SPECIAL REPORT

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From Grantmaking to Problem Solving: The Power of Charitable LLCs

Donors are starting to use new and existing corporate structures to bring about social change

Charitable giving has traditionally been associated with gifts to tax-exempt, non-profit organizations.[1] However, the world of charitable action has expanded in recent years. In fact, nearly half the participants in a recent Lilly Family School of Philanthropy survey considered contributions to non-exempt crowdfunding as a form of charitable giving.[2] Additionally, 16.3% of respondents grouped gifts to political organizations under this category, while roughly one in 10 did the same for impact investing.[3] As society's understanding of the nature of charitable giving evolves, philanthropic individuals have started using new and existing corporate structures to bring about social change. We'll take an in-depth look at one such structure—the charitable limited liability company (charitable LLC).

Pros and Cons

Billionaire philanthropists have been leading the way in leveraging a traditional LLC structure to solve larger social issues, as it enables members to target systemic problems through a combination of advocacy, alternative investing and grantmaking.[4]

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Importantly, traditional charitable vehicles—such as public charities or private foundations (PFs)—don't offer this same flexibility. Instead, they discourage or even prohibit involvement in policy work or profit-generating activities.[5] Proponents are also attracted to charitable LLCs because they allow members to consolidate a wide variety of assets—including cash, marketable securities, real property and operating business interests—while sidestepping restrictions like self-dealing rules and excess business holdings tax.[6] What's more, this type of closely held entity offers the same benefits as its noncharitable counterpart, including the opportunity for pass-through tax treatment, statutory freedom to negotiate communication and decision-making procedures and use of valuation discounts for gift and estate tax purposes.

Despite these advantages, pursuing a charitable LLC comes with a notable trade-off: The LLC isn't a tax-exempt entity. This means: (1) contributions to the LLC don't generate an immediate income tax deduction, and (2) the LLC members must pay tax on the entity's income each year. And while the members will share in the income tax deduction generated by the LLC's charitable contributions, such deduction will be subject to each member's applicable adjusted gross income (AGI) limitation.[7]

For philanthropists seeking to address the legislative and commercial roots of complex social issues, does flexibility outweigh potential tax inefficiency? While many well-publicized examples of charitable LLCs involve only one or two decision makers, can a larger family use this strategy in a way similar to more traditional structures? To explore these questions, let's delve deeper into the creation and use of a charitable LLC within the context of a multigenerational family, the Patels.

Meet the Patels

The Patels are a three-generation family who own a private business founded by Grandma and Grandpa Patel. The business is structured as a for-profit LLC and taxed as a partnership. The founders own a majority interest while their children (brother and sister Patel) and the grandchildren own the balance of the LLC's membership interests. Though the family hasn't ruled out a future sale, they don't currently plan to exit the business just yet.

In addition to running the family business, Grandma and Grandpa Patel want to foster a love for philanthropy across generations. However, they recognize that their extended family views charitable giving through the lens of varying values, skills and interests. Grandma and Grandpa Patel also want to promote a sense of family unity through their philanthropic efforts and encourage the youngest generation to steward the family's wealth for long-lasting impact. To that end, they would ideally prefer any formal philanthropic structure to last in perpetuity.

Next Steps

Identifying the right cause. Given the scope of their vision, Grandma and Grandpa Patel reached out to their wealth advisory team for help with next steps. The family's advisor begins facilitating both in-person and virtual meetings where the Patels engage in interactive exercises designed to uncover each member's individual values and guiding principles. The family reaches a consensus on the top five shared values that will ground their collective charitable efforts: impact, responsibility, integrity, community and freedom.

Next, the team leads the family through an exercise focused on the charitable causes that inspire the most passion. The Patels discover a shared desire to further early childhood education coupled with a generational divide on how best to achieve those results. Grandma and Grandpa Patel want to continue making grants to education-based Internal Revenue Code Section 501(c)(3)s through their nonoperating PF. Yet their children wish to support political advocacy and policy changes in state and federal education funding. For their part, the Patel grandchildren believe that startups—especially in the tech sector—can advance early childhood education by providing broader access to online learning tools. Grandma and Grandpa Patel are excited by the chance to tackle an important social issue in ways that appeal to and leverage individual strengths and talents. However, they quickly realize that their PF won't accommodate all their family's endeavors. For instance, the PF could face restrictions on political and legislative activities and additional tax hurdles on for-profit venture investments.[8]

Financing collective efforts. Beyond what they hope to achieve, the family also struggles with how best to finance their collective efforts. Initially, they consider asking individual family members to set aside a percentage of their business income to contribute to the PF at regular intervals, while funding policy-driven or for-profit ventures separately. However, Grandma and Grandpa Patel express concern that this approach wouldn't effectively integrate and manage the family's non-grantmaking activities alongside the PF's distributions. For instance, if the Patel siblings make independent political contributions, they could inadvertently support a political campaign that conflicts with the family's objectives or the PF's grant recipients. Additionally, Grandma and Grandpa Patel worry that leaving annual support to each family member's discretion could result in inconsistent support and insufficient liquidity to meet the PF's obligations and goals. This uncertainty could also impact the PF's investment strategy, as it would require greater levels of excess cash on hand to account for unpredictable contribution levels, rather than investing such funds for a return.

Weighing flexibility against tax efficiency. To address these concerns, the wealth advisory team suggests the family establish a charitable LLC to fund:

- contributions to the PF,
- lobbying activities and political campaigns, and
- start-up seed capital.

The Patels are intrigued by this approach, as it offers the flexibility that the younger generations desire. By contributing an interest in the business to the LLC, the family can eliminate the need for discretionary contributions while avoiding concerns about punitive tax consequences. This shared funding source will encourage family members to discuss their use of funds and better align their impact to further the overall cause. Only individuals who contribute to the

LLC may participate in its management as members, ensuring that only those with "skin in the game" have a say in the final decision making. Moreover, the charitable LLC's involvement in various fields allows for cross-marketing, with the lobbying and for-profit investment arms able to leverage the PF's reputation within the community and vice versa.

Before moving ahead, the Patels seek to better understand how the charitable LLC would function and its potential tax ramifications. The family proposes funding the LLC with a 10% family business interest that will generate approximately $1 million of income per year. Their wealth advisory team then coordinates with the Patels' tax professionals to determine the tax impact to the members, assuming the charitable LLC uses 20% of this pretax income for non-grantmaking activities while contributing the balance to the PF.

Each member's precise tax liability would depend on individual tax rates, deductions, credits and other personal circumstances. With that said, their advisors note that members will recognize the charitable LLC's $1 million of income—along with any future taxable investment income on the LLC's reinvested funds—on their personal tax returns in proportion to their LLC interests. Notably, this additional income could be partially offset by a dollar-for-dollar charitable deduction for LLC funds contributed to the PF, subject to each member's AGI limit.[9] Net investment income (such as interest, dividends or capital gains) generated inside the PF would escape taxation as part of the members' gross income but would be subject to a 1.39% excise tax.[10] Lastly, the PF must make aggregate distributions equal to at least 5% of the value of its investment assets (minus any excise tax paid) each year.[11] In summary, operating business or investment income in the LLC would be subject to individual tax rates but could be retained within the entity for as long as desired. Meanwhile, the funds within the PF would potentially be subject to a 1.39% tax instead of ordinary income tax rates but could also be expelled from the PF as part of its annual distribution requirement.

Contributing a family business interest to the PF could result in an onerous excess business holdings tax,[12] while the income tax outcome of the charitable LLC would differ little from their current tax circumstances. For that reason, the family views any potential tax inefficiency as an acceptable downside to achieve their desired impact and promote family unity.

Operating Agreement

With that settled, the family then shifts their attention to the LLC's operating agreement, where they see an opportunity to codify shared values and determine how they will make philanthropic decisions moving forward. To help organize these efforts, their wealth advisory team offers to partner with the Patels in assigning formal roles within the LLC based on individual talents and interests. Each member's assigned position will shape how the family comes together to make decisions, with additional provisions incorporated to address conflict resolution. In crafting the operating agreement, the family leverages its family constitution—a formal document that defines the family's values, goals and purpose, along with agreed-on protocols and expectations for family interaction.[13]

While refining the operating agreement, the wealth advisory team inquires whether the LLC should make distributions to pay the members' tax liabilities. This type of provision is common when an LLC generates a substantial income tax liability that may be unsustainable for one or more members, especially when the LLC doesn't regularly make cash distributions. To help explore this point, the wealth advisory team forecasts the impact of such tax payments on the PF's sustainability.

Specifically, if the LLC sets aside $200,000 of its expected $1 million of yearly income to support its non-grantmaking activities and contributes the balance of this income to the PF, there's an 82% probability of maintaining the PF's purchasing power over the next 30 years. That is, the PF could achieve perpetuity even under some of the most challenging market environments. If the LLC instead makes annual tax distributions to the members (assuming top marginal rates),[14] the odds of the PF maintaining its initial inflation-adjusted value over 30 years decrease to 55%. See "Benefit of Support From Charitable Limited Liability Company (LLC)," p. 50.

After much discussion and with the assurance that the PF's long-term survival is likely regardless of their decision, the family agrees to allow for tax distributions from the LLC. They also decide to

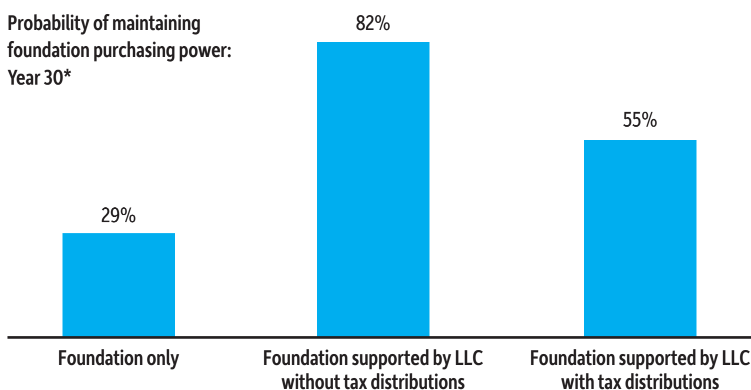
modify this approach in the future if challenging markets jeopardize the PF's existence or their personal liquidity needs change.

The Patels then turn to the frequency of the LLC's financial support for the PF. Is there a benefit to making staggered contributions? For example, they ponder whether reserving the allocated 80% of the LLC's income each year and making larger distributions to the PF every three, five or 10 years, instead of annually, would be beneficial. While the LLC's reserved funds would be taxed at ordinary income rates, they would also evade the PF's 5% distribution requirement and continue to benefit from compound growth.

The wealth advisory team revisits the analysis assuming annual tax distributions to the LLC members. This time, they find that bunching the contributions to the PF in 3-, 5- and 10-year increments adds an additional $600,000, $800,000 and $1.8 million to the PF's 30-year value, respectively. Plus, this staggered distribution pattern increases the PF's value by as much as 12% should the family decide to "turn off" the tax distributions in the future.[15] Grandma and Grandpa Patel appreciate that this lumpy contribution pattern will protect the PF from fluctuations in the operating company's income stream. A prosperous year's income can offset disappointing returns from a previous year, resulting in a more stable level of support. This will enable the PF to incur binding obligations with assurance and establish an investment policy that can allocate more cash to higher return-seeking, and potentially less liquid, investments. Additionally, this consistency will benefit the PF's grant recipients for their internal planning purposes.

Benefit of Support From Charitable Limited Liability Company (LLC)

Enhances the long-term durability of the foundation



*All portfolios are invested in 70% global equities and 30% bonds. Foundation has an initial value of $25 million, reduced by a 0.75% annual operating expense and the minimum required distribution. The charitable limited liability company (LLC) holds a 10% interest in the business, which generates annual income of $1 million, of which 20% of the pre-tax income is reserved to support advocacy and other non-grantmaking causes. The remaining income is transferred to the family foundation annually. The "Foundation only" bar assumes no additional inflows into the foundation. The "Foundation supported by LLC without tax distributions" bar assumes that the LLC makes no distributions to the members to cover their personal tax obligations prior to transferring the remaining income to the foundation. The "Foundation supported by LLC with tax distributions" bar assumes the LLC makes an annual distribution to the members of the LLC to support their personal tax obligations prior to transferring the remaining income to the foundation. The distribution assumes that the income from the LLC is taxable to each of the members as ordinary income subject to top marginal federal rates and a 5% state income tax rate. Assumes the income from the business to the members isn't subject to the net investment income tax. The charitable deduction generated by the LLC's contributions to the foundation are assumed to be used by each member of the LLC based on their personal circumstances, the value of which isn't contemplated in this illustration.

— Bernstein

Additional Vehicles

While the Patels are satisfied that the LLC will meet their primary philanthropic goals, they wonder about amplifying their impact with additional corporate structures. For example, the Patel family still hopes to leverage the family business as a vehicle for social change in some way despite wishing to retain control for the foreseeable future. To that end, they ask their wealth advisor and legal team to explore combining their financial and nonfinancial goals without impairing the profitability of the business. Based on what they've learned so far, three vehicles have piqued the Patels' interest—a low profit limited liability company (L3C), a public benefit corporation or benefit corporation (a BC) and a certified B corporation (B Corp).

Their advisor team quickly dispenses with using an L3C

structure due to the strict requirements in the handful of states that authorize L3Cs by statute. Notably, the entity:

- must further one or more charitable or educational purposes as defined under IRC Section 170(c)(2)(B) and wouldn't have been formed but for its relationship with such purpose(s),
- doesn't have production of income or property appreciation as a significant purpose, and
- has no political or legislative purpose within the meaning of IRC Section 170(c)(2)(D).[16]

As the production of profit is a primary purpose for the Patels' continued business operation, the business won't meet the statutory guidelines for an L3C.

A BC could be a better fit. While also created by state statute, a BC allows for a broader corporate purpose. It's a for-profit entity intended to deliver a public benefit—defined as a net positive effect on one or more persons, entities, communities or interests—and committed to balancing its stockholders' financial interests with the corporation's impact on its stated public benefit purpose and those materially affected by its operations.[17] Although a BC doesn't provide any tax benefit, it may allow the corporation's directors and officers to incorporate nonfinancial factors into their decision making with less risk of stockholder reproach due to the delineation and adoption of a public benefit purpose.[18] Such status may also signal a commitment to corporate responsibility that builds customer loyalty with individuals favoring sustainable brands.[19] The Patels like the general ethos of a BC but worry about the tax ramifications of converting their business into a corporation. Their advisory team notes that only a few states authorize the equivalent "benefit LLC."[20] Ultimately, the Patels decide to revisit this option if their state ever follows suit.

That leaves the Patels to consider pursuing B Corp certification. Rather than a type of legal entity, a B Corp is a certification mark acquired from B Lab (a 501(c)(3))[21] that's awarded after a business achieves a minimum score on a "B Impact Assessment"—a tool designed to rate the business' impact on its employees, consumers, community and environment.[22] A B Corp must then satisfy a risk review process and publish its assessment on B Lab's website.[23] A B Corp structured as a corporation must further agree to become a BC if allowed under applicable state law. Regardless of structure, all business types must amend their organizational documents to include language allowing decision makers to consider all stakeholders' interests and further the business' social purpose.[24] Commonly cited goals for obtaining B Corp certification include maintaining mission, attracting talent, collaborating with like-minded peers and raising capital. Given their current circumstances, the Patels find this option the most reasonable of the three and decide to explore the certification process after they establish the charitable LLC.

The Patel siblings also suggest creating an IRC Section 501(c)(4) organization to further their advocacy interests. Although Grandma and Grandpa Patel have heard of this type of entity, they aren't well versed in its specific advantages and disadvantages. To provide them with a clear understanding, their wealth advisory team explains that a Section 501(c)(4) organization is a tax-exempt, non-profit organization that promotes social welfare—that is, the common good and general benefit of the community's inhabitants.[25] Unlike Section 501(c)(3) organizations, which are prohibited from engaging in political activity and must limit lobbying efforts,[26] a Section 501(c)(4) organization may engage in unlimited lobbying efforts to further its cause. However, it can't attempt to influence elections as its primary activity.[27] It's also important to note that while a Section 501(c)(4) offers additional flexibility, contributions to it aren't deductible.[28]

After reviewing the description, brother and sister Patel conclude that a Section 501(c)(4) organization could partially fulfill their advocacy goals, though it lacks the flexibility of a charitable LLC. Nonetheless, they recognize that this entity could complement the LLC. Specifically, the LLC could donate funds to the Section 501(c)(4) organization, which would benefit from its favorable tax treatment and support the family's objectives. Their advisors highlight several prominent philanthropists who have implemented a similar integrated approach.[29] However, given the complex tax considerations involved, the family decides to concentrate on the LLC for the time being

and revisit this additional structure once they have more clearly defined their policy objectives.

A Positive Impact

A charitable LLC can be an effective tool for families seeking to create a lasting philanthropic legacy while maintaining control over their assets. However, it's important to carefully consider the related tax implications and funding approach to ensure that the strategy aligns with the family's goals and values. Staggered contributions can provide more consistent support for the foundation and shield it from volatility in the operating company's income stream. Additionally, a charitable LLC can allow for more flexibility in investment strategies and asset allocation. With proper planning and execution, a charitable LLC can be a powerful tool for families looking to make a positive impact on their communities and the world.

— Bernstein doesn't provide tax, legal or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

Endnotes

1. Lilly Family School of Philanthropy, Indiana University, *What Americans Think About Philanthropy and Nonprofits* (April 2023), *https://scholarworks.iupui.edu/server/api/core/bitstreams/b5904a8a-5081-42cd-bd44-56740b98fb67/content.*
2. *Ibid.*
3. *Ibid.*
4. Kelsey Piper, "Why This Billion-Dollar Foundation Is Becoming a Corporation," *Vox* (Feb. 7, 2019), *www.vox.com/future-perfect/2019/2/7/18207247/arnold-foundation-corporation-nonprofit-charity*.
5. Internal Revenue Code Sections 501(b) and (c)(3).
6. IRC Sections 4941 and 4943.
7. IRC Section 170(b)(1).
8. As a Section 501(c)(3), the private foundation (PF) can't participate or intervene in any political campaign or make lobbying a substantial part of its activities without risking its tax-exempt status. Section 501(c)(3). Additionally, were the PF to invest in a tech start-up structured as a partnership or other pass-through entity, and the activity of which wasn't substantially related to the PF's exempt purpose, any resulting income could be classified as unrelated business taxable income subject to tax under IRC Section 512. IRC Section 512(c)(1); Treasury Regulations Section 1.513-1. The start-up interest could also trigger the imposition of an excess business holdings tax if the PF plus all related "disqualified individuals" owned in the aggregate more than 20%—or in certain cases 35%—of the entity. IRC Section 4943.
9. IRC Section 170(b)(1).
10. IRC Section 4940.
11. IRC Section 4942.
12. IRC Section 4943.
13. For more information on how formal governance can support multigenerational philanthropy, *see* "Govern Your Giving: Putting Structures in Place to Promote Philanthropic Traditions," *www.bernstein.com/our-insights/insights/2022/whitepaper/govern-your-giving.html.*
14. Including a 5% state income tax rate.
15. Assuming a 30-year horizon, with contributions made every 10 years, and no distributions from the limited liability company (LLC) to pay for the members' tax liabilities.
16. *E.g.,* Vt. Stat. Ann. Tit. 11, Ch. 21, Section 4162. State low profit limited liability company (L3C) statutes may vary. However, the overarching requirements match those for a program-related investment (PRI) under IRC Section 4944, meaning a contribution to an L3C may qualify as an expenditure that counts towards a PF's annual 5% required distribution under Section 4942. However, the IRS has previously noted that L3C status isn't determinative as to whether a contribution qualifies as a PRI. T.D. 9762, 81 Fed. Reg. 24,024 (April 25, 2016).
17. *E.g.,* Del. Code. Ann. tit. 8, Section 361-368. State benefit corporation statutes may vary.
18. *See The Need and Rationale for the Benefit Corporation: Why It Is the Legal Form That Best Addresses the Needs of Social Entrepreneurs, Investors, and, Ultimately, the Public*, Benefit Corporation White Paper (Jan. 18, 2013), *https://benefitcorp.net/benefit-corporation-white-paper.*
19. *Ibid.*
20. Currently, only five states allow for benefit LLCs. Farzana Khaleda, "Public Benefit Limited Liability Company: The New Entity on the Block" (Sept. 10, 2020), *www.cogencyglobal.com/blog/public-benefit-limited-liability-company-new-entity-on-the-block.*
21. Melanie Broom, "'I Want to Be a B Corp': What This Means and What to Consider Before Stepping into the World of Benefit Corporations" (July 6, 2020), *www.dwt.com/blogs/startup-law-blog/2020/07/i-want-to-be-a-b-corp.*
22. *Ibid.*
23. *www.bcorporation.net/en-us/certification/.*
24. *Ibid.*
25. IRC Section 501(c)(4) and Treas. Regs. Section. 1.501(c)(4)-1(a)(2)(i).
26. Section 501(c)(3).
27. Treas. Regs. Section 1.501(c)(4)-1(a)(2)(ii).
28. IRC Section 170(c)(2)(D).
29. Piper, *supra* note 4.

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