The Chan Zuckerberg Initiative: LLC for Philanthropy

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Adding flexibility but not tax savings, the use of an LLC rather than a private foundation for philanthropic efforts should not be controversial.

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In December 2015, Mark Zuckerberg and Priscilla Chan announced an innovative type of philanthropic initiative. Perhaps never before, however, have people been so vilified for pledging to give away most of their net worth. The expression "no good deed goes unpunished" does not even begin to explain the way that the Chan Zuckerberg Initiative (CZI) and Priscilla Chan and her husband Mark Zuckerberg have been treated by some members of the press and academia.

Never in the history of mankind have two people pledged to do so much to advance human potential and promote equality and have been treated so harshly for it. Perhaps some explanations are in order, however, as even some fair-minded individuals have gotten the technical aspects of the CZI planning wrong. For purposes of simplicity, Ms. Chan and Mr. Zuckerberg are referred to in the discussion that follows as "the Zuckerbergs."

Pledge rather than immediate gift

The Zuckerbergs' commitment to give 99% of their Facebook shares (worth about $45 billion) is a pledge. It is not an outright current gift, donation, investment, or expenditure. The Zuckerbergs agreed to spend their money over time and have made a very public commitment to do so.

Pledging cash or property to a charity is a very common practice. A pledge means that the pledger intends to perform in the future when the money is actually needed by the charity or when a specific event occurs—such as attaining a commitment letter for construction of a building, the hiring of a new CEO, or even the death of the pledger.

The law governing the enforceability of pledges by charities against pledgers is well-settled. As a general rule, these pledges are not enforceable, meaning a pledge to a charity is only as good as the word of the person making the pledge. An exception applies, however, when the charity detrimentally relies on the pledge, which means that a particular charity incurred expenses or obligations specifically because of the pledger's promise to donate and the pledger knew this and that the charity would be irreparably damaged if the pledger did not perform on his or her pledge. This is no different in substance than what the Zuckerbergs have done here except that their pledge, unlike the pledge of

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most people to a specific charity, was offered more broadly, quite publically, and with great fanfare thereby creating even greater assurance that the Zuckerbergs will perform lest they be subject to great public ridicule or, in contemporary parlance, pubic "shaming" via social media and the Internet.

Tax effect of entity selection

The Zuckerbergs will continue to own indirectly the Facebook stock contributed to the limited liability company (LLC) until either it or the proceeds of its sale are donated to a charity, gifted to an individual, invested in a for-profit company, or used to pay lobbying or other expenditures. This probably puts them in a worse tax position than had they just donated some of the shares to a combination of public charities and a private foundation.

A domestic LLC is treated as a "flow-through entity" for most tax purposes. This means that an LLC's tax attributes flow through to its owners, who are in this case the Zuckerbergs. At present, the primary asset of the LLC will be Facebook stock, so the Zuckerbergs will continue to be responsible for any taxes associated with dividends paid by the company on the shares and gains from the sale of the shares by the LLC, if any are in fact sold. Dividends, however, are unlikely to be paid now or in the foreseeable future by the company because of the company's focus on growth investing, and the ongoing requirement to pay dividends would reduce the financial flexibility of the company. Facebook's website, under Investor Relations, clearly states that "Facebook does not pay a dividend."

Likewise, the LLC's expenditures will flow through to the Zuckerbergs for tax purposes only when the LLC actually donates cash or Facebook stock to a charity, makes a gift to an individual, or expends funds for other purposes (e.g., lobbying for causes consistent with the LLC's business purpose). The Zuckerbergs will receive the exact same tax treatment with respect to these items of income and gain and expenditures as they would have received had they recognized the income and gain, or paid the expenditures directly and not through the LLC. Nothing about an LLC changes the way the Zuckerbergs will be taxed.

The LLC model does afford greater flexibility for lobbying and for-profit activities than the charitable model.

For instance, if the LLC makes a contribution to a charity of cash or Facebook stock at some time in the future, the Zuckerbergs would at that time be entitled to a tax deduction subject to the various statutory limitations (some of which are addressed below). While the tax treatment would be the same regardless of whether the LLC was ever formed, many of the strategies deployed in tax planning however are based on time value of money principles. This means that tax professionals use techniques designed to accelerate deductions so that they can be used to reduce current taxes. The principle is simple: A tax deduction taken now is better than one taken later.

One important exception to this proposition, not relevant here, is if tax rates are expected to substantially increase in a future year when the tax deduction could be taken. In that situation, the increased benefit of the deduction taken at a higher tax rate could be greater than the time value of money benefit of taking the deduction in an earlier year. If the Zuckerbergs were to make contributions of cash or stock today to either public charities (generally churches, schools, hospitals, governmental entities, private operating foundations, and other nonprofit entities organized for charitable, religious, educational, scientific, or literary purposes) or to their own private foundation, instead of using an LLC, they would be entitled to a current tax deduction against their income for the year the contributions were made that could also be carried forward, if not fully used, and applied against future income for a maximum of five years.[1] Once contributions are made to these charities, and a current tax deduction taken by the Zuckerbergs, public charities would be under absolutely no obligation to immediately deploy the funds or stock contributed by the Zuckerbergs for charitable purposes. Instead, the charity could decide not to use the funds for its charitable purposes until many years later.

In the case of a contribution to a private foundation, the only obligation would be to make the mandatory annual distribution of 5% of the value of its endowment[2] but even this can be minimized in several ways. For example, besides grants or contributions to other charities for charitable purposes, reasonable administrative expenses necessary for the conduct of the charitable activities of the foundation itself, costs of all direct charitable activities, amounts paid to acquire assets used directly in carrying out charitable purposes (such as computers, office furniture, or an office building), assets set aside for charitable purposes and program-related investments and loans, are all treated as qualifying distributions for this purpose. While these charitable organizations do have limitations on their ability to lobby, these restrictions are not absolute and they can use their funds to invest in for-profit businesses, and they may make grants to private individuals without incurring gift tax.

The bottom line is that by not making tax-deductible contributions immediately and instead contributing the stock to the LLC, the Zuckerbergs may be foregoing the immediate tax benefit they would have received from contributing directly to one or more public charities or their own private foundation. Furthermore, much of the criticism leveled at the Zuckerbergs for using an LLC could still be perpetuated even if the Facebook stock were initially contributed directly to these charities because there are either no or minimal requirements for charities to immediately deploy the contributions they receive for their charitable purposes. Also, charities may make grants to individuals, invest in for-profit businessses, donate to foreign charities, and engage in various forms of lobbying.

With regard to lobbying, Section 501(c)(3) provides two options under which charities may lobby:

1. The “no substantial part” rule, which allows for lobbying, provided the lobbying is not a substantial part of a nonprofit’s overall activities.

2. Specific definitions of lobbying and “safe harbor” spending ceilings for how much charities may spend on lobbying.

While the LLC model does afford greater flexibility for lobbying and for-profit activities than the charitable model, it is less tax efficient than the charitable model in making grants to individuals because in the former case, such grants would be treated as taxable gifts subject to a 40% gift tax.[3]

Also, while much has been made of the ability of the Zuckerbergs to avoid the capital gains tax on the appreciated, publicly traded Facebook stock contributed to charities, this benefit would not apply when the LLC needs to sell the shares in order to generate the cash necessary to make gifts to individuals, to invest in for-profit businesses, and to pay governmental policy liaisons (i.e., lobbyists). The same taxation would apply to the Zuckerbergs even if the LLC made gifts, purchased investments, or made payment for services by merely exchanging the Facebook stock for them rather than by selling the stock and then transferring the cash. These capital gains taxes would obviously not be incurred if these expenditures were instead paid by the charities themselves after they received and then sold the Facebook stock to generate cash.

Thus, in many ways, the Zuckerbergs are in a worse tax position than they would have been had they simply donated some of their Facebook stock to a combination of public charities and their private foundation. The Zuckerbergs could have perhaps also received a current tax deduction and avoided the greater restrictions imposed on private foundations by partially using a donor-advised fund, which is treated as a public charity yet gives the donor many of the attributes of a private foundation.

Charitable contribution deduction limits

The ability of the Zuckerbergs to receive the benefits of a charitable contribution tax deduction at any time is curtailed by the various limitations imposed by the Internal Revenue Code. This makes it unlikely that the Zuckerbergs will receive the full benefit of the deduction.

In the case of contributions to public charities, and not the Zuckerbergs’ presumed private foundation, the aggregate deductible contributions (including those subject to the separate 20% or 30% limitations discussed below) cannot exceed 50% of adjusted gross income (AGI).[4] As mentioned above, excess contributions may then be carried over to the succeeding five tax years and are used on a first-in, first-out basis. There are also two 30% limitations that may apply in any tax year:

- The first limitation applies to donations of cash or other property other than capital gain property to certain private foundations and certain other charities like veterans organizations and fraternal societies.[5]
- The second 30% limitation applies to gifts of capital gain property (like the Facebook stock) to public charities.[6]

The charitable contribution amount for capital gain property is measured by its fair market value on the date of the contribution; however, taxpayers willing to limit their deduction to the tax basis of the property can elect to use the 50% limitation rather than the 30% limitation for capital gain property contributed to a public charity.[7] Finally, the 20% limitation applies to gifts of capital gain property to private foundations.[8] This 20% limit is applied after considering the 50% and 30% limits for the year.

Thus, based on the limitations described above, if the Zuckerbergs were to donate all or some of their Facebook stock to public charities, the deduction would be the lesser of either:

1. 30% of their AGI.

2. 50% of their AGI less all other contributions they made to public charities during the year.

If the Zuckerbergs instead were to contribute some or all of their Facebook stock to their private foundation, the deduction would be the lowest of:

1. 20% of their AGI.

2. 30% of their AGI less contributions subject to the 30% limit.

3. 30% of their AGI less contributions of capital gain property to public charities.

4. 50% of their AGI less the total of contributions to public charities and contributions subject to the 30% limit.

Because the Zuckerbergs' AGI may be low relative to the amount of the charitable contribution deduction in any year and because the carryover is limited to five years, the Zuckerbergs may never be able to fully receive the benefit of the deduction.

Conclusion

The availability or lack of availability of the tax deduction for the contribution of Facebook shares does not appear to be even a slight motivation for the Zuckerbergs to form CZI or for making the public pledge they did. Certainly the limitations described above, among others, illustrate that the alleged benefits to the Zuckerbergs of receiving a full fair market value deduction for their Facebook shares is merely theoretical. But even without these deduction limitations, it would be highly unlikely that the Zuckerbergs could generate enough future income from 1% of their assets to be able to fully use the deduction created by the donation of 99% of their assets.

True, the Zuckerbergs will avoid the capital gains tax on the built-in gain inherent in their shares, but this has nothing to do with the structure they chose for CZI. This treatment is available to all taxpayers. The Zuckerbergs could, of course, voluntarily sell their Facebook shares and recognize the full capital gain and also refuse to take the tax deduction for the charitable contributions they make with the cash proceeds of the sale. They would then pay their increased tax out of the proceeds of the sale—leaving more for the Government and less for the causes CZI and the Zuckerbergs wish to pursue. But why should they do this? This treatment is not the law; if it were, it would be bad public policy.

The IRC does not make a judgment as to which qualified organizations are better suited to give to than others. The statutory scheme does not require that a donor give his or her money directly to the Government and then let it decide how the money will be allocated. If this were the rule then the wealthy would contribute far less to charity than they do. The IRC does make a few distinctions among charities, including those between public charities and private foundations, but these distinctions go to the amount of the deduction a donor is permitted and the kind of governmental oversight to which the organization will be subject.

The use of an LLC for CZI will, of course, permit secrecy not afforded to charitable organizations. Charitable organizations are required by law to make their tax returns available to the public, and CZI will not be required to do this. However, charities that do receive contributions from CZI will have to make their tax returns available for public inspection. Given the for-profit investments that may be made as part of CZI's presumed business plan and the tax reporting that will end up being reflected on the Zuckerbergs' personal income tax returns, the desire for confidentiality here is abundantly reasonable.

As to the criticism that the LLC will be able to engage in transactions and activities that are not considered bona fide charitable transactions and activities like gifts to individuals, investments in innovative for-profit businesses, contributions to foreign charities, and lobbying for legislation that advances human potential and promotes equality, all of these activities can presently be conducted in some form through traditional charitable organizations. So to the extent that the LLC form is criticized for being able to engage in these transactions or activities, such criticism is misguided.

Finally, the argument that the Zuckerbergs will not be subject to tax at all on the appreciation in their Facebook stock is equally baseless. A fundamental principle of tax law is that one does not pay tax until the gain is both recognized and realized for tax purposes. If these events have not occurred, the Zuckerbergs could not legally be subject to taxation. While it is true that the direct donation of Facebook stock by CZI to charities (but, as discussed above, not if it is used as currency for other purchases or expenditures) will not subject the built-in gain to income tax, to the extent that CZI does not donate all of its assets to charity prior to the last of the Zuckerbergs to die, any remaining value of these assets will be included in the estate of the last to die, thus subjecting these assets to state and federal estate taxes. And, as discussed above, gifts to individuals though CZI during the Zuckerbergs' lifetime will be subject to the gift tax; this would not be the case if the gift was instead paid by a charity and treated as a grant.

Endnotes

1 Section 170(d)(1)(A).

2 Section 4942.

3 Section 2502.

4 Section 170(b)(1)(A).

5 Section 170(b)(1)(B).

6 Section 170(b)(1)(C)(i).

7 Section 170(b)(1)(C)(iii).

8 Section 170(b)(1)(D).

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