Private Foundations in Life and Death

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#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

<table>
<thead>
<tr>
<th></th>
<th>Public Charity</th>
<th>Private Foundation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash contributions</strong></td>
<td>Deductible up to 50% of AGI</td>
<td>Deductible up to 30% of AGI</td>
</tr>
<tr>
<td><strong>Contributions of</strong></td>
<td>Deductible at <strong>fair market value</strong> up to</td>
<td>Deductible at <strong>fair market value</strong> up to</td>
</tr>
<tr>
<td><strong>appreciated stock</strong></td>
<td>30% of AGI</td>
<td>20% of AGI</td>
</tr>
<tr>
<td><strong>Payout requirement</strong></td>
<td>None</td>
<td>≥5%/year</td>
</tr>
<tr>
<td><strong>Inv’ment Income Tax</strong></td>
<td>None</td>
<td>1-2%</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>Private Foundation</th>
<th>Hold Dividend-Paying Stock</th>
<th>Hold Non-Dividend-Paying Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gift to Public Charity in 1 Year + 1 Day</td>
<td>$183.01</td>
<td>$179.17</td>
<td>$183.33</td>
</tr>
</tbody>
</table>

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?**

<table>
<thead>
<tr>
<th>Rank</th>
<th>Name</th>
<th>Market Cap</th>
<th>Dividend Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Apple Inc</td>
<td>$896.8B</td>
<td>1.44%</td>
</tr>
<tr>
<td>2</td>
<td>Alphabet Inc</td>
<td>$719.7B</td>
<td>0%</td>
</tr>
<tr>
<td>3</td>
<td>Microsoft Corp</td>
<td>$647.0B</td>
<td>2.00%</td>
</tr>
<tr>
<td>4</td>
<td>Amazon.com, Inc</td>
<td>$542.3B</td>
<td>0%</td>
</tr>
<tr>
<td>5</td>
<td>Facebook, Inc</td>
<td>$518.6B</td>
<td>0%</td>
</tr>
<tr>
<td>6</td>
<td>Alibaba Group</td>
<td>$477.4B</td>
<td>0%</td>
</tr>
<tr>
<td>7</td>
<td>Berkshire Hathaway Inc</td>
<td>$453.5B</td>
<td>0%</td>
</tr>
<tr>
<td>8</td>
<td>Johnson &amp; Johnson</td>
<td>$374.9B</td>
<td>2.41%</td>
</tr>
<tr>
<td>9</td>
<td>Exxon Mobil Corp</td>
<td>$351.4B</td>
<td>3.71%</td>
</tr>
<tr>
<td>10</td>
<td>JPMorgan Chase &amp; Co</td>
<td>$338.3B</td>
<td>2.30%</td>
</tr>
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</table>
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 \times (220 - 0.02 \times 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 × $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 × $220 + 0.5 × $25 = $122.50
Arbitrage Opportunity
Public Charities vs. Private Foundations

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<th>Private Foundation</th>
<th>Hold Volatile Non-Dividend-Paying Stock</th>
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<tbody>
<tr>
<td>Expected Value of Gift to Public Charity in 1 Year + 1 Day</td>
<td>$108.80</td>
<td>$122.50</td>
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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?

<table>
<thead>
<tr>
<th></th>
<th>Assets $100k to $1m</th>
<th>Assets &gt; $100m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and other expenses as % of assets</td>
<td>5.9%</td>
<td>1.4%</td>
</tr>
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</table>

Source: IRS Statistics of Income (2014)

- **Economies of scale in charitable giving?**
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
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 $\rightarrow$ 100 units of warm glow
    - Bequeath $100 to child; 40% estate tax leaves $60; $\rightarrow$ 60 units of warm glow
  - **BUT:** If child is in 40% bracket, $60 cash finances $100 contribution $\rightarrow$ **100 units of warm glow**
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** while alive
  - 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 (if gift is made prior to death)
  - Note: Assumes estate tax survives.
- 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 and 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)