

# SOCIAL WELFARE ORGANIZATIONS AS GRANTMAKERS: FURTHER THOUGHTS

*Responding to David S. Miller, Social Welfare Organizations as Grantmakers*

*Response by Robert A. Wexler\**

I. POINTS OF AGREEMENT .....	597
II. POINTS OF DISAGREEMENT .....	598
III. WHAT ELSE MIGHT THE ARTICLE HAVE ADDRESSED? .....	600

In his article, David Miller provides a well-written and comprehensive account of Internal Revenue Code (“Code”) § 501(c)(4) social welfare organizations acting in the role of grantmakers.<sup>1</sup> The article successfully addresses not only domestic § 501(c)(4) organizations but also international § 501(c)(4) organizations and how they might be even more useful tools for grantmaking.

In Part I of this Response, I outline points of agreement with Miller. In Part II, I explain points of disagreement. In Part III, I suggest areas that could be developed further.

## I. POINTS OF AGREEMENT

The most important point Miller makes is this: why use a § 501(c)(3) private foundation when there is no tax advantage in doing so, as in situations where the donor cannot use the full tax deduction? Miller explains that private foundation donors have to live with the private foundation restrictions set forth in §§ 4940 through 4946 of the Code, as well as the 990-PF reporting requirements, as a quid pro quo for both receiving the charitable contribution deduction and retaining

---

\* Mr. Wexler is a Principal with the San Francisco law firm of Adler & Colvin, a firm that specializes in the representation of nonprofit organizations and their donors, with an emphasis on tax and corporate matters.

1. David S. Miller, *Social Welfare Organizations as Grantmakers*, 21 N.Y.U. J. LEGIS. & PUB. POL’Y 413 (2018).

an element of control—though not ownership—over the post-contribution funds. Miller’s article articulates why, for donors willing to forgo the deduction, there are clear advantages to using a domestic § 501(c)(4) organization, and even more tax advantages for using a foreign § 501(c)(4) organization.

From a technical standpoint, Miller’s article carefully and thoughtfully distinguishes the § 501(c)(4) organization as a tax vehicle from the private foundation, the supporting organization, the donor-advised fund, and the relatively newly conceived “philanthropic LLC,” which are currently the four main competitors to the § 501(c)(4) organization. The article also makes what is overall the most important point in considering alternatives: why not use a combination of all of the tools available to the donor, including a donor-advised fund, a private foundation, and a § 501(c)(4) organization (foreign or domestic) to maximize the donor’s tax deduction, flexibility, and control? Indeed, most of my wealthy clients will use a variety of tools to accomplish their charitable goals.

Some public policy experts, charity watchdogs, and academics criticize the idea of using anything other than a private foundation, where an entity funded by a single family or company is engaged primarily in grantmaking. They argue that a § 501(c)(4) organization does not offer sufficient public transparency and accountability, and that a philanthropic LLC offers no public transparency and accountability. Some believe that even without the § 501(c)(3) tax benefits, donors need to be accountable and transparent if they have committed their funds for charity. One has only to look at the outrage that abounded when Mark Zuckerberg announced that he would be dedicating \$45 billion in Facebook shares to charity but would be placing them initially in a wholly owned LLC. Where is the public accountability, many cried? Of course, had Mr. Zuckerberg’s shares gone into a § 501(c)(4) organization, there would be a publicly available 990 and, had the shares gone into a private foundation, there would be an even more transparent (some would argue) 990-PF.

## II.

### POINTS OF DISAGREEMENT

I disagree with four main points Miller makes in his article. First, one of the primary problems with the § 501(c)(4) organization is that unless the donor relinquishes control, the organization will be brought back into the estate for estate tax purposes. As of the publication of this response, we still have an estate tax and so, particularly for wealthy donors, the effect of the estate tax still matters. The article

points out that there are two ways to prevent a gift made to a § 501(c)(4) organization from being pulled back into the estate for estate tax purposes.<sup>2</sup> One of the two solutions Miller proposes is that the taxpayer step away from the social welfare organization and not be an officer, director or member (and not retain the power to participate in grantmaking in any of them). In my experience, however, this solution would not work in practice. Wealthy donors are often “control freaks,” who beyond all else do not want to give up control. I have had many clients eschew a § 501(c)(4) organization for just this reason, and I do not think Miller recognizes this reality well enough. Donors are not likely to give up control just to prevent their assets from being pulled back into their estate, and perhaps for this reason alone, the § 501(c)(4) organization may be much less useful than the article suggests. The second solution Miller proposes is to have the § 501(c)(4) bylaws require that, upon the death of the donor, all assets be donated to one or more § 501(c)(3) organizations. This solution might work, but then the original § 501(c)(4) organization is only useful, as such, for the life of the donor, and not in perpetuity.

Second, Miller states that “[b]equests to a social welfare organization do not appear to qualify for an estate tax deduction.”<sup>3</sup> Indeed, Miller concludes, “[i]t is damning that Congress specifically amended § 2501(a) to provide that gifts to social welfare organizations are not subject to gift tax, but left § 2055(a)(2) alone, strongly implying that bequests to social welfare organizations are subject to estate tax.” In my view, it is completely clear that there is no charitable deduction under § 2055 for gifts to a § 501(c)(4) organization. Section 2055 specifically references § 501(c)(3) and not § 501(c)(4). I do not think there is even an argument under the current formulation of the law that this works.

Third, Miller states, “[o]nce a U.S. donor is willing to forgo a charitable deduction, then there is no tax benefit to using a domestic social welfare organization; a foreign one is just as good, and sometimes better.”<sup>4</sup> The article is clear and methodical in its analysis of why such a strategy is highly tax advantaged, particularly for avoiding unrelated business taxable income (“UBTI”). When read carefully, though, it looks like the primary advantage of an international § 501(c)(4) organization over a domestic one is the ability to avoid taxation on § 514 debt-financed UBTI income. In most other respects, the exemption ends up being the same for a domestic or an interna-

---

2. *Id.* at 422.

3. *Id.* at 420.

4. *Id.* at 422.

tional § 501(c)(4) organization. From a tax standpoint, many domestic § 501(c)(4) and § 501(c)(3) organizations will avoid UBIT under § 514 by using a foreign blocker in any case, and so it is not clear to me that there is a very significant advantage to using a foreign § 501(c)(4) organization.

Miller suggests that an international § 501(c)(4) organization can still be managed by U.S. persons. I know that a handful of very successful organizations have used this approach, and it works. But I have to say that many of my clients, as sophisticated as they may be in other ways, would not be comfortable using a foreign entity that nonetheless conducts most of its affairs in the United States and has its main offices and assets in the United States. Many of my clients have several dozen employees working in their philanthropic offices, and I am not convinced that these donors would perceive a foreign § 501(c)(4) organization as the most suitable vehicle for their operations.

Finally, unlike Miller, I am not convinced that the Chan-Zuckerberg or Omidyar LLC models do not make more sense for wealthy donors than a § 501(c)(4) organization. The Omidyar LLC model allows the donor to fund charities out of the LLC each year to the extent of available deductions, but then preserves complete control and discretion over funds not in a charity. The § 501(c)(4) organization, though much less restrictive than the private foundation, may still be subject to state-law prudent-investor rules (depending on how it is structured) and subject to intermediate sanctions, as well as the filing of publicly available 990s.

### III.

#### WHAT ELSE MIGHT THE ARTICLE HAVE ADDRESSED?

Miller's article is the starting point for future research and analysis. First, the discussion would be enhanced by examples of existing § 501(c)(4) grantmakers in the United States that do not involve funding from a wealthy donor. Such entities might include those that instead funded out of the sale or conversion of a health care system or HMO or simply by a corporation as a company foundation. One important example is the California Healthcare Foundation that was funded from the Blue Cross conversion in California in the mid-1990s. This § 501(c)(4) organization, which is a grantmaker, was formed as a sister organization to a § 501(c)(3) private foundation, the California Endowment. The § 501(c)(4) organization was formed largely to hold the shares of the converted Blue Cross so that it could avoid excess

business holdings (regulated under § 4943) and self-dealing (regulated under § 4941) while holding shares and then having them redeemed.

Another area ripe for further exploration is that of corporations that want to form grantmaking foundations but that cannot benefit from tax deductions because of the limitations on corporate deduction ability. Why would such corporations want to subject their charitable arms to the rules that apply to private foundations, when they do not realize the corresponding benefit of receiving a charitable tax deduction. Corporations can only deduct up to ten percent of their net income. Many start up corporations have little or no net income in early years, even though they might have assets, including stock, with which to set up charitable arm. In particular, company foundations that are established as private foundations often address complex self-dealing and taxable expenditure issues, which can be avoided by forming a § 501(c)(4) organization. Where no deduction is needed, the § 501(c)(4) organizational structure is advantageous. Also, the corporation would not have to worry about the estate-tax claw back discussed above. Accordingly, I wonder whether the § 501(c)(4) structure might not be an even better choice for corporations than for individuals.

In addition, I think Miller's analysis would benefit from an exploration of § 863, which addresses withholding, and the targeted grant exception. United States § 501(c)(3) entities are generally not required to withhold grants to foreign entities that do not spend the grant funds in the United States. That exception does not apply, however, to § 501(c)(4) grantmakers. Accordingly, by using a § 501(c)(4) organization to make foreign grants, there is an argument that the foreign grants are U.S.-sourced income and are subject to withholding requirements. Different organizations have taken more conservative or more aggressive positions on this issue.