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COUNSELLORS AT LAW

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# REID AND RIEGE, P.C.

NONPROFIT ORGANIZATION REPORT – WINTER 2016

## **Zuckerberg and Chan Face Down the Philanthropy Industrial Complex**

If at some point 100 years from now, someone writes a book about the history of American philanthropy, Facebook founder Mark Zuckerberg may well be described as a paradigm-breaking revolutionary who turned the private foundation world on its ear both legally and philosophically. This thought follows the December 2015 announcement that he and his wife, Priscilla Chan, will “donate” ninety-nine percent of their Facebook shares (\$45 billion) to a “charity” that takes the form of a limited liability company (LLC) – as opposed to an IRS approved tax-exempt *private foundation* of the type traditionally used for these purposes (such as the Bill and Melinda Gates Foundation, the Ford Foundation, or the thousands of others around the country).<sup>1</sup>

For readers not familiar with LLCs, it is important to understand that they are a form of for-profit business entity that emerged on the legal scene in the 1990s when all 50 states passed authorizing legislation. They are popular because they combine two desirable operating features that previously had not been available in a single business entity: limited liability (the owners are not responsible for the LLC’s liabilities) and pass-through taxation (the LLC’s income is reported only on the tax return of its owners).<sup>2</sup>

So why did they choose this type of for-profit entity for their “charitable” endeavors (called the “Chan-Zuckerberg Initiative”)? While we were not in the room when they met with their lawyers, it is easy to infer the reasoning that led to their decision, which we suggest is as follows.

**First: A for-profit entity can engage in charitable activities.** There is nothing in the law that prevents a for-profit entity from conducting activities of the type traditionally undertaken by tax-exempt nonprofits (lessening poverty, improving education, etc.) as long as the owners of the entity (Zuckerberg and Chan – whose money is a capital investment in the LLC) are willing to forgo two things: the financial gains that their money would otherwise produce if invested with the sole objective of profit *and* the tax benefits (deductible contributions and tax-exempt income) that come

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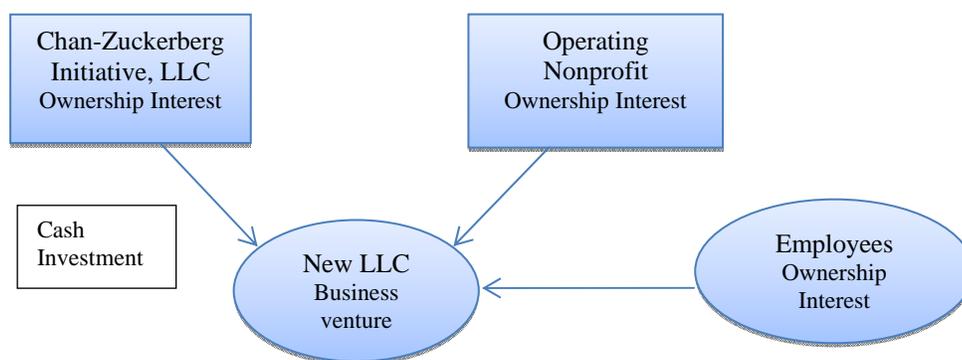
<sup>1</sup> A “private foundation” is a unique type of Section 501(c)(3) tax-exempt entity and should not be confused with Section 501(c)(3) organizations classified as “public charities.” Private foundations are typically created and funded by an individual or family (a small non-public group), and their activities are limited to making grants to Section 501(c)(3) organizations qualified as “public charities” (hospitals, universities, churches, shelters, human service providers, publicly supported organizations and others). Private foundations are subject to a tax on investment income, are prohibited from making high risk investments, cannot own more than an insignificant interest in a business, and must adhere to complex limitations if they make “program related investments” (designed to enhance a public purpose) or grants to individuals (scholarships or research).

<sup>2</sup> Prior to the advent of LLCs, corporations offered limited liability protection to shareholders, but their income was generally taxed twice – first at the corporation level and again when distributed to shareholders. “S corporations” provide some help on the tax side, but are subject to substantial limitations on permitted shareholders and equity structuring. Partnerships do not offer liability protection to their partners, but their income is taxed only once – at the partner level. LLCs combine the best features of corporations and partnerships.

with Section 501(c)(3) status. In other words, they are putting \$45 billion of capital into a business entity that they will own, and charging that entity with the task of advancing charitable objectives.

**Second: The tax benefits afforded to private foundations come at a regulatory cost that Chan and Zuckerberg are not willing to pay.** While the benefits of tax exemption are financially desirable, it is easy to infer that Chan and Zuckerberg may have concluded that the burden of the private foundation operating restrictions (described in footnote 1) outweighs the tax/financial benefits of exempt status; and more specifically, to infer that the initiatives they contemplate will have a commercial and business orientation designed to benefit the people and communities in the locations where their initiatives are located. While we are not privy to specific plans, the possibilities that come to mind include high risk loans or equity investments in properly scaled business enterprises designed to create jobs, economic opportunities, and ownership in an impoverished location.<sup>3</sup>

**Third: LLCs have gained a permanent place in the nonprofit sector in other settings.** While LLCs were intended for the business sector, over the last 20 years they have found a permanent place in the nonprofit sector generally, and to its credit the IRS has helped by sanctioning the use of LLCs in a variety of settings. The IRS permits donors to make tax deductible contributions to an LLC that is 100% owned by a nonprofit. Nonprofits can co-own an LLC with for-profit investors to undertake projects from which both will derive financial benefit – such as a new or existing business, health care facilities, or educational programs. We are sure Zuckerberg and Chan are aware of the flexibility LLCs offer, and to this end we would expect that their plans include, for example, the creation of other subsidiary LLCs for specific projects, with these LLCs co-owned with nonprofits and individuals in appropriate settings. Here is a diagram to help explain how this could work:<sup>4</sup>

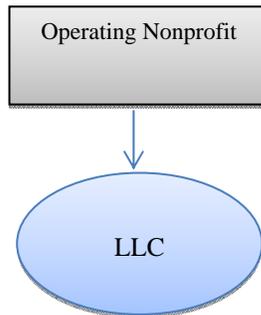


**Fourth: There is understandable confusion about the “disregarded entity” nature of LLCs – but this is a manageable issue for nonprofit management and boards.** There is an almost metaphysical aspect of LLCs that results from the fact that they can be two things at once – a separate legal entity that provides a liability shield to protect owners, but a “disregarded entity” for tax purposes. This

<sup>3</sup> Our inference that the LLC’s initiatives will be commercial in nature is based on the fact that the IRS regulations make it nearly impossible for private foundations to undertake activities of this type. In addition to the restrictions on private foundation grants to individuals (see footnote 1), all Section 501(c)(3) organizations (not just private foundations) are subject to prohibitions on “private benefit” and “private inurement” that could make it very difficult, for example, to transfer ownership of new business ventures to the people who live in communities targeted for assistance.

<sup>4</sup> Note that the IRS has issued rulings on the details of these arrangements that need to be taken into account – but the requirements and risks are manageable.

“dual nature” can be confusing, and we offer the following diagram and example to help keep things clear:



Assume the operating nonprofit provides services to people with intellectual disabilities and that it created the LLC to operate a gift shop at one of its locations – to provide jobs for its disabled clients and to create an alternative source of income. If a liability arises at the gift shop (for example, a slip and fall accident or contract dispute with a supplier) the LLC’s separate existence as a state law created entity should protect the nonprofit from monetary liability associated with the claim. However, from a federal tax perspective the LLC is deemed to be “disregarded,” which means that all of its items of income and expense are reported on the Form 990 (tax return) of the nonprofit.<sup>5</sup>

**Fifth: The philanthropic establishment’s reaction to the Chan-Zuckerberg Initiative has not all been positive – likely because it challenges the establishment’s operating model.** Pablo Eisenberg (of the Center for Public and Nonprofit Leadership at the McCourt School of Public Policy at Georgetown University) had the following to say about the LLC in the December 2015 *Chronicle of Philanthropy*:

Although this arrangement may suit the wishes of the donors, it does not provide the public with any accountability or transparency. There is no indication that the LLC will have a board of directors, that Dr. Chan and Mr. Zuckerberg will consult anybody as they give, or that there will be any oversight of the LLC’s activities. They are creating an instrument of oligarchy, not democracy. The very size of the eventual gift makes the structure of their donation potentially more alarming. Had they followed the example of Mr. Zuckerberg’s mentor, Bill Gates, the donors would still have had plenty of leeway to guide public policy, fund organizations that do advocacy work and some lobbying, and support some for-profit organizations.

We suggest that Mr. Eisenberg’s comments articulate the very reasons why Chan and Zuckerberg decided *not* to follow the example of Bill Gates, as follows:

First, while terms such as *public accountability* and *transparency* have a pleasant rhetorical hue, they are too often a euphemism for a desire to gain or influence control over the use of other people’s

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<sup>5</sup> If the income generating activity is related to the exempt purpose of the nonprofit (which it should be in the example because it provides jobs for the intellectually disabled), the income reported on the Form 990 will be exempt purpose income. If the LLC’s activities constitute an unrelated trade or business, the items of income and expense would be reported on Form 990T (for taxable income) of the nonprofit.

money – to spend it the way foundation board members and management, or public interest groups, would prefer. For example, Mr. Eisenberg’s remark that Chan and Zuckerberg would have had plenty of leeway to guide public policy and fund organizations that do advocacy work reveals much about how Mr. Eisenberg would spend the money to make the world a better place – without regard to what Chan and Zuckerberg have in mind (let alone what the goals of any advocacy would be). Another example is the hard lesson that Chan and Zuckerberg learned about complex systems, public accountability, and control over donated funds, from the abject failure of their 2010 gift of \$100 million to the Newark, New Jersey school system (intended to improve educational outcomes).<sup>6</sup>

Second, while there is no question that private foundations have made many positive contributions to society, the track record is mixed at best when it comes to general social welfare issues for which poverty and its derivative maladies are a common denominator. Moreover, there are many people who make their living as staff members of private foundations. They have an interest in the perpetuation of the industry and no personal accountability if their grants fail to produce results (it is not their money at stake). We were at a local conference of private foundation leaders a few years back and heard a foundation CEO remark how difficult and how much work it is to give away money. We bit our tongues and did not say what we had in mind – namely, that if the CEO thinks it is hard to give away money, he should try making it.

The private foundation establishment should applaud Zuckerberg and Chan for their willingness to try something different – and should hope that they succeed where traditional philanthropy has failed.

*The Reid and Riege Nonprofit Organization Report is a quarterly publication of Reid and Riege, P.C. It is designed to provide nonprofit clients and others with a summary of state and federal legal developments which may be of interest or helpful to them.*

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<sup>6</sup> The Newark failure was massive and is the subject of a new book titled “The Prize: Who’s in Charge of America’s Schools.” The Newark gift did not involve a private foundation; we mention it in response to the admonition about public accountability and transparency – which can result in too many cooks trying to stir the same pot.