March 10, 2023

Generations Winter 2023 - The Philanthropist as Community Stakeholder: The Rise of 501(c)(4) Organizations

Patagonia recently made headlines with its founder's announcement that he would give up control of the company in favor of a philanthropic vehicle. While seemingly abrupt, this solution in fact represents the culmination of several years of expanded thinking about the intersection of philanthropy, legislative activism and the corporate role.

Traditional philanthropy for family offices has historically consisted of either direct giving to charitable organizations or, in many instances, the family creating their own private foundation. The private foundation often becomes central to the family office structure, with the charitable arm serving as a representation of community involvement while affording next-generation family members the opportunity to engage more directly with philanthropy and to generally become more involved with the family's charitable priorities.

While private foundations remain a dominant structure for grant-making, the limitations imposed by the Internal Revenue Code have become more apparent in recent years as families struggle to comply with the often-onerous disclosures and opaque compliance requirements that private foundations must abide by pursuant to the code. These limitations, coupled with shifting views of the possibilities and extent of what philanthropy can mean in a larger societal context, have given rise to an increased use of 501(c)(4) organizations.

501(c)(4) organizations are so named for the corresponding section in the Internal Revenue Code and are also referred to as "social welfare" organizations due to the scope of permissible activities. Features of 501(c)(4) organizations include eligibility for a lifetime gift tax deduction, an unlimited ability to lobby and an ability to engage in political activity, provided that the political activity does not represent the primary activity, with "primary" generally acknowledged to represent more than 40 percent of the organization's activity. Importantly, donations to 501(c)(4) organizations are not eligible for a federal income tax deduction. Representing a broader "catchall" category of activity, examples include organizations that may not quite be "charitable" within the meaning of Section 501(c)(3) but still promote the common good or otherwise seek to influence legislation.

Although a 501(c)(4) is also exempt from federal income taxation, this type of entity differs in terms of formation and compliance in a few ways from the 501(c)(3) organization that is more widely known to the public. A few relevant ways in which they differ are as follows: First, a 501(c)(3) must be charitable within the meaning of the Internal Revenue Code, a definition that can potentially be difficult to meet; and second, 501(c)(3)s are further divided into two subcategories — public charity or private foundation, depending on the level of public support the organization receives. Due to the heightened scrutiny that private foundations receive, which is a result of the perceived family control, complex regulations in connection with self-dealing, annual minimum distributions, lobbying, business holdings and investments apply.

One tax-driven aspect of a 501(c)(3) organization, the charitable income tax deduction, is often less relevant for family offices. In many instances, the individual making the donation will not benefit from the income tax deduction in the same manner that more income-dominant families might. Instead, the ability to obtain a capital gains deferral is more attractive, given that appreciated capital assets represent the bulk of family wealth. In addition, private foundations have onerous rules on self-dealing and excess business holdings that require a strict separation of the wealth-generating entity from the other goals and activities of the family. In contrast, a family may contribute assets to a newly formed 501(c)(4) without the greater compliance burden that would traditionally apply with a 501(c)(3). The formation itself is relatively simple, including a simple filing requirement and payment due to the IRS within 60 days of formation. Other state-level registrations may apply.

With these options available, Yvon Chouinard, Patagonia's founder, historically may have fit the mold of the traditional philanthropist seeking to form a private foundation. Instead, he represents the mindset of new philanthropists who increasingly are viewing traditional 501(c)(3) charitable organizations as inefficient or less desirable. The restrictions of a 501(c)(3) in many ways are a "cost of entry" for an organization to enjoy tax-exempt status and receive tax-deductible donations.

The more inflexible nature of a 501(c)(3), coupled with a desire by changemakers to use their existing skills, networks and resources to effect social change on a local and even global scale, regardless of whether they derive a tax benefit in the process, have made the 501(c)(4) structure particularly attractive. Chouinard, along with his wife, Malinda Pennoyer, and their two children made headlines when they announced that they transferred all of the company's voting stock (which comprises 2 percent of the total company stock) to a trust named the Patagonia Purpose Trust and the remaining 98 percent of the company stock, valued at roughly $3 billion, to a 501(c)(4) social welfare organization called the Holdfast Collective. With this new arrangement, the Patagonia Purpose Trust will oversee the company's operations while the Holdfast Collective will use the company's profits to combat climate change.

Although the Chouinard family did not receive an income tax deduction, among other tax benefits from this structure, the family was willing to pay this price in order to continue to have control of the company, even though its future profits are irrevocably committed to the Holdfast Collective for social welfare purposes. For the Chouinard family, the permanency of the arrangement was part of its appeal. Concluded Yvon, "Now I could die tomorrow. The company is going to continue doing the right thing for the next 50 years and I don't have to be around."

While the 501(c)(4) organization can work well for family offices, some careful planning is still required. One potential pitfall of a 501(c)(4) is the control requirements in connection with estate tax inclusion. Although contributions are eligible for a gift tax deduction, estate tax statutes pertaining to ongoing control must also be a consideration when structuring such an entity. Too much control will result in estate tax inclusion, therefore negating the lifetime benefits, as the appreciated assets will be includible in the individual's estate at the fair market value at the time of death. In addition, in structuring an estate plan, contributions to a 501(c)(4) at death are not eligible for a deduction from the estate tax. To avoid this potentially disastrous outcome, the 501(c)(4) must be governed by independent board members. It is especially important that the board members not be viewed as proxies for the donor.

Another compliance requirement is the need to maintain ongoing activity. One potential outcome, although not yet tested, may involve the reclassification of a 501(c)(4) as a 501(c)(3) private foundation by the IRS. Like 501(c)(3) organizations, 501(c)(4)s must file a Form 990, which can be inspected by the public in addition to the IRS. It is important that some grant-making activity, or ideally even more active engagement, take place in the organization on an annual basis. In addition, the formalities such as regular board meetings are applicable to both for-profit and not-for-profit entities.

With this understanding, philanthropists seeking to broaden their impact while incorporating their own desires and business networks may find that the 501(c)(4) is the best fit for preserving their legacy. Each philanthropist will have their own desired level of control and relationship to the tax benefits. For these reasons, it is important to consider the options available when determining a structure that meets the goals of philanthropy, legacy, tax planning and ease of compliance.

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