Using Non-501(c)(3) Vehicles to Accomplish Philanthropic Objectives

*By Dana Brakman Reiser, Sharon C. Lincoln, and Ingrid Mittermaier**

Dana Brakman Reiser, Sharon C. Lincoln, and Ingrid Mittermaier explore why philanthropists are seeking out private foundation alternatives and evaluate the advantages and disadvantages of both traditional workarounds and recent experiments.

Twenty-first century philanthropists can look far beyond the traditional private foundation to structure their prosocial activities. Along with well-known private foundation alternatives like donor-advised funds ("DAFs") and supporting organizations ("SOs"), creative donors and their attorneys are adapting a diverse array of other vehicles to these purposes. Social welfare organizations exempt under Section 501(c)(4) of the Internal Revenue Code[1] are a flexible tool for funders seeking to pursue a wide range of charitable, investment and political activities and retain entity level tax exemption—though donations to them do not qualify as tax-deductible charitable contributions. Funds donated to a business league exempt under Section 501(c)(6) of the Code may be income tax deductible business expenses. These organizations also can mix charitable, investment and political activities, so long as they are organized to pursue a common business purpose. Philanthropists willing to forego tax-exempt alternatives entirely can obtain even greater flexibility, along with privacy and control, by utilizing taxable vehicles. LLCs are a particularly tax-efficient private foundation alternative, though new hybrid forms like the benefit corporation can also be useful for other kinds of philanthropic endeavors. This article will explore why philanthropists are seeking out private foundation alternatives and will evaluate the advantages and disadvantages of both traditional workarounds and recent experiments.

DANA BRAKMAN REISER is a Professor at Brooklyn Law School in New York.

SHARON C. LINCOLN is a Partner at Casner & Edwards, LLP in Boston.

INGRID MITTERMAIER is a Principal at Adler & Colvin in San Francisco.

The Impetus to Consider Alternatives to Traditional Philanthropy

As discussed in more detail below, the traditional model of philanthropy is for family wealth to be given to a family foundation or private foundation. A private foundation can be endowed either through grants while the founder is alive or with bequests at the founder's death. The foundation will typically carry out the founder's philanthropic mission through a program of grant making to support operating charities. DAFs and SOs have traditionally provided philanthropists with more flexible alternatives to private foundations. However, all of these traditional options still operate within the paradigm of rules established under section 501(c)(3) of the Code.

There are several emerging factors that prompt donors to seek alternatives to traditional philanthropic vehicles and the restrictions under which these vehicles must operate. Specifically, these factors include (i) increased donor engagement, (ii) the desire for greater flexibility, (iii) increased blending between the for-profit and nonprofit world in achieving social good, (iv) the desire to create ongoing value, and (v) the growth of "micro philanthropy."

Donor Engagement

Engagement can be an important factor for many successful entrepreneurs-turned-philanthropists. A hands-on approach to giving and a track record of being able to create and structure transactions can leave an entrepreneur somewhat frustrated with the rules and restrictions that apply to traditional charitable entities. In addition, successful entrepreneurs whose outside-the-box thinking has contributed to their success in the business world may also seek to create significant impact through initiating innovative solutions on a scale that is measurably broader than what traditional charitable grant making may have achieved to date.

For example, Thomas Siebel, the founder of Siebel Systems, Inc., developed an innovative and highly effective approach to combatting methamphetamine ("meth") addiction in Montana. Instead of merely making a contribution to any one of the many charities in the state that provide social services to drug addicts or that conduct addiction-related educational campaigns, Siebel made the effort to understand the causes of meth addiction. He learned that most first-time users are teenagers who are unaware of meth's risks. He then initiated the Meth Project to change teenagers' perception of the drug and its associated risks. Through collaboration with experts and a leading San Francisco advertising agency, the Meth Project developed a hard-hitting ad campaign designed to capture the attention of Montana's teens by featuring the physical ravages caused by the drug, as well as the social disruption it engenders—teens attacking and robbing their own families, prostituting themselves, or dying from an overdose. Hollywood directors directed the advertisements, which had budgets of $500,000 to $1 million. The ad campaign saturated Montana's small advertising market and became the largest purchaser of advertising in the state. In two years, the results were incredible. Between 2005 and 2007, meth addiction in Montana dropped 45% among teens and 72% among adults, while meth-related crimes fell by 62%. Siebel's innovative approach and outside-the-box thinking resulted in a high-impact and scalable solution that created measurable change within a very short time.[2]

Flexibility

Entrepreneurs who have built their companies from the ground up may be used to having a level of creative flexibility that would prompt them to seek options when determining how to structure a specific philanthropic investment. However, the types of investments that a private foundation may make and the types of entities which a private foundation may support are restricted under the rules applicable to private foundations. Similarly, DAFs and SOs are subject to a regime of rules that limit the scope and extent of what these vehicles may support. The tax benefits that accrue from making charitable contributions are not insignificant—the federal government estimates that the tax subsidy accruing to charitable donations from corporations and individuals will amount to nearly $58 billion in 2017.[3] However, in many cases, the desire to use a donor's resources to create more than a nominal impact in the most effective and large-scale manner may outweigh potential tax benefits from employing those resources in traditional charitable structures.

Seeking to use every tool in the toolbox, so to speak, to create impact and advance the social good—through charitable and noncharitable means alike—is a growing trend. As noted in the Stanford Social Innovation Review's article "Catalytic Philanthropy":

> The prominence of the U.S. nonprofit sector and the tax deductibility of donations have lulled people into thinking that IRS-sanctioned philanthropy is the only way to solve social problems. Donors have the freedom, however, to complement traditional grantmaking with a wide array of other tools from

outside the nonprofit sector, including many that can influence social, economic, and political forces in ways that traditional charitable giving cannot.[4]

The article profiled Siebel and the Meth Project and described the efforts of other philanthropists using other unconventional "tools" for creating social change, including use of corporate resources, investment capital, advocacy, litigation, and lobbying.

Pierre Omidyar, the founder of eBay, noted this toolbox approach as well in an article he authored for Harvard Business Review in 2011:

> Many people don't distinguish between charity and philanthropy, but to me there's a significant difference. When I use the word "charity," I think of what's needed to alleviate immediate suffering. It's just pure generosity driven by compassion, and it's important but never-ending work—there will always be more suffering. Charity is inherently not self-sustaining, but there are problems in the world, such as natural disasters, that require charity.
>
> Philanthropy is much more. It comes from the Latin for "love of humanity." Philanthropy is a desire to improve the state of humanity and the world. It requires thinking about the root causes of issues so that we can prevent tomorrow's suffering. And if we want to make sustainable change, we have to put all the tools at our disposal to their best possible use.[5]

Although Omidyar originally established a family foundation when his personal net worth skyrocketed to over $1 billion after eBay's initial public offering in 1998, the constraints related to the private foundation rules (discussed below) prompted him and his wife Pam to rethink their approach to philanthropy. He noted that eBay had impacted millions of people in providing them with primary or secondary income, and over time "… it increasingly became clear to me that eBay has had a huge social impact in the process of running its core business, and it wasn't a philanthropy."[6] As a result, the Omidyars wound down their family foundation and instead created a hybrid structure called the Omidyar Network consisting of an LLC and a private foundation that invest in a variety of enterprises—for-profit and nonprofit—that show promise in creating meaningful and scalable social impact. When Mark Zuckerberg and his wife Priscilla Chan announced the creation of the Chan–Zuckerberg Initiative ("CZI") in 2015, they essentially co-opted Omidyar's approach of using an LLC to make investments in innovative ventures with the potential for high impact but left out the private foundation component.[7]

Common Ground

The charitable sector and the commercial world share increasingly common ground when it comes to engaging in activities intended to accomplish a social good. Companies such as Toms, which donates a pair of shoes to a child in need for every pair of shoes purchased, are successful examples of commercial entities engaging in activities that are charitable as a core element of their business plan. As noted above, Omidyar sees eBay's social impact as being a noteworthy component of his company's success. Philanthropists that want their funds to make an impact may opt to invest in commercial startups that are similarly focused on achieving some public benefit through their commercial activities. In addition, it is interesting to note that in the press, CZI, which is an LLC, is often referred to as a "philanthropy" and compared to established private foundations such as the Bill and Melinda Gates Foundation in evaluating the scope of its potential charitable impact.[8]

Private foundations are now only one of many possible choices for those establishing philanthropic institutions.

The growing success of social impact bonds is another example of a greater blending of the charitable and commercial sectors. Social impact bonds are created for the purpose of scaling the successful social, environmental or health-related impact of charitable programming. They involve private financing of a public charity to increase the scope and impact of a program that (i) has a track record of success and (ii) results in quantifiable savings to a state or local government. If the program as scaled meets certain benchmarks, the government then pays the private investors the cost of their initial financing plus a set rate of return, essentially sharing with the investors a portion of the government's cost savings realized from the scaled-up program.[9]

Ongoing Value

Entrepreneurs-turned-philanthropists may find it attractive to establish a self-sustaining mechanism by which investments in one social venture may provide the funding needed for a subsequent venture. Increased interest in impact investing is also becoming a means by which to create lasting and measurable social impact that also results in a return for the investor—a return that may be used to fund another worthy initiative. Impact investing generally involves the use of private capital to achieve a social good. Impact investors are attracted to social enterprises because of their mission and impact. These investors often see double or triple bottom-line opportunities to earn a return while still supporting the accomplishment of a social good. The financial return generated by a successful social enterprise enables it to operate and grow in a self-sustaining manner.

Entrepreneur and philanthropist James Lee Sorenson has noted that the tech business he established—aimed at helping deaf persons communicate more effectively with others through the use of a video relay service—was able to scale rapidly because the business was sustainably profitable. The social impact of the business was far greater than if he had housed the initiative in a charitable vehicle dependent on the good will (and generosity) of donors.[10]

Statistically speaking, the potential for growth in the impact investing sector is significant. Approximately, $59 trillion is expected to be transferred from baby boomers to millennials over the next few decades.[11] For millennial investors, social impact takes a priority over financial return when they evaluate potential investments. Thus, in evaluating whether or not to make an investment or a donation, the socially conscious millennial may prioritize impact over financial return or tax benefit and opt to allocate funding to promising social enterprises that may—or may not—be housed in charitable entities.

Microphilanthropy

The rapid rise of crowdfunding sites such as Kickstarter and GoFundMe.com has made it much easier to get the word out to a wide audience about a social venture or charitable cause. This "democratization" of fundraising has further increased the shared space between the charitable and commercial sectors by creating a common platform on which any initiative that creates a public benefit may seek funding—whether started by an individual, a charity or a for-profit company. These crowdfunding sites enable ventures with few resources to tap into the collective funding power of the "many." The success of these sites shows that "microphilanthropists" who donate small sums through crowdfunding sites do not necessarily discriminate in favor of the type of entity seeking funding, but rather look carefully at the idea or purposes that are being funded.

Crowdfunding is becoming big business, with $17.25 billion of funding raised in 2015 in North America alone.[12] As the crowdfunding sector has grown, and the use of these sites to fund philanthropic endeavors has increased, some sites now focus on such fundraising requests. Indiegogo has started a new crowdfunding platform for "socially minded fundraising" called Generosity.[13] The no-fee aspect of the site encourages donations to support requests aimed at helping individuals or communities and enabling those who request such funding to get the most out of what they receive. Individuals as well as organizations are able to post requests on the site.

All of these factors are combining to impel philanthropists to consider alternatives to the traditional private foundation. Legal factors, particularly the comparison of the regulatory costs and benefits of this traditional structure versus conventional and emerging alternatives, will also impact these decisions. Understanding the private foundation and its regulatory environment is a pivotal first step.

Traditional Vehicles (Private Foundations)

The "private foundation" may be the best known philanthropic vehicle. It is a type of charity, *i.e.*, an organization that qualifies for charitable tax exemption under Section 501(c)(3) of the code (a "Section 501(c)(3) charity"). A Section 501(c)(3) charity is classified as a private foundation if it is not able to qualify as a public charity under any of the Code Sec. 509 provisions[14] (the most common way to qualify as a public charity is to meet a public support test). Family foundations and corporate foundations that receive their principal funding from one family or one corporation generally cannot meet this or the other tests to qualify as public charities and are therefore typically classified as private foundations.

Philanthropists may want to establish their own private foundation versus simply giving directly to the institutions and causes important to them, for a variety of reasons. They may want control over their philanthropic vehicle: a founder and her family members are permitted to control a private foundation. They may want the prestige and name perpetuation. They may want to get their children involved in their philanthropy and hope that establishing a foundation will encourage that. A private foundation can also serve as a buffer between the philanthropist and those seeking philanthropic funding. From a tax perspective, philanthropists may be prompted to establish private foundations because they have a liquidity event or for other reasons wants a large immediate charitable tax deduction. Setting up a private foundation can allow them to quickly fund a charitable vehicle while still taking time to decide on ultimate uses.

In establishing a Section 501(c)(3) charity, philanthropists agree to conduct their philanthropy subject to rules and regulatory oversight based on federal tax law, as well as state level oversight in the states where the charity is formed and conducts business. A special regulatory scheme applies to private foundations in addition to the basic rules governing all charities. Following, several of the key rules applicable to charities, and private foundations in particular, are discussed.

One of the most important characteristics of Section 501(c)(3) charities is their ability to receive tax deductible contributions. Donations to such charities, including private foundations, are generally eligible for a charitable contribution deduction. The deduction rules are described in Section 170 of the Code. These rules limit the amount of tax deduction for donors of *inter vivos* gifts to private foundations,[15] in comparison to gifts to public charities. Generally, certain property gifts that qualify for a full fair market value deduction if given to a public charity only receive a deduction equal to the basis of the contributed property if given to a private foundation. In addition, the amount of the deduction that a donor can use in a given year varies for public charities and private foundations: Cash contributions to public charities are limited to 50% of the donor's adjusted gross income ("AGI") versus contributions to private foundations, which are limited to 30% of the donor's AGI.[16] For donations of appreciated property, the deduction is generally limited to 30% of AGI for donations to public charities and 20% of AGI for donations to private foundations.[17]

Importantly, gifts to charities, including private foundations, are not subject to gift tax.[18] In addition, funds transferred at death to a private foundation (or public charity) are fully-deductible for estate tax purposes, with no percentage or other limitation. Any such assets simply will not form part of the estate on which the estate tax is levied.[19]

Generally, Section 501(c)(3) charities are also exempt from federal income tax. However, private foundations must pay an annual excise tax equal to 2% (in some cases reduced to 1%) of net investment income.[20] Also, charities must pay unrelated business income taxes at regular income tax rates on their net unrelated business income, as described in sections 511 through 513 of the Code.

Under federal tax law, most financial transactions between a private foundation and its insiders are outright prohibited. Self-dealing transactions are prohibited by Section 4941 of the Code, which makes it impossible for private foundations and their "disqualified persons" (including substantial contributors, managers and any related parties[21]) to enter into any sales, leases or other uses of property between them, unless the disqualified person is providing a benefit free of charge to the charity. Note, there is no "fair market value" exception for most acts of self-dealing. Furthermore, a private foundation may not pay compensation to a disqualified person nor pay nor reimburse the expenses of a disqualified person, unless two conditions are both met.[22] First, the compensation must be for personal services that are reasonable and necessary to carrying out the foundation's exempt purposes. Second, the amount of compensation, payment, or reimbursement must be reasonable and not excessive under the circumstances.

Private foundations must make distributions for charitable purposes each year in prescribed minimum amounts, generally equal to 5% of their investment assets.[23] Grants and charitable distributions qualify, as do reasonable and necessary administrative expenses, payments for assets used in exempt purposes, and professional fees for advice on program activity.

For entrepreneurs seeking flexibility to innovate and generate impact using commercial as well as traditionally charitable methods, however, the variety of alternatives beyond Code Sec. 501(c)(3) vehicles can be even more attractive.

Private foundations also are subject to a number of investment restrictions. Section 4943 of the Code generally limits the total holdings of a private foundation and all of its disqualified persons in any business enterprise to 20%. These "excess business holdings" rules permit a private foundation to hold a somewhat larger stake (up to 35%) if the investee business is controlled by parties unrelated to the foundation or its disqualified persons. In addition, a private foundation is prohibited from making investments that jeopardize the foundation's ability to carry out its charitable purposes.[24] Fortunately, updated regulations and guidance on the jeopardy investment rule have provided much needed clarifications. Under them, foundations have considerable leeway to engage in impact investment through both program-related investments and mission-related investing of their endowments.[25]

All Section 501(c)(3) charities risk loss of exemption if they engage in more than insubstantial lobbying and are banned from campaign activities.[26] The private foundation rules go further, prohibiting and imposing excise taxes for lobbying and electioneering and defining campaign activities so broadly that even many voter registration drives would trigger penalties.[27] The same excise tax provision[28] also prohibits or limits various other types of private foundation grants deemed to be made for noncharitable purposes. For example, grants to individuals or to entities that are not U.S. public charities typically require extensive paperwork, including in some cases preapproval by the IRS.

Private foundations must file Form 990-PF, *Return of Private Foundation*, with the IRS annually.[29] This form asks for information about the foundation's receipts and expenditures, including detailed information on donors and grantees, assets and liabilities, and a variety of other topics.[30] Form 990-PFs are available to the public. In many states, charities, including private foundations, need to submit regular filings to Attorneys General or other regulators as well. Both the IRS and state Attorneys General have the ability to audit charities and impose sanctions or require corrections if noncompliance is determined.

Earlier Alternatives (SOs and DAFs)

Two charitable vehicles exist that offer some of the benefits of establishing a private foundation, but that qualify as a public charity: SOs and DAFs. By qualifying as a public charity, these vehicles enjoy the more favorable tax treatment of public charities (better charitable deduction rules, no 2%/1% excise tax) and avoid some of the restrictions imposed on private foundations described above.

Supporting Organizations

First, an SO is a vehicle described in Section 509(a)(3) of the Code that qualifies as a public charity, not because it meets a public support test, but because it supports and is controlled by one or more other public charities (the "Supported Charities"). These Supported Charities must be identified by name in the SO's Articles of Incorporation, or, for certain SOs, a class of Supported Charities can be described in the Articles. In other words, even if only one philanthropist funds the SO, the SO can avoid private foundation status and qualify as a public charity. To qualify for classification as an SO under Code Sec. 509(a)(3), the SO must meet *all four* of the following tests:

- *Relationship test.* This test is most easily met if the Supported Charities control the SO, by appointing at least a majority of the Board of Directors of the SO (referred to as a Type I SO). A "Type II" SO is typically controlled by the same persons that control the Supported Charities. A "Type III" SO has the least control by its Supported Charities but is subject to increasingly complicated rules to nonetheless ensure sufficient oversight by the Supported Charities.
- *Organizational test*. This test is met if the SO's Articles of Incorporation have certain required language, including language limiting the purposes of the SO to operate "exclusively for the benefit of, to perform the functions of, or to carry out the purposes of" the identified Supported Charities.
- *Operational test*. The SO may make payments to the Supported Charities or otherwise use its funds in a manner that supports them. It may make grants, conduct independent programs, and raise funds. However, the permissible beneficiaries of its grants or programs are limited to:
  a. The Supported Charities named in the Articles of Incorporation;
  b. Individual members of the charitable class served by Supported Charities, either through direct payments or benefits to the individuals, or earmarked for such individuals and given through an unrelated organization;
  c. Other SOs that support the Supported Charities; or
  d. Public colleges and universities.
- *Lack of outside control test*. The control test is a negative test, requiring that the SO not be "controlled" by "disqualified persons." Generally, a person becomes a "disqualified person" by being a substantial contributor to the SO. It also includes a person who owns an entity that is a substantial contributor and family members of a substantial contributor.

A Section 501(c)(3) charity that is able to meet these very technical requirements can offer a donor the same more favorable tax deduction rules as other public charities. Also, traditionally an SO was a good vehicle to avoid some of the least flexible private foundation rules, such as the prohibition on self-dealing and the 5% minimum distribution requirement. However, the 2006 Pension Protection Act imposed additional rules that impose new complicated requirements on SOs. For example, donors to an SO and certain related parties may not receive a grant, loan, compensation, or similar payments from the SO (whether or not the exchange is at fair market value). As another example, new rules limit the ability of donors to the SO to control a Supported Charity.

As Section 501(c)(3) charities, SOs are also subject to the IRS and state Attorney General (and/or other state regulator) oversight. SOs must file Form 990 annually with the IRS, which form also becomes public (although donor information is redacted). Aside from donor details, the Form 990 discloses even more information about a public charity than the Form 990-PF discloses about private foundations. Among other things, detailed information on the compensation of certain insiders and transactions between the charity and insiders need to be disclosed and are regulated.

Donor-Advised Funds

Another alternative to setting up a private foundation is to establish a DAF. A DAF is not a separate charity. Instead, a donor makes a contribution to a pre-existing public charity, which holds the contributions in a separate account. The assets in the account belong to the charity and are reported on the charity's financial statements and returns. The charity, per an agreement with the donor, permits the donor or another designated advisor to provide nonbinding advice to the charity regarding what grants to make from the DAF.

If implemented correctly, the contribution to the DAF is treated as a contribution to the public charity host and can thus take advantage of its more favorable deduction rules. A DAF is also less expensive to establish than a separate entity and can typically be started with a much smaller amount of assets than would make sense for a private foundation. Another advantage is that the charity holding the fund takes care of all administration and paperwork. The real disadvantage is that the donor must give up legal control over the fund and can only act in an advisory capacity.

The Pension Protection Act also imposed new requirements and limitations on DAFs.[31] A DAF is defined as a fund or account identified by reference to a donor, with respect to which the donor (or a designee) reasonably expects to have advisory privileges. Excluded are funds that distribute only to one identified charity or "scholarship" funds with an independent selection committee. DAFs may generally not make distributions to natural persons, or to entities other than public charities without following "expenditure responsibility" rules. Grants in which the donor receives a more than "incidental" benefit are prohibited, as are grants, loans, or compensation to donor-advisors.

Individual DAFs are not overseen and regulated by the IRS and state regulators. Rather, the charity housing the DAF reports financial information regarding the DAF on the charity's own Form 990 and is subject to oversight by the state Attorney General. Notwithstanding these disclosures and oversight, if a relatively small DAF is housed in a much bigger charity, which may host many of hundreds of other DAFs, the activities of the individual DAF would typically not stand out and thus would be hard to track.

The Code Sec. 501(c)(4) "Foundation"—An Opportunity Created by the PATH Act

On December 18, 2015, President Obama signed into a law an omnibus appropriations bill that included a package of tax extenders known as The Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"). Section 408 of the PATH Act amended Section 2501 of the Code to provide an exemption from the U.S. federal gift tax for all transfers to organizations described in Section 501(c)(4), (c)(5), or (c)(6) of the Code. (Note, however, that donations to these organizations still do NOT qualify for an income tax charitable contribution deduction.)

With the increasing popularity of Code Sec. 501(c)(4) entities in particular to participate in lobbying and political campaign activity, it appears that the intent of the amendment was to resolve an ongoing ambiguity as to whether individual contributions to these types of organizations to support lobbying and political campaign activity constituted gifts subject to the federal gift tax. After the PATH Act, such contributions are clearly exempt. However, the new exemption has consequences beyond contributions for lobbying and political campaign activity.

The gift tax exemption for transfers to Code Sec. 501(c)(4) organizations creates an opportunity for philanthropic planning using such organizations. An organization can qualify for exemption under Code Sec. 501(c)(4) so long as it is not organized for profit and is operated exclusively for the promotion of social welfare. The promotion of social welfare has historically included the conduct of charitable activities that could be performed by a Section 501(c)(3) charity. Therefore, an individual donor should be able to establish a Code Sec. 501(c)(4) organization to carry out many of the same activities that could be performed through a private foundation. But a Code Sec. 501(c)(4) organization would have the added benefit of being able to participate in lobbying and political campaign activities (activities prohibited for private foundations) and would not be subject to the various restrictions imposed on private foundations.

Therefore, a Code Sec. 501(c)(4) "Foundation" provides many of the benefits obtained through the Omidyar or CZI model:

- It may invest in and make grants to organizations that are not public charities in support of its mission;
- It may hold, indefinitely, shares in a company controlled by the donor without meeting a minimum payout or the limitations on excess business holdings;
- It may freely engage in lobbying activities and could engage in political activities (so long as it is not the primary purpose of the organization);[32] and
- It is not subject to the restrictions on self-dealing.

In addition, it provides some tax benefits not available with an LLC. Contributions to a Code Sec. 501(c)(4) organization would be eligible for a gift tax deduction and could be removed from the donor's taxable estate without the need to make an eventual transfer to a Section 501(c)(3) charity, and the Code Sec. 501(c)(4) organization would not owe any tax on capital gains triggered on the sale of appreciated stock it was gifted. On the other hand, as with Section 501(c)(3) charities, Code Sec. 501(c)(4) organizations do need to file the publicly available Form 990, and insider transactions, including compensation, need to be disclosed and are regulated.

There are, however, some traps for the unwary with this new vehicle. First, the PATH Act only provides an exemption for federal gift taxes; transfers to a Code Sec. 501(c)(4) organization at death would not generate a deduction against the federal estate tax. Therefore, donors contributing to a Code Sec. 501(c)(4) organization would need to ensure that all transfers to the Code Sec. 501(c)(4) are *inter vivos* gifts and the donors do not retain sufficient control over the organization to cause inclusion of the assets in the donor's estate under Section 2036 of the Code. Second, it does not appear that this was the intention of the PATH Act or the IRS's traditional understanding of the use of Code Sec. 501(c)(4) organizations. Therefore, it is possible that through IRS guidance or legislative action limitations will be placed on Code Sec. 501(c)(4) "Foundations" to curb their use as an alternative to avoid the private foundation restrictions.

While the amendments to Section 2501 of the Code exempted donations to Code Sec. 501(c)(5) and (c)(6) organizations from the gift tax, using one of these types of entities for the purpose of functioning as a type of "foundation" may not be as straightforward as using a Code Sec. 501(c)(4) organization for that purpose. A Code Sec. 501(c)(4) organization may be organized for purposes that promote the social welfare—which may mirror or approximate charitable purposes described under Section 501(c)(3) of the Code. The purposes for which a Code Sec. 501(c)(5) and (c)(6) organization must be established are narrower and less flexible. A Code Sec. 501(c)(5) organization must be organized and operated to promote the betterment of conditions of those engaged in the pursuits of labor, agriculture, or horticulture; the improvement of the grade of their products; and the development of a higher degree of efficiency in their respective occupations. A Code Sec. 501(c)(6) organization must be organized and operated to promote a common business interest and to improve business conditions in a particular industry or in a particular region. Further, both Code Sec. 501(c)(5) and (c)(6) organizations are generally expected to be membership organizations, which leaves less of an opportunity for a single funder to form and control the organization.[33] Further, although a Code Sec. 501(c)(6) organization may make grants to other organizations in furtherance of its exempt purposes, it is arguably limited in making grants to individuals, especially individual members of the Code Sec. 501(c)(6), as this generally would run afoul of the prohibition against a tax-exempt business league's net earnings inuring to the benefit of any private shareholder or individual.[34]

Taxable Alternatives (LLCs)

For philanthropists willing to sacrifice—or at least delay—tax advantages, taxable vehicles offer even greater operational flexibility, along with privacy and control. The most significant cost of these structures is their potential to generate tax burdens. For some donors, these tax burdens will exact too high a price for taxable alternatives to be palatable.

The Costs of Taxable Alternatives

Unlike donations to SOs or DAFs, contributions to a for-profit entity will not qualify as deductible under the federal income, gift, or estate tax regimes. Funds contributed to nonprofit entities organized under sections 501(c)(4) and (c)(6) of the Code can likewise fail to generate income tax deductions, but these entities are themselves exempt and the income they generate will often be shielded from taxation. In contrast, income earned by a philanthropic initiative housed within a for-profit will be taxable.

Although these tax disadvantages cannot be eliminated entirely, they can be mitigated in important ways. Some tactics lie in the hands of donors, beginning with the choice of for-profit form. As in other cases, LLC structures are often the most tax-efficient option. The most basic income tax advantage of the LLC is avoiding double taxation. Only an LLC's owners are taxed on its income—not the LLC itself. Incorporated taxable entities are instead taxed on their income at both the entity and owner levels. Neither a taxable corporation nor an LLC can offer the tax value that exempt organizations provide, but the LLC's one level of taxation remains clearly preferable to the corporation's two. If a donor structures her philanthropic vehicle as an LLC, she will pay tax only on the LLC's distributions of income to her. As the LLC's owner, the donor will also have significant control over whether and when the LLC earns and distributes such income.

This passthrough nature means that the LLC's comparative advantage will persist over not only traditional for-profit corporations but also new hybrid corporate forms. Over the past several years, more than half of the states have adopted legislation enabling new organizational forms designed to house entities with a social mission as well as a profit motive. By far the most common of these new forms is the benefit corporation, a corporation with "a purpose of creating general public benefit,"[35] although Delaware's somewhat different public benefit corporation (PBC)[36] may also prove popular. Fiduciaries under both types of statutes are given broad discretion to pursue public benefit, even in situations when profit may suffer as a result.[37] Despite their dedicated social purpose, none of these new entities qualify for exemption under federal tax law. Nonetheless, philanthropists and their counsel should be aware of these developments, as benefit or PBC structures can be useful in organizing certain kinds of philanthropic endeavors, especially operating entities that pursue earned revenue strategies. The clear latitude legislation grants these entities and their fiduciaries to prioritize social mission over profit can be particularly attractive to nonprofits setting up for-profit subsidiaries. That said, benefit corporations and PBCs are still corporate entities. For donors considering private foundation alternatives, the tax efficiencies of an LLC typically will outweigh any benefits of these hybrid structures.

LLC structures can also allow founders to recapture many deductions that their choice to organize their philanthropy as a taxable entity initially appears to abandon. An LLC intended as an alternative to a private foundation will almost certainly eventually make charitable contributions qualifying under Section 170(c) of the Code. As these donations are made, they will be deductible by the LLC's philanthropist owners. The donor can avoid recognizing the capital gain on appreciated property eventually donated in kind to an exempt entity. If the recipient is a public charity, the donor will be able to deduct the asset's full market value. Rather than being lost entirely, these deductions can instead merely be delayed by using a taxable structure.

The founder of a philanthropic LLC will not likely obtain all of the deductions a private foundation founder could claim. After all, part of the reason to use an LLC structure is to enable the assets it receives to be used for purposes other than charitable grants. Such uses will not afford the donor any associated charitable contribution deduction. Additionally, the charitable contribution deductions to which a donor will be entitled under either structure will remain subject to percentage limitations, as discussed above.[38] Some wealthy donors have little income to shield or significant prior giving that already maximizes the deductions the percentage limits will accommodate. For them, deductibility will not matter much either way.

As tax law evolves, creative advisors will develop new possibilities to add to this stable of options. In doing so, they will continue to help new generations of donors structure institutions to fulfill their unique philanthropic visions.

The gift tax implications of taxable structures are potentially more salient than their income tax consequences—especially for philanthropists with more wealth than income or who have already maxed out their income tax deductions with prior charitable gifts. This tax broadly applies to any "transfer of property by gift"[39] and imposes rates as high as 40%. Donors obviously contribute assets to private foundations without consideration, but gifts to these tax-exempt entities explicitly avoid the tax by virtue of the 100% deduction for charitable contributions under Section 2522 of the Code. As noted above, the PATH Act also clarified that contributions to Code Sec. 501(c)(4) and (c)(6) entities likewise are not subject to the gift tax.[40] In contrast, *gratuitously* transferring one's assets to taxable entity would likely come with a very hefty gift tax bill.[41] On reflection, though, this concern quickly evaporates. Philanthropy LLC founders like Omidyar, Chan and Zuckerberg do not make gratuitous transfers to their LLCs. Instead, they receive membership interests in return for the assets they contribute. Since they make no gifts, there is no gift tax liability to fear from the initial funding of such entities.[42]

Concerns about estate taxation in a philanthropy LLC structure are also largely avoidable. Provided that an individual's wealth is substantial enough to exceed the estate tax's unified credit,[43] the estate tax applies to tax "the transfer of the taxable estate of every decedent who is a citizen or resident of the United States."[44] Again, rates top out at 40%, but funds transferred at death to a private foundation (or a public charity) are fully deductible, with no percentage or other limitations. In contrast, a donor's interest in a taxable philanthropic vehicle would be treated as part of their estate and would be fully subject to the estate tax. But an estate plan that transfers any such interests to a Section 501(c)(3) charity will provide a quick and easy fix. Such transfers will qualify for the unlimited charitable deduction and pass to their new owners without estate taxation.

For young donors with a "spend down" philosophy, who plan to distribute all of their philanthropic assets before death intercedes, the estate tax may not loom large. But the future is always uncertain. Even for those intending to do all of their giving during their lives, it remains important to advise them of the estate tax risks inherent to taxable structures for philanthropy.

Of course, the tax hit for-profit philanthropic vehicles will take as compared to their tax-exempt counterparts may shift with the political winds. Congress may well repeal the estate tax or dramatically reduce its application. The value of income tax deductions decreases along with rates, which may also be on their way down. The contours of any upcoming tax reform legislation remain uncertain, but many options under consideration would further reduce the disadvantages of taxable alternatives to private foundations.

The Benefits of Taxable Alternatives

The numerous factors that can diminish the tax disadvantages of for-profit alternatives must be considered alongside the considerable advantages these vehicles offer. The benefits again appear in most stark relief when comparing an LLC structure with a traditional private foundation. Private foundations are the most heavily regulated of exempt entities, subject to a strict excise tax regime, and heightened transparency requirements. Even when compared to other exempt entities, however, LLCs enjoy significant operational freedom and offer donors unparalleled control.

The private foundation excess business holdings rules will constrain donors in two different ways. The rules restrict the amount of equity a foundation, together with certain insiders including substantial contributors, can hold in any business.[45] These rules would force a private foundation that received a controlling interest in a business from an entrepreneur-turned-philanthropist to dispose of it on the tax code's timeline. In contrast, for-profit vehicles could accept a controlling stake and allow the donor to retain control over it until they chose to divest.

The same excess business holdings rules also limit the stakes foundations may hold in unrelated businesses, a constraint that will impede certain investment strategies. Many philanthropists today view patient investments in startup and growth-stage social enterprises as an important part of their charitable activities. For private foundations, though, the limits on excess business holdings will also restrict the size and terms of such impact investments. The excise tax imposed on private foundation investments that "jeopardize" their charitable purposes has also long been criticized for chilling interest in investments that trade financial returns for social performance. As mentioned above, updates in this area have increased flexibility, but a for-profit structure offers philanthropists still greater latitude; they can simply invest their assets however they wish.

Philanthropists who value operational flexibility will also bridle under the private foundation self-dealing rules discussed above. A philanthropy that shares employees, space, and other resources with its donors and their related businesses can spur collaboration and generate efficiencies, like a family office. But such arrangements between a private foundation, its substantial contributors, and entities they control, will trigger burdensome regulatory compliance and documentation at best and IRS scrutiny and penalty taxes at worst.[46] Even compensation is more complicated for private foundations. A taxable alternative gives founders free rein.

Structuring a philanthropic vehicle as a for-profit likewise avoids the private foundation rules' minimum distribution requirement and exempt organizations' limitations in the political arena. Rather than meeting statutory demands to steadily and annually expend 5% of its assets, taxable philanthropic vehicles make donors the masters of their philanthropies' time horizons. A philanthropist who views political and electoral advocacy as a key part of their charitable mission simply cannot use a private foundation to helm a coordinated effort. But a nonexempt philanthropic vehicle structured as an LLC can easily be put to this use.

Of course, as noted above, private foundations are not the only exempt category available to structure a philanthropic vehicle. Code Sec. 501(c)(4) social welfare organizations and Code Sec. 501(c)(6) business leagues can accommodate a great deal of political activity and are already frequently used by politically oriented donors. Yet, political activities sap the tax advantages of such organizational structures, as they are subject to tax on the lesser of their political expenditures or their investment income.[47]

For a typical Code Sec. 501(c)(4) organization established to engage in a combination of social welfare and political activities (with social welfare ones scrupulously remaining primary) and to be funded by ongoing donations, this incursion into exemption poses no danger. The same analysis applies to business leagues funded by membership payments. With investment income at zero or very low levels, their tax exemption will remain essentially intact. Using a social welfare organization or business league as a private foundation substitute with a large founding contribution creating an endowment, however, contemplates significant investment income to maintain the philanthropy's coffers over time. In these circumstances, without careful management, political expenditures could result in significant taxes, limiting the comparative advantage of these forms over taxable vehicles.

Additionally, taxable structures offer donors far more privacy than tax-exempt ones. The benefits of nonprofit and tax-exempt status come with the burden of transparency, and the burden of transparency is particularly severe for private foundations. While other exempt organizations also provide the IRS with a schedule reporting the names and addresses of contributors, private foundations must also make their donor lists open to public inspection.[48]

Taxable vehicles compare very favorably to this intense spotlight, as tax confidentiality will protect the contents of their filings from public view. Indeed, single member LLCs typically will not file at all; income will simply be reported on the member's own (again confidential) return.[49] For donors seeking to avoid public scrutiny of their philanthropic activities, the privacy offered by a taxable entity may outweigh its costs.

Finally, taxable entities provide donors with unparalleled control over the funds they contribute to a philanthropic organization. The LLC form is incredibly malleable in terms of governance arrangements, which can be designed to suit the founders' goals and plans. The founder can be its sole member and enjoy complete control over the assets it manages. But the ultimate facet of the control a taxable structure offers is the ability to exit. If a donor utilizes an LLC to establish a philanthropic initiative, and changes their mind later and would like their assets back, they can simply dissolve the entity and take back the funds. Of course, a donor could secure substantial day-to-day control over a philanthropic entity organized as private foundation by using the charitable trust form and naming the donor as sole trustee. Still, the type of about-face that would claw back previously donated funds will not be possible even with a single-trustee charitable trust. The assets of tax-exempt philanthropic entities are locked into the charitable stream in perpetuity. Clear legal bars prevent them from ever being diverted back to the donor.[50]

Taxable alternatives to private foundations lack universal appeal. But for donors who do not view their tax costs as an insurmountable barrier—and this group may expand as tax law changes—taxable alternatives offer myriad benefits. They evade the regulatory thicket imposed on the investments, resource-sharing arrangements, and political activities of tax-exempt entities, particularly private foundations. They can avoid exposure of sensitive information. And, they put donors in the driver's seat.

Conclusion

Private foundations are now only one of many possible choices for those establishing philanthropic institutions. SOs and DAFs continue to offer founders tax benefits that exceed private foundation alternatives, provided they are willing to limit their charitable agendas to a set of Supported Charities or cede ultimate control to a public charity DAF host. For entrepreneurs seeking flexibility to innovate and generate impact using commercial as well as traditionally charitable methods, however, the variety of alternatives beyond Code Sec. 501(c)(3) vehicles can be even more attractive. Organizing one's philanthropy as a "501(c)(4) foundation" can preserve many of the tax advantages attendant to traditional charitable forms, while avoiding the intensive regulation imposed on private foundations. Utilizing an LLC structure accepts somewhat greater potential tax burdens but offers founders the broadest range of activities, freedom from regulation, privacy, and control. As tax law evolves, creative advisors will develop new possibilities to add to this stable of options. In doing so, they will continue to help new generations of donors structure institutions to fulfill their unique philanthropic visions.

ENDNOTES

* The authors Dana Brakman Reiser, Sharon C. Lincoln, and Ingrid Mittermaier can be reached *via* mail at *dana.brakman@brooklaw.edu*, *lincoln@casneredwards.com*, and *ingrid@adlercolvin.com*, respectively.

1 Unless otherwise noted, all Code section and Reg. § references are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

2 In 2007, the Montana Meth Project was established as a public charity to enlist ongoing support and continue this work. To date, similar charities have been established in Colorado, Georgia, Idaho, Hawaii, and Wyoming.

3 *See www.treasury.gov/resource-center/tax-*

policy/Documents/Tax-Expenditures-FY2016.pdf.

[4] *See https://ssir.org/articles/entry/catalytic_philanthropy.*

[5] *See https://hbr.org/2011/09/ebays-founder-on-innovating-the-business-model-of-social-change.*

[6] *See www.nytimes.com/2006/11/13/us/13strom.html?pagewanted=all&_r=0.*

[7] *See https://chanzuckerberg.com/.*

[8] *See, for example, www.recode.net/2017/7/10/15771676/priscilla-chan-facebook-philanthropy-mark-zuckerberg-initiative-cure-diseases.*

[9] A prominent organization involved in orchestrating social impact bonds is Social Capital Inc. *See www.socialcapitalinc.org/.*

[10] *See www.forbes.com/sites/kerryadolan/2016/01/11/rethinking-philanthropy-why-impact-investing-makes-giving-sustainable/#7d323a30251d.*

[11] *See www.thinkadvisor.com/2014/05/29/the-biggest-wealth-transfer-in-history-just-got-bi.*

[12] *See http://crowdexpert.com/crowdfunding-industry-statistics/.*

[13] *See www.generosity.com*. In a related move, GoFundMe recently acquired Crowdrise, which focused on philanthropic funding requests. Going forward, Crowdrise is intended to be the charity fundraising site and GoFundMe is intended to be the personal fundraising site; however, any individual or charity may make a request on either site.

[14] Code Sec. 509 describes specific types of organizations like schools, churches, and hospitals; broadly publicly or governmentally supported organizations; organizations which earn income from their charitable activities from many sources; and supporting organizations to publicly-supported charities.

[15] See Section 170(b), (e)(1), and (e)(5) of the Code.

[16] *See* Code Sec. 170(b), (d).

[17] *id.*

[18] *See* Code Sec. 2522.

[19] *See* Code Sec. 2055(a)(2).

[20] *See* Code Sec. 4940.

[21] *See* Code Sec. 4946.

[22] *See* Code Sec. 4941(d)(2)(e).

[23] *See* Code Sec. 4942.

[24] *See* Code Sec. 4944.

[25] *See* Reg. §53.4944-3 (providing 19 examples to clarify when an investment will qualify as program-related); IRS Notice 2015-62, *Investments Made for Charitable Purposes*, available online at *www.irs.gov/pub/irs-drop/n-15-62.pdf* (addressing investments by private foundations for charitable purposes, but that will not qualify as program-related investments).

[26] *See* Code Sec. 501(c)(3) (exempting organizations "no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation … and which does not participate in, or intervene in … any political campaign on behalf of (or in opposition to) any candidate for public office").

[27] *See* Code Sec. 4945(d)–(f).

[28] Code Sec. 4945.

[29] *See* IRS, *Which Forms Do Exempt Organizations File*, available online at *www.irs.gov/charities-non-profits/form-990-series-which-forms-do-exempt-organizations-file-filing-phase-in*.

[30] *See, e.g.*, Form 990-PF Instructions, at 27, available online at *www.irs.gov/pub/irs-pdf/i990pf.pdf* (describing the requirements for listing "Information About Officers, Directors, Trustees, Foundation Managers, Highly Paid Employees, and Contractors" on private foundations annual disclosures).

[31] *See* Code Secs. 4966, 4967, and 4958(c)(2).

[32] *See* Reg. §501(c)(4)-(1)(a)(2)(ii) (providing that an organization "may qualify [for exemption] under Section 501(c)(4) even though it is an action organization," meaning it engages in lobbying); Rev. Rul. 61-177, 1961-2 CB 117 (stating that an organization may be exempt under Code Sec. 501(c)(6) "even though its sole activity is directed to the influencing of legislation which is germane to such common business interest"). For comprehensive treatment of the tax consequences of political activity by social welfare organizations and business leagues, *see* IRS, *Exempt Organizations-Technical Instruction Program for FY 2003*, available online at *www.irs.gov/pub/irs-tege/eotopicl03.pdf*. For a discussion of the Code Sec. 501(c)(4) scandal that embroiled the IRS in 2013, *see* Evelyn Brody & Marcus Owens, *Exile to Main Street: The I.R.S.'s Diminished Role in Overseeing Tax-Exempt Organizations*, 91 Chi.-Kent. L. Rev. 859 (2016).

[33] For example, Reg. §1.501(c)(6)-1 provides that a Code Sec. 501(c)(6) business league must be organized to promote the business interests of its members. By failing to secure members or to receive any meaningful membership support, a purported business league risks securing tax-exempt status. *See American Auto. Assoc.*, 19 TC 1146, 1159, Dec. 19,537 (1953) (an automobile club failed to meet the common business interest requirement where membership in the club, under its bylaws, was available to individual motorists without regard to business interests or activities); LTR 201242016 (providing that for an entity to be exempt business league, its members must "have a voice in [its] operation" and there must be "meaningful extent of membership support"); and LTR 201024066 (organization whose operating revenue was comprised of donations from individuals and grants, but not any revenue from members, failed to show any meaningful membership support and thus was denied Code Sec. 501(c)(6) status).

[34] *See* Reg. §1.501(c)(6)-1, *See also* Rev. Rul. 67-251, 1967-2 CB 196 (financial aid to members is a form of inurement and would preclude an organization from being recognized as a tax-exempt business league under Section 501(c)(6) of the Code). Compare the grant making made by Freedom Partners Chamber of Commerce, Inc., which amounted to more than $237.7 million in 2011, $41.7 million in 2012, $18.8 million in 2013, $87.6 million in 2014, and $65.4 million in 2015; most of these grants were made to Code Sec. 501(c)(4) organizations.

[35] Model Benefit Corporation Legislation, §201(a). Well over half of U.S. states now offer the benefit corporation form of organization. For current state-by-state details, *see* Social Enterprise Tracker, available online at *http://socentlawtracker.org/#/bcorps*.

[36] *See* Del. Code Ann. tit. 8, §§361–368.

[37] *See, e.g.*, Model Benefit Corporation Legislation, §301 (mandating that directors consider the interests of various constituencies as they lead a benefit corporation, but not requiring them to give any of these factors priority); Del. Code Ann. tit. 8, §§365 (instructing a PBC's directors to "balance[] the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation's conduct, and the specific public benefit or public benefits identified in its certificate of incorporation").

[38] Either situation is also more tax advantageous than having deductions trapped at the corporate level, where the relevant percentage limitation is reduced to only 10%. *See* Code Sec. 170(b)(2).

[39] Code Sec. 2501.

[40] *See* Act Sec. 408 of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act).

[41] A shareholder may characterize a transfer of funds to a taxable corporation as a contribution to capital, which generally would not be taxable to the corporation under Section 351 of the Code. A nonshareholder might be able to structure a transfer to a taxable corporation as a nonshareholder contribution to capital under Section 118 of the Code. However, in order for there to be consistent treatment of the transfer by the recipient corporation, it must treat the basis of any property acquired with the transferred funds as $0 (or reduce the basis in other property held by the taxpayer if no property is acquired within 12 months of the transfer). Nonshareholder contributions to capital also may attract additional scrutiny by the IRS. So while it is possible to transfer funds to a taxable corporation without generating taxable income to the corporation or triggering the gift tax, it may present a more cumbersome process in general.

[42] Should this nongift argument encounter resistance, philanthropists funding LLCs may also avoid gift taxation if they can set up a single member LLC, which is disregarded under federal tax law. *See* IRS Publication 3402, *Taxation of Limited Liability Companies* (June 2016), at 2, available online at *www.irs.gov/pub/irs-pdf/p3402.pdf*. While a gratuitous transfer of one's assets to a for-profit corporation, partnership, or multimember LLC triggers the gift tax, that same shift of assets to a single member LLC is no different than moving one's money from one pocket to another. No gift tax applies. *Compare Pierre*, 133 TC 2 (Aug. 24, 2009) (holding the disregarded nature of a single-member LLC

cannot be used to defeat the gift tax when a gift of interests in that LLC is transferred to a taxable individual or entity). The single-member criterion is also somewhat broader than it appears at first glance. Spouses in a community property state can create disregarded single member LLCs. *See* Rev. Proc. 2002-69, 2002-2 CB 831, available online at *www.irs.gov/pub/irs-drop/rp-02-69.pdf*. Spouses in all states can also take advantage of the unlimited marital deduction to make gifts to each other without triggering gift taxation. *See* Code Sec. 2523(b).

[43] Most estates pay no estate tax, as only those whose death and lifetime gratuitous transfers exceed the unified credit are subject to it. In 2017, this unified credit stood at $5,490,000. *See* IRS, *Estate Tax*, available online at *www.irs.gov/businesses/small-businesses-self-employed/estate-tax/*. Notably, spouses can combine their credits to double this amount.

[44] *See* Code Sec. 2001.

[45] *See* Code Sec. 4943.

[46] *See* Code Sec. 4941 (stringently regulating private foundation "self-dealing").

[47] *See* Code Sec. 527(f).

[48] *See* Schedule B, Schedule of Contributors, General Instructions, at 5, available online at *www.irs.gov/pub/irs-pdf/f990ezb.pdf*.

[49] *See* IRS Publication 3402, *Taxation of Limited Liability Companies*, at 2 (June 2016), available online at *www.irs.gov/pub/irs-pdf/p3402.pdf*.

[50] This lock-in, coined the "nondistribution constraint" by Henry Hansmann, is the defining characteristic of nonprofit organizations. *See* Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 501 (1981).