Private Foundations in Life and Death

Daniel Hemel
University of Chicago
#nta2017

Private Foundations

Why We Should Care

- Tax Year 2014 (IRS Statistics of Income)
  - **Number of returns: 97,484**
  - **Contributions in: $63.7 billion**
    - ~15% of total charitable contributions
  - **Disbursements for exempt purposes: $66.7 billion**
  - **Total assets: $738.4 billion**
    - Close to 1% of US household + nonprofit wealth

Tax Benefits of Charitable Contributions

Public Charities vs. Private Foundations

	Public Charity	Private Foundation
Cash contributions	Deductible up to 50% of AGI	Deductible up to 30% of AGI
Contributions of appreciated stock	Deductible **at fair market value** up to 30% of AGI	Deductible **at fair market value** up to 20% of AGI
Payout requirement	None	≥5%/year
Inv'ment Income Tax	None	1-2%

So why channel charitable contributions through a private foundation?

Deduction-Timing Only (Small?) Part of the Story

- **57.1%** of contributions to private nonoperating foundations → foundations w/assets ≥ \$100m
- **81.8%** of contributions to private nonoperating foundations → foundations w/assets ≥ \$10m
- Hard to believe that significant share of donors to these foundations ever fall out of top bracket
  - Though maybe some are trying to match donations to high-AGI years

Decide Now to Give Later?

Public Charities vs. Private Foundations

- I have $100 (cash)
- I want to donate to charity but not yet
  - Not sure where I want to donate?
  - Want to retain leverage over donee?
- Assume 40% marginal rate (39.6% rounded up)
  - 25% rate on qualified dividends/long-term capital gains (20% + Pease + ACA)
  - 10% rate of return

Decide Now to Give Later?

Public Charities vs. Private Foundations

- **Donate to private foundation and then distribute to public charity after 1 year + 1 day?**
  - \$100 cash finances \$166.67 contribution to public charity (\$100 + \$40 + \$16 + \$6.40 + . . .)
  - \$166.67 x 10% = \$16.67
    - ≤2% tax on net investment income
    - 2% x \$16.67 = \$0.33
      - **\$166.67 + \$16.67 - \$0.33 = \$183.01** available to distribute

Decide Now to Give Later?

Public Charities vs. Private Foundations

- **Hold in taxable account and then distribute to public charity after 1 year + 1 day?**
  - Invest $100 in **dividend-paying** stock
  - $100 x 10% = $10
    - 25% tax on qualified dividend
    - 25% x $10 = $2.50
      - **$100 + $10 - $2.50 = $107.50** available to contribute
        - $107.50 cash finances **$179.17** contribution to charity

Decide Now to Give Later?

Public Charities vs. Private Foundations

- **Hold in taxable account and then distribute to public charity after 1 year + 1 day?**
  - Invest $100 in **non-dividend-paying stock**
  - $100 x 10% = $10
    - $100 + $10 = $110 available to contribute
      - $110 in stock finances **$183.33** contribution to charity

Decide Now to Give Later?

Public Charities vs. Private Foundations

	Private Foundation	Hold Dividend-Paying Stock	Hold Non-Dividend-Paying Stock
Gift to Public Charity in 1 Year + 1 Day	$183.01	$179.17	$183.33

Private foundation route potentially preferable for taxpayer who decides now to give later and wants to hold dividend-paying stock (or bonds)

Note: >81% of private foundation securities portfolio assets = corporate stock

No-Dividend Stock?

Rank	Name	Market Cap	Dividend Yield
1	Apple Inc	$896.8B	1.44%
2	Alphabet Inc	$719.7B	**0%**
3	Microsoft Corp	$647.0B	2.00%
4	Amazon.com, Inc	$542.3B	**0%**
5	Facebook, Inc	$518.6B	**0%**
6	Alibaba Group	$477.4B	**0%**
7	Berkshire Hathaway Inc	$453.5B	**0%**
8	Johnson & Johnson	$374.9B	2.41%
9	Exxon Mobil Corp	$351.4B	3.71%
10	JPMorgan Chase & Co	$338.3B	2.30%

Arbitrage Opportunity Outside Private Foundation

- Volatile non-dividend-paying stock worth x
- In 1 year + 1 day:
  - With probability = 50%, will rise to 2.2x
  - With probability = 50%, will fall to zero
- **Private Foundation:**
  - $60 cash finances $100 contribution
  - Purchase $100 of volatile asset
  - 0.5 x ($220 – 0.02 x $120) = **$108.80**

Arbitrage Opportunity Outside Private Foundation

- **Hold in taxable account for 1 year + 1 day:**
  - Purchase \$60 of volatile asset
    - 50% probability stock → 2.2 x \$60 = \$132
    - 50% probability stock → \$0
  - \$132 finances \$220 contribution
  - \$60 capital loss → \$15 tax benefit (assuming losses are usable to offset capital gains elsewhere); \$15 finances \$25 contribution
  - 0.5 x \$220 + 0.5 x \$25 = **\$122.50**

Arbitrage Opportunity

Public Charities vs. Private Foundations

	Private Foundation	Hold Volatile Non-Dividend-Paying Stock
Expected Value of Gift to Public Charity in 1 Year + 1 Day	$108.80	$122.50

Better to hold volatile stock in taxable account rather than in private foundation

- **Irony:** We discourage the holding of volatile assets in private foundations (§ 4944) but encourage it with respect to philanthropic portfolios in taxable accounts

Why Else to Use Private Foundation?

Diversification

- **Want to diversify philanthropic portfolio without triggering capital gains tax**
  - Can do so via private foundation by giving stock and then selling and reallocating
    - **But why would one want to diversify philanthropic portfolio?**
      - Increasing or decreasing private/social returns to charitable giving?

Reconsidering Diversification

Increasing Private Returns?

- $1 million contribution to University won't get me a named chair, but $10 million contribution probably will
  - In philanthropic portfolio, maybe I value 10% probability of $10 million more than 100% probability of $1 million

Reconsidering Diversification

Increasing Social Returns?

	Assets \$100k to \$1m	Assets > \$100m
Salaries and other expenses as % of assets	5.9%	1.4%

Source: IRS Statistics of Income (2014)

- **<u>Economies of scale in charitable giving?</u>**

Reconsidering Diversification

Additional Considerations

- **Maybe:** Easier to find \$1 million of worthy causes than \$10 million?
  - **BUT:** Large pot of \$\$\$ attracts worthy causes
- For some philanthropic projects, discontinuous utility function
  - **E.g.:** Need \$10 million for new building
    - Risk-loving below \$10 million; risk-averse above
- **Bottom line:** Unclear whether diversification is desirable from private/social perspective because unclear whether marginal utility of charitable dollars is increasing/decreasing

Intergenerational Transfer of Warm Glow?

- I have $100 asset in my hands at death and want my children to experience warm glow associated with charitable giving
  - Assume estate tax is binding; rate = 40%
    - Bequeath $100 to **private foundation → 100 units of warm glow**
    - Bequeath $100 to **child**; 40% estate tax leaves $60; → **60 units of warm glow**

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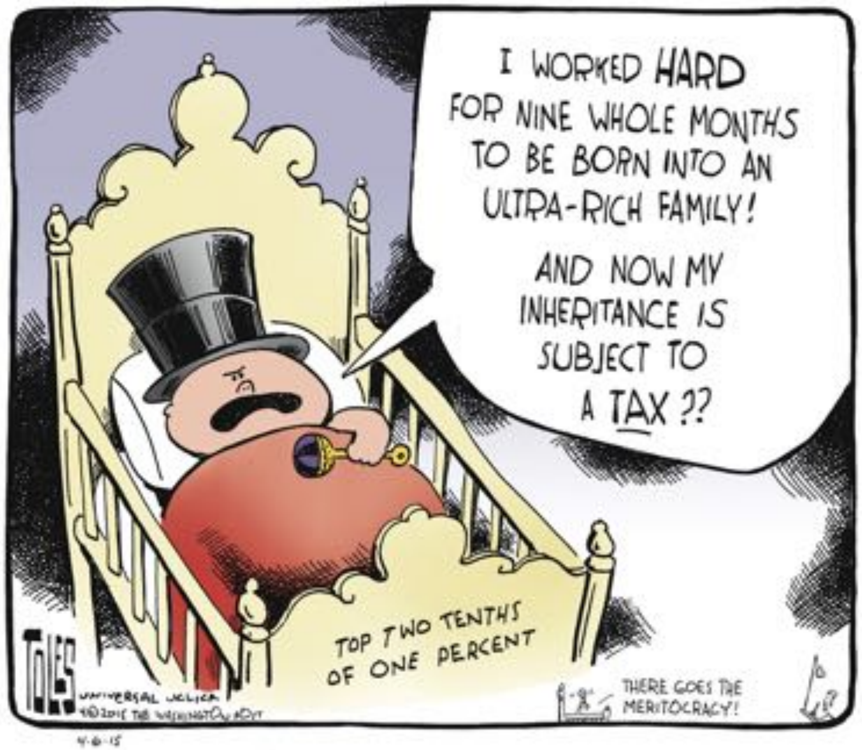
    - Bequeath \$100 to **child**; 40% estate tax leaves \$60; → **60 units of warm glow**
      - **BUT:** If child is in 40% bracket, \$60 cash finances \$100 contribution → **<u>100 units of warm glow</u>**

Intergenerational Transfer of Warm Glow?

- Testamentary transfer to private foundation doesn't significantly increase ability to transfer warm glow across generations



Decide Now to Give to Children to Give

- Give $100 asset to **private foundation** <u>while alive</u>
  - Finances **166.67 units warm glow**
- Give to child while alive . . . .
  - **Basis = $100:** Finances $71.43 gift → **119.05 units warm glow**
    - $71.43 + (40% x $71.43) = $100
  - **Basis = $0:** Finances $65.22 gift → **108.7 units warm glow**
    - Realize gain of $34.78 → $26.01 after tax
    - Use to pay tax of 40% x $65.22 = $26.01

Tax Reasons to Give to Private Foundation?

- Donor decides now to give later and wants to hold dividend-paying stock + fixed income assets in the interim
- Donor wants to diversify philanthropic portfolio
- Donor wants to transfer warm glow to future generation (<u>if</u> gift is made prior to death)
  - **Note:** <u>Assumes estate tax survives</u>.
- Donor decides now to give later and is well above 50% x AGI threshold
  - And wants to pay philanthropic expenses w/pre-tax $$$ + avoid dividend tax

Non-Tax Reasons to Give to Private Foundation?

- Tax planning mistake?
- Prestige associated with having a foundation?
  - Is there any <<< prestige associated with Chan-Zuckerberg Initiative (LLC)?
- **Tie hands of children/heirs?**
  - Possible outside foundation structure (via trust/LLC), but foundation structure → benefit (?) of IRS enforcement

Implications for Policy Toward Private Foundations

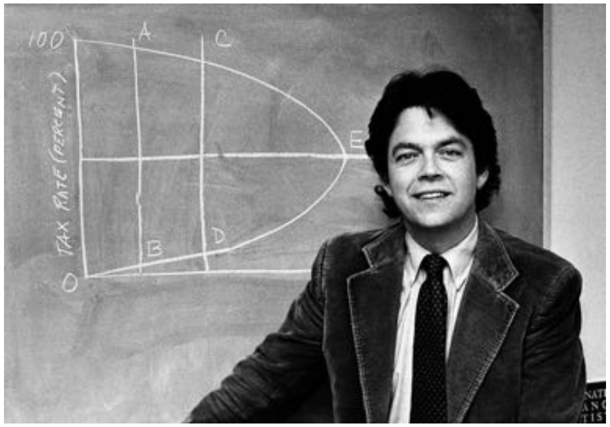
- Should we encourage philanthropists to hold diversified portfolios?
  - **Ambiguous**
- Should we encourage intergenerational transfer of warm glow?
  - **Kaplow 1995:** Maybe yes?
    - **Hypothetical:**
      - Parent gives $100 to charity
        - 100 units of warm glow for parent
      - Parent gives $100 to child to give to charity
        - >0 (but <100?) units of warm glow → parent
        - 100 units of warm glow → child
        - Transfer is warm glow-increasing but might need subsidy

Implications for Policy Toward Private Foundations

- If we prefer social spending **now** to social spending **later**, should we dislike (and discourage) intergenerational transfer of warm glow for that reason?
  - Government can accelerate social spending through **public debt**
  - Can shift social spending from now to later via debt repayment/sovereign wealth fund
    - **BUT:** If we think equity premium is real <u>and</u> that there are real barriers/disadvantages to government holding equity, then **perhaps:** encourage foundations to save and use public debt to accelerate social spending if foundations oversave?
      - **Second-** (or nth-) **best** (fees)

Implications (cont'd)

Regulatory Laffer Curve?



- If tax benefits of private foundations are slight, then regulatory changes that make private foundations less attractive (e.g., >>> payout requirement) → ambiguous effect on rate of social spending
  - → Faster spend-down for private foundations but more donors choosing to hold assets outside private foundation
    - **Repeal of estate tax would reduce tax benefits of private foundations even further** (potentially → >>> shift from private foundations to taxable accounts)

Implications for Policy Toward Private Foundations

- Insofar as private foundations are a transaction-cost-reducing mechanism for donors to achieve what they otherwise could achieve through trusts/LLCs . . .

  . . . **argument for default rather than mandatory payout rules?**

Implications for Policy Toward Private Foundations

- Perhaps we should think about the private foundation less as a tax subsidy for delayed giving and more as a **mechanism that allows donors to achieve ends that generally could be achieved through other means** (sometimes at slightly higher tax cost; sometimes at slightly lower cost)