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ZUCKERBERG LLCS: AN ALTERNATIVE WAY TO GIVE

With an ultimate goal of giving away 99% of their Facebook shares for charitable purposes, Mark Zuckerberg and his wife, Dr. Priscilla Chan, plan to contribute up to $1 billion of Facebook shares each year to the Chan Zuckerberg Initiative, a limited liability company (the "Zuckerberg LLC"). This plan is notable not just due to the sheer size of the gift, but also due to the unconventional nature of using a limited liability company as the foundation for a philanthropic initiative. While Chan and Zuckerberg are not the first to employ a limited liability company for substantial charitable gifting (both eBay founder Pierre Omidyar and Steve Jobs' wife, Laurene Powell Jobs utilize LLCs for their charitable endeavors), the high-profile nature of the Zuckerberg LLC has sparked a discussion about the benefits of using limited liability companies to support charitable causes.

The stated purpose for the Zuckerberg LLC is to promote progress in solving global issues on a variety of fronts, specifically in areas such as health, energy, education, and scientific research. Traditionally, a common, ideal organization to accomplish such feats would be a private foundation because of the significant income tax advantages it offers. One of the main tax benefits of a private foundation is the ability to deduct for income tax purposes any contributions made to the private foundation during the relevant taxable year. These income tax deductions, together with the fact that any income earned from the assets held in the foundation is exempt from income taxation, make private foundations an attractive option for those looking for a way to make charitable giving a part of their overall estate plan. But, there is a "flipside" to these advantages that is important to consider when contemplating the use of a foundation. In order to receive the income tax benefits private foundations offer, one must surrender a certain degree of freedom in the administration of the private foundation's assets. For some (like Zuckerberg), this flipside may change their preferred method for charitable giving.

Potential Downsides to a Private Foundation

First, while contributions made to a private foundation are deductible for income tax purposes, there are limitations on this available deduction. The Internal Revenue Code (the "Code") limits the amount of the deduction to a percentage of the taxpayer's adjusted gross income ("AGI"). For contributions of appreciated public securities to a private foundation, taxpayers may only deduct 20% of their AGI, with a 5 year carry-over of any unused deduction. Accordingly, the higher an AGI a person has, the higher their available deduction will be. For those, however, who have a low annual income compared to their overall gross wealth, the deduction limitations can severely reduce the immediate tax benefits of giving to a private foundation. Zuckerberg himself, though having an estimated net worth of $46 billion, likely has a low annual AGI due to the fact that Facebook shares currently do not pay dividends and Zuckerberg reportedly draws a salary of just $1 annually. Thus, the attraction of taking charitable deductions is greatly reduced in his situation.

The second part of the flipside is the number of regulations the Code imposes on private foundations. Because private foundations receive Section 501(c)(3) treatment, the Code sets up a framework of rules to ensure the charitable nature of the foundation is not compromised:

Self-Dealing Rules. The Code's prohibition against self-dealing means that various types of transactions are forbidden if they occur between the foundation and a disqualified person (which includes founders, contributors, managers, trustees, etc.), regardless of whether the foundation benefits from the transaction or whether the transaction is objectively reasonable. (IRC § 4941.)

Annual Distribution Requirements. Pursuant to the Code, a private foundation must pay out in qualifying charitable distributions at least 5% of its net investment assets annually. (IRC § 4942.)

Excess Business Holdings Rule. Generally, the excess business holdings rule provides that the foundation, along with all disqualified persons, cannot own more than 20% of the stock of a corporation. Any holdings in excess of the 20% threshold are subject to a 10% excise tax. (IRC § 4943.)

Jeopardy Investments Rule. The jeopardy investments rule aims to prevent private foundations from engaging in risky or speculative investments that may prove detrimental to the purpose of the foundation. The rule requires foundations to exercise ordinary business care and prudence in making investment decisions and imposes excise taxes if violated. (IRC § 4944.)

Taxable Expenditures Rule. The taxable expenditures rule prohibits private foundations from making expenditures that are inconsistent with the tax-exempt purpose of the organization, including payments made for the purpose of legislative lobbying or the promotion of a political candidate or agenda. (IRC § 4945.)

These private foundation rules safeguard the integrity of the tax exempt organization, but for Chan and Zuckerberg, the advantages of avoiding these rules outweighed the tax benefits of using a private foundation.

Advantages of a Limited Liability Company

Essentially, the greatest advantage of the Zuckerberg LLC is the freedom it creates. Structuring their charitable organization as an LLC allows Chan and Zuckerberg to retain complete freedom not only to choose how the LLC will practically pursue its charitable objectives, but also to control the administration of the LLC, as well as the contributed Facebook shares. By sidestepping the private foundation rules and regulations, the Zuckerberg LLC will take what some are calling a revolutionary approach to philanthropy because the LLC is not constrained to making "qualified charitable donations." Rather, it may distribute money to whomever it deems lucrative to the causes it advocates, including for-profit companies.

In the view of Chan and Zuckerberg, any serious attempt to solve some of the world's most daunting problems will require a broad strategy that draws on all available resources. The private company on the edge of a breakthrough to cure an infectious disease, the politician or policy group with a groundbreaking educational platform, and the countless charitable organizations across the globe will all be available tools for the Zuckerberg LLC to place in its toolbox as it strives to solve major humanitarian issues.

Moreover, the LLC allows Chan and Zuckerberg the freedom to provide services to the LLC, sell or lease property to or from the LLC, and engage in various other transactions with the LLC either individually or via other entities they own without violating self-dealing prohibitions. Unlike a private foundation, the LLC will not be required to distribute 5% of its net investment assets annually to qualified charitable organizations, providing the flexibility to invest in companies or give to non-qualified organizations or individuals without being penalized, and because the Zuckerberg LLC may one day hold assets valued at $45 billion, this flexibility will ease the burden of administering such a large amount of assets.

When it comes to their Facebook shares, Chan and Zuckerberg have considerably more freedom with an LLC structure due to their avoidance of the excess business holdings rule, which would have effectively prevented a private foundation from owning most of the shares. An LLC, on the other hand, allows Zuckerberg to continue to control his shares without any limitations as to how much Facebook stock the LLC may own.

The jeopardy investments regulations and taxable expenditures regulations are wholly inconsistent with Chan's and Zuckerberg's vision to utilize as many resources as possible in pursuit of their charitable goals. An investment in a start-up company could subject a private foundation to penalties, and any donations to political groups lobbying for a cause certainly would. With an LLC, Chan and Zuckerberg have the freedom to make donations at their own discretion.

Beyond avoidance of the private foundation rules, an LLC provides anonymity. Private foundations must file an annual Form 990-PF with the IRS, which details all distributions made by the private foundation and which is also a matter of public record. An LLC has no similar filing requirement. Chan and Zuckerberg are also free to move assets in and out of the LLC without the adverse tax consequences or self-dealing violations that would occur with a private foundation. Furthermore, the LLC itself could be dissolved, if necessary, with relative ease compared with the termination of a private foundation.

The unique philanthropic goals Chan and Zuckerberg have require a level of freedom not available with a private foundation. Gifts made to the LLC will not be deductible, and income earned within the LLC will not be exempt from income taxation. If the LLC sells Facebook shares, Chan and Zuckerberg will still owe capital gains tax because profits and losses of the LLC will flow through to them individually. However, the LLC could donate the Facebook shares, or the whole LLC, to a qualified charitable organization and take a deduction for the fair market value of the gift. (If you decide to set up a Zuckerberg LLC, you'll want to make sure that at the death of the surviving spouse, the LLC goes to charity or the family will owe a 40% estate tax on the value of the LLC.) Ultimately for Chan and Zuckerberg, the tax benefits of using a private foundation were not enough to overcome their need for flexibility in how they are allowed to use the assets they have for charitable causes.

Some have criticized the Chan Zuckerberg Initiative as being nothing more than an investment vehicle framed for publicity purposes as a significant charitable endeavor. These critics point to the fact that a Zuckerberg LLC is not philanthropically binding because there will be no government oversight to preserve charitable accountability and Chan and Zuckerberg have not really parted with any of their assets. Others see Zuckerberg LLCs as a new, flexible way to approach charitable giving that will facilitate an efficient and more comprehensive approach to solving global issues. While it is too soon to grade the performance of the Chan Zuckerberg Initiative, it is undeniable that a Zuckerberg LLC, in the hands of someone truly devoted to philanthropy, could be an exciting and flexible way to approach the concept of charitable giving.

Private foundations are a well-established, tax efficient tool for incorporating philanthropy into an estate plan, but for those more interested in freedom of administration than in potential income tax savings, a Zuckerberg LLC may be a solid alternative to the more traditional avenues of giving.