2018).

2. *Id.* at 921.

3. *Id.* at 922.

4. *Id.* at 943, 945.

5. *Id.* at 956–57.

6. *Id.* at 940–42.

tax on the appreciation in the stock *and* they get to deduct the full appreciated value of the stock.⁷ This double benefit is one of those tax perks in the charitable sector that seem almost too good to be true. It certainly is good enough that Chan and Zuckerberg are making full use of it. But they are making full use of it over time, rather than all at once. As Professor Reiser points out, using a philanthropy LLC (rather than making one's contributions to a traditional charitable entity all at once) gives donors "the ability to stage donations to take maximum advantage of deductibility."⁸ In this way, philanthropy LLC is more like a method for making a charitable pledge (a promise to make contributions in the future) than it is like a substitute for a traditional charity, but it is even less binding than a pledge. So long as Chan or Zuckerberg is alive and want to control their own philanthropy (and manage their own tax liability), they need not be in any hurry to make irrevocable contributions to a charity. They can set aside the assets they intend to use for charity at some point and use them when they choose.

Professor Reiser compares the philanthropy LLC to a traditional charitable entity that is also used to hold wealth until such time as it will be deployed in active operating charities—the private foundation.⁹ In 1969, Congress amended the tax code to provide special treatment for such entities, concerned that they were being used by philanthropists to get the benefit of charitable contributions while delaying deploying wealth actively for charitable purposes.¹⁰ Private foundations permit philanthropists to get the benefit, including the tax benefit, of charitable contributions *before* such contributions are deployed for charitable purposes.¹¹ If philanthropists wanted to wait to get the tax benefit of their contributions, then they could always wait to create a private foundation, keeping complete control of their assets until they chose to donate them. Many major philanthropists in the last century waited until they were older to create their private foundations, maintaining the flexibility to use their assets as they saw fit while they were alive and relatively young, and only committed major portions of their wealth to private foundations as they thought about transitioning their wealth to the next generation. When viewed that way, the use of the philanthropy LLC to avoid the restrictions placed on private foundations seems less stark.

7. *Briefing Book: What is the Tax Treatment of Charitable Contributions?*, TAX POL'Y CTR. (2016) [hereinafter *Briefing Book*], <https://www.taxpolicycenter.org/briefing-book/what-tax-treatment-charitable-contributions> [<https://perma.cc/4FHD-J4GD>].

8. Reiser, *supra* note 1, at 951.

9. *See id.* at 931–32.

10. *See, e.g.*, S. COMM. ON FIN., 89TH CONG., TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS 23 (Comm. Print 1965).

11. *See* I.R.C. § 170 (2018) (outlining the tax benefits awarded to those who give to private foundations); *see also* Reiser, *supra* note 1, at 932 (noting how private foundations use their gifts to enable the efforts of other charitable organizations)

As Professor Reiser points out, though, the ability to “stage” the tax benefits of charitable contributions does not last forever.¹² When people as wealthy as Chan and Zuckerberg die, their estates are subject to a substantial federal estate tax.¹³ Under current law (2019), a tax of up to 40% is imposed on the value of an estate that exceeds 11.4 million dollars (22.8 million for a married couple).¹⁴ Because the exemption amount is so high, less than one in a thousand estates will pay federal estate tax,¹⁵ but for truly large estates the estate tax can be a significant cost. Assets contributed to charity avoid the estate tax, even if they are contributed to a charity under the control of the decedent’s heirs.¹⁶ As Professor Reiser points out:

A private foundation can hold a family's assets through generations without any application of the estate tax. A philanthropy LLC cannot function as such a perpetual tax-free vehicle To avoid the estate tax, those with assets over the credit amounts will need to transfer their LLC stakes to exempt entities on death, or pay Uncle Sam his share.¹⁷

Therefore, so long as there is an estate tax, philanthropists like Chan and Zuckerberg have a very strong tax incentive not to continue to hold assets they plan to use for charity outside of traditional charitable entities once they both die.

That means that the benefits of the philanthropy LLC will likely last only a single generation. There is nothing about the philanthropy LLC that permits Chan and Zuckerberg to avoid the estate tax. So, as long as the estate tax is not repealed before they die, and as long as their estate is still substantial when they die, they will have to choose whether to pay the estate tax or pour their LLC into a private foundation then. In fact, they almost certainly have already made this decision (at least preliminarily) in their wills. Life is long and Chan and Zuckerberg are young; but it’s not *that* long, and they’re not *that* young. At the end of one generation, the difference between a private foundation and a philanthropy LLC is likely to evaporate for CZI. That means that the most important question about the philanthropy LLC is whether it creates

12. Reiser, *supra* note 1, at 955.

13. See I.R.C. § 2001(a) (2018) (“A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.”).

14. See *What’s New – Estate and Gift Tax*, INTERNAL REVENUE SERV. (June 13, 2019), <https://www.irs.gov/businesses/small-businesses-self-employed/whats-new-estate-and-gift-tax> [<https://perma.cc/F2PJ-8GDX>].

15. See *Briefing Book*, *supra* note 7.

16. See *Frequently Asked Questions on Estate Taxes*, INTERNAL REVENUE SERV. (July 3, 2019), <https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-estate-taxes> [<https://perma.cc/U9MR-WV8C>].

17. Reiser, *supra* note 1, at 955.

social costs because it facilitates delay of creation of a private foundation *for one generation*—not because it facilitates the avoidance of a private foundation entirely, at least for estates big enough to be subject to the estate tax, and at least so long as the estate tax is not repealed.

Professor Reiser provides a very balanced presentation of social benefits and costs of philanthropy LLC. She argues that the rise of philanthropy LLCs will be beneficial if it increases the amount of money going to charity, but as compared to private foundations, it might do so in a way that magnifies certain costs to the general public.¹⁸ But thinking of a philanthropy LLC as only a single-generation strategy casts some of her analysis in a different light. For example, she argues that the philanthropy LLC structure magnifies donor control and might insulate founders from outside influence.¹⁹ She contrasts philanthropy LLCs to large private foundations, which have made major contributions to the social good in the 20th Century.²⁰ She cites some examples, including the Ford Foundation's support for the civil rights movement.²¹ But the significant accomplishments she cites have been made by professionalized private foundations largely in the years after the death of their founders. As discussed above, the philanthropy LLC structure is probably most often a single-generation structure, and so should not be compared to mature, professional, multi-generational private foundations, like the Ford Foundation. It might be more illuminating to compare CZI to a private foundation whose founders are still very much alive, like the Gates Foundation. Do the private foundation rules effectively limit founder control? Do they effectively prevent founders from being insulated from outside influence?

More importantly, Professor Reiser points out that the choice of a philanthropy LLC over a private foundation permits a philanthropist to avoid an “army of restrictions” on philanthropic activities.²² Again, to the degree to which this avoidance only lasts a single generation, the choice might be less socially costly than it might initially appear. To take just one example, private foundations are subject to the so-called “excess business holdings” rules, which generally prevent a private foundation from owning a controlling share in a for-profit company.²³ If Chan-Zuckerberg had contributed Facebook stock (which constitutes the vast majority of their wealth) to a private foundation, the foundation would have to divest itself of the vast majority of the stock. The rules operate to prevent a major shareholder of a company from using a private

18. *Id.* at 969.

19. *Id.* at 966.

20. *Id.* at 936–37.

21. *Id.* at 962 n.213.

22. *Id.* at 932.

23. *See id.* at 933.

foundation under their control to maintain control over the company. If they want to maintain control over the company, they must use the stock they own directly to do that, and the foundation under their control must divest itself of its stock in the company. In fact, there is a compelling argument that the concerns that led to the creation of the federal private foundation restrictions in 1969—exactly those laws that Chan and Zuckerberg are avoiding with their philanthropy LLC—came almost entirely out of concerns with *dynastic* control of philanthropic assets, and the avoidance of the estate tax that comes from such intergenerational, dynastic, control.²⁴ I don't think anyone seriously thinks that founders should be forced to give up control of the companies they found while they are alive. The purpose of the excess business holdings rule is primarily to prevent them from avoiding estate tax and simultaneously maintaining control for their heirs. There is nothing wrong with Zuckerberg and Chan choosing not to divest themselves of control of Facebook while they are both living.

Professor Reiser also points out that the private foundation rules would restrict the ability of CZI to take a controlling equity interest in social enterprises they wish to invest in, potentially complicate investment in social enterprises, complicate (and possibly restrict) compensation for employees of the organization, and prevent the use of the organization's assets for political activities.²⁵ Again, if CZI permits them to use their own money to do things that they are permitted to do with their own money, it is not clear why that's a problem.

Even accepting that CZI is likely to live only until Chan and Zuckerberg are dead, there may be some very real costs associated with the use of a philanthropy LLC instead of a private foundation if the form is widely adopted. First, and most importantly, the single-generational limit on the philanthropy LLC is dependent on the taxation of intergenerational transfers. Under current law, some quite large estates can escape estate taxes, and for those estates a philanthropy LLC might be a viable philanthropic vehicle for generations. If the philanthropy LLC is adopted by the "millionaire next door" as Professor Reiser predicts,²⁶ then the LLC may be a useful device to create intergenerational dynastic control over philanthropic wealth, exactly the situation the private foundation rules sought to control. Even more worrisome, the legislative trend appears to be continuing to reduce the number of estates that owe the estate tax, and there is still a politically powerful movement to eliminate the estate tax entirely.²⁷ If that were to happen, then the

24. See S. COMM. ON FIN., 89TH CONG., TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS 34 (Comm. Print 1965).

25. Reiser, *supra* note 1, at 938, 940.

26. *Id.* at 957.

27. See, e.g., Jeff Stein, *Top GOP Senators Propose Repealing Estate Tax, Which is*

philanthropy LLC would cease being a single-generation delay in making charitable contributions even for estates as large as Chan's and Zuckerberg's, and would become a potentially eternal one, with all of the social costs that Professor Reiser identifies.

But even when the benefits of a philanthropy LLC are limited to single generation, there are potential social harms associated with it. In some ways, it might even be worse than philanthropists simply holding onto their money until they are ready to make contributions to active charities. These harms potentially arise because a philanthropy LLC permits philanthropists to make a *claim* about their wealth that is different from simply holding onto it: They are claiming they are doing philanthropy, even as they maintain complete control over their property. Not only that, they are creating an *entity* that holds the "allocated" wealth, appearing as if they have committed their wealth to charitable purposes without binding themselves to do so. That raises the question: Is there anything wrong with that? I think the answer to that is a resounding "maybe."

The dominant economic theory of nonprofits suggests that thinking about agency costs will help us evaluate the circumstances in which avoiding the regulation of charities is likely to be harmful.²⁸ Nonprofit organizations rely on their structure (and the regulations that enforce it) to communicate their trustworthiness to various stakeholders. Take as an illustrative example the most basic difference between a private foundation and a philanthropic LLC: The foundation has *irrevocably* committed its assets to charitable purposes, while the members of an LLC can change their minds at any time.²⁹ So, in order to understand if it matters that Chan and Zuckerberg have chosen to make a claim about their charitable intent without binding themselves to it with the tools provided in charity law, we need to understand what they are communicating when they created their philanthropy LLC. Is anyone relying on that symbolic act in the way they would be if Chan and Zuckerberg had chosen to make an irrevocable decision? Does it matter

Expected to be Paid by Fewer than 2,000 Americans a Year, WASH. POST (Jan. 28, 2019, 4:44 PM), <https://www.washingtonpost.com/us-policy/2019/01/28/top-gop-senators-propose-repealing-estate-tax-which-is-expected-be-paid-by-fewer-than-americans-year/> [<https://perma.cc/LYQ4-4PTD>] (reporting Republican legislative proposals to repeal the federal estate tax).

28. See generally Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980) [hereinafter Hansmann, *Enterprise*] (developing a broad perspective on the economic role that nonprofit organizations perform); Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497 (1981) [hereinafter Hansmann, *Reforming*] (discussing the shortcomings of traditional nonprofit corporation law and proposing a restructure that allows broader use of corporate statutes); Benjamin Moses Leff, *The Case Against For-Profit Charity*, 42 SET. HALL L. REV. 819 (2012) (expanding upon agency theory to explain why the government should provide tax benefits only to nonprofit charitable firms).

29. See Reiser, *supra* note 1, at 962.

to the owners of Facebook stock, or to employees of CZI, or to the charities seeking funds from CZI, or lawmakers, or the potential beneficiaries of CZI initiatives, or anyone else? If any of these stakeholders relies on CZI's "charitable" mission, but CZI is able to (purposely) avoid the terms of the law that define and constrain a charitable mission, then those stakeholders may be harmed. More importantly, if the rise of philanthropy LLCs confuses societal stakeholders generally about the meaning of charitable entities, and what rules apply to them, then the whole charitable sector could be harmed by this confusion. Almost forty years ago, Henry Hansmann posited that the charitable sector depends for its very existence on the ability of charities to make credible commitments to stakeholders (like donors) about what it will and will not do with their charitable assets.³⁰ When stakeholders are confused about which organizations are charities and which are not, the ability of the entire charitable sector to make these credible commitments is diminished, and that in itself could be a harm caused by philanthropy LLCs.

On the other hand, Professor Reiser does an excellent job of pointing out that there are numerous benefits as well, and I am as optimistic as she is about getting wealthy entrepreneurs involved in philanthropy. But it is important that all stakeholders understand that a philanthropy LLC is not a charity, while a private foundation (for all its many flaws) is. Luckily, Professor Reiser is around to explain that important fact so clearly.

30. Hansmann, *Enterprise*, *supra* note 28, at 844.