Dividing Philanthropy on Dissolution of Marriage

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INTRODUCTION

Couples build things together in a marriage. Sometimes they build substantial wealth allowing them to engage in philanthropy. This philanthropy can take several forms, such as establishing a private foundation or a donor-advised fund. The couple may leverage their tax planning objectives by contributing highly appreciated/low basis assets while also achieving their philanthropic goals. When spouses separate, their assets must be divided. But what happens to the couple's philanthropy on dissolution of the marriage? This article provides an overview of the most common types of charitable entities established by high net worth individuals, reviews Family Code disclosure obligations and discovery issues, and explains the issues to be considered in resolving the parties' rights with respect to control of their philanthropic interests in the context of a marital dissolution action.

THE BASICS

What is a charity?

Core to any charitable organization that is tax-exempt under Internal Revenue Code section 501(c)(3) are the requirements that assets received are (i) no longer owned by the donor and (ii) irrevocably dedicated to charitable purposes.

A Charity has no Owner.

Assets contributed to charity are no longer part of the marital estate because the charitable recipient, often a charitable entity, owns them. However, the spouses could continue to have control over the charitable purposes for which the assets are used. This continued control could occur if the charitable recipient is a private foundation whose only directors are the spouses or if the charitable recipient is a donor-advised fund and the spouses are the advisors of that fund. Thus, even though the assets are not technically part of the marital estate, the spouses often have strong opinions about who will control them for both investment and philanthropic purposes during and after dissolution, and not surprisingly, they may not (or no longer) agree. In addition, to the extent that the donors have retained some part of the asset, such as an income stream from a charitable remainder trust, the retained portion must be characterized and allocated in the overall division of the marital estate.

Summary of Basic Philanthropic Forms

A family's philanthropy can take several forms. Below is a brief summary of the most common types of charitable entities and the unique issues that need to be considered in the context of a marital dissolution action.

Private Foundation. In California, a private foundation is usually formed as a nonprofit public benefit corporation[1] and it is tax-exempt under Internal Revenue Code section 501(c)(3). It is common for the spouses to hold the director and officer positions of a family foundation. Thus, although the assets have been given *irrevocably* to the foundation, the spouses often continue to *control* the way the assets are invested and used for charitable purposes. Because they are typically funded and controlled by the same people, private foundations are also subject to strict regulation under the Internal Revenue Code and offer a less favorable income tax charitable contribution deduction than other types of charitable vehicles. Divorcing spouses may no longer agree on investment strategy or charitable purposes. It may also be unrealistic for spouses to continue to hold director and officer positions in the same entity following divorce.

Supporting Organization. Like a private foundation, a supporting organization is usually formed as a nonprofit public benefit corporation and is tax-exempt under Internal Revenue Code section 501(c)(3). Donors to supporting organizations enjoy a more favorable income tax charitable contribution deduction than what is available to a private foundation. However, unlike a private foundation, substantial contributors (typically the spouses) to a supporting organization cannot comprise the majority of the board of directors, so the spouses do not control the organization. They typically constitute a minority of the board and often do not want to continue to serve together if the marriage dissolves.

Donor-Advised Fund. As its name suggests, a donor-advised fund is a fund over which the donors have advisory input as to how money in the fund will be spent. Practically speaking, this is just a restricted fund at a public charity, like a community foundation, and is owned and controlled by the public charity. Typically, the spouses are both named as fund advisors. On dissolution of the marriage, they may not want to share advisory privileges over the fund.

Charitable Remainder Trust. This is a split-interest gift. The donor(s) make a contribution (this could be a gift of community or separate property) to a trust for the lifetime of the donor(s), or for a term of years. The trust generates an income stream for the donor(s)[2] and a future gift to a charity that receives the remainder when the trust terminates. The gift is considered complete at the time the charitable remainder trust is funded. The income tax charitable contribution deduction is discounted based on the expected term of the charitable remainder trust and the expected payout to the income recipient(s).

If the charitable remainder trust was funded with community property, the income stream should also be community property and an asset of the marital estate. On dissolution of the marriage, spouses need to determine what to do with the income stream (if anything) and, if they reserved the right to amend the charitable remainder beneficiary, they will need to determine how they will name the charitable remainder beneficiary.

Pledges. While not a philanthropic vehicle *per se*, a pledge to make a future gift to charity raises an interesting question as to whether the pledge amounts to a binding obligation to make a gift. To be binding, the pledge would need to be enforceable, which generally requires there to be consideration. The necessary consideration can be as nominal as a naming right ("I pledge $1 million and you agree to name the new building after me") or more substantial consideration such as detrimental reliance ("we broke ground on the new building based on your pledge to make this gift"). The charity beneficiary of the pledge may have an obligation to enforce a binding pledge like any other receivable. Understanding whether a pledge is enforceable, and against whom, is important on dissolution of the marriage.

Practice Tip: *Obtain copies of the governing documents of any charitable vehicle and/or outstanding pledge agreements. Review them with the client to understand who has control, what obligations remain to the charity, and to identify the client's goals for the charitable vehicle in light of the divorce.*

What is a charitable gift?

A gift to a qualified charity is generally eligible for the charitable contribution deduction from income tax. At common law, a gift is defined as the transfer of property without consideration. However, a gift, for federal income tax purposes (i.e. to be eligible to receive the charitable contribution deduction), requires (i) a recipient who is a qualified charity and (ii) more importantly, donative intent. According to the U.S. Supreme Court, a charitable

gift "proceeds from a 'detached and disinterested generosity'" (*Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960)). Thus, a transfer does not become a charitable gift unless it is made with "detached and disinterested generosity." To put a finer point on this, the U.S. Supreme Court also states that if a payment "proceeds primarily from 'the constraining force of any moral or legal duty,' or from 'the incentive of anticipated benefit' of an economic nature (*Bogardus v. Commissioner,* 302 U.S. 34, 41), it is not a gift." (*id*.)

Here are some examples of what is, versus what is not, a gift for federal income tax purposes:

IS A GIFT: I give $50 to the local friends of the public library charity. (I made the gift with detached and disinterested generosity, and got nothing in return.)

IS A GIFT: I give $1,000,000 (or securities) to a donor advised fund or to my family private foundation. (Although I am giving the funds to a charitable vehicle I control or have retained advisory privileges, I made the gift with detached and disinterested generosity.)

IS NOT A GIFT: I give $50 to my local public radio station and in return I receive $50 worth of magazines. (I'm getting return benefits equal to my gift, thus negating the gift.)

IS NOT A GIFT: I give $100,000 to a community development charity in exchange for the charity's promise to hire my company as a contractor to build the new community playground. (I have made the gift not out of generosity, but because I anticipate that the charity will hire my firm.)

IS NOT A GIFT: Under a marital settlement agreement, I contractually obligate myself to contribute funds to my ex-spouse's foundation or donor advised fund. (I am under a legal duty in the marital settlement agreement to contribute funds, thus the transfer to my ex-spouse's foundation is not a gift.)

Who has jurisdiction over charitable assets in California?

Three agencies generally oversee charitable assets.

1. The California Attorney General is charged with ensuring that charitable assets are properly used for, and dedicated to, charitable purposes, and that a charity's use of assets is consistent with the donor's intent. When a dispute arises over the use of charitable assets, the Attorney General has jurisdiction to resolve the dispute. Most charities must register with and report to the Attorney General. The Attorney General is authorized to audit charities and can remove directors of a charity in cases of extreme misuse.
2. The Internal Revenue Service also oversees charities to ensure compliance with provisions of the Internal Revenue Code applicable to tax-exempt organizations. The Internal Revenue Service can audit charities, impose excise taxes for improper use of assets, and, in egregious circumstances, has the authority to revoke a charity's tax exempt status.
3. The California Franchise Tax Board oversees charities in a manner similar to the Internal Revenue Service.

CONSIDERATIONS UPON DIVORCE

Does the family court have jurisdiction?

Under California Family Code section 2010, family courts have limited jurisdiction. Specifically, family courts may inquire into and make orders regarding, in relevant part, the settlement of the property rights of the parties. Because charitable gifts no longer belong to either spouse, the family court does not have jurisdiction over the disposition or allocation of the gifted assets, and cannot generally "undo" a gift. However, to the extent that community property was gifted without the other spouse's knowledge and/or consent, the issue to be raised in a marital dissolution proceeding is a reimbursement claim between spouses (not from the charity) or breach of fiduciary duty, again as between the spouses.

Disclosure Obligations, Discovery, and Fiduciary Duties

Consistent with codified public policy, parties to a marital dissolution action have a mutual fiduciary duty to identify with sufficient particularity, and to disclose all material information regarding, any assets (or liabilities) in which either or both parties have or may have an interest. Further, each party must fully disclose their income and expenses. Even though charitable assets no longer belong to a party, and thus arguably do not fall within a party's disclosure obligations under Family Code sections 2104 & 2105, best practice for practitioners is to include charitable entities in the "Other Assets" section of the Schedule of Assets and Debts. After all, over-disclosure is always better than under-disclosure. In addition, any charitable outstanding pledges made by the spouses, whether or not binding, should also be disclosed

on the Schedule of Assets and Debts. With respect to a charitable entity with an income stream, the income stream must be disclosed, at a minimum, on the Income and Expense Declaration.

When representing a spouse with little visibility into the parties' assets or financial circumstances, formal discovery may need to be undertaken. Examples of items to request include: tax returns (beyond the two years required with the Preliminary Declaration of Disclosure), gift tax returns, identification of any and all gifts made to a charitable entity during marriage, and governing documents for any charitable entities.

***Practice Tip**: An easy discovery tool is the Family Law Form Interrogatories. For example, Form Interrogatory #13 requires a party to identify property held by a third party over which a party has any control. Form Interrogatory #21 requires the responding party to disclose any gifts made without the consent of his/her spouse or domestic partner in the last 24 months, the values and recipients of those gifts. Tax returns should be reviewed carefully to identify any income stream from a charitable vehicle such as from a charitable remainder trust.*

Character of funds used to make a charitable gift and tax issues

In the divorce context, it is also important to understand the source and character of the gift that was made and understand who was entitled to the tax benefit of the gift. For example, if a separate property gift was made for which the community benefitted, there may be a reimbursement issue. Likewise, if a community property gift was given without the other spouse's consent, there may be a reimbursement claim, or a claim for breach of fiduciary duty.

CONTROL, the key issue in negotiating the allocation of charitable interests

Similar to a family business, in the divorce context, the issue of who *controls* the charitable entities is often a key issue: Who will control the private foundation? Who will participate on the board of the supporting organization? Who will advise grants from the donor advised fund? In the case of a charitable remainder trust, the spouses are typically negotiating over who is entitled to the income stream and, if not irrevocably named at the time the trust was created, the designation of the charitable remainder beneficiary. These control issues can be resolved in a number of ways, including terminating the private foundation and creating two new foundations, dividing the donor advised fund, or terminating the charitable remainder trust which can include accelerating the income stream and making a further gift to charity. Each of these solutions has complex tax consequences. The family law practitioner is well served by engaging counsel experienced in nonprofit and tax-exempt organizations law.

Considerations for drafting the Marital Settlement Agreement.

The assets held by charitable entities are not owned by the spouses. Thus, the practitioner must be careful when including provisions related to the charitable entities in the Marital Settlement Agreement for two key reasons: first, the charitable entity is not a party to the dissolution proceedings and second, certain provisions could trigger adverse tax effects.

Provisions that <u>may not</u> be included in a Marital Settlement Agreement (or should not) to avoid unintended adverse tax effects:

- <u>No Required Charitable Gift</u>. The Marital Settlement Agreement should not obligate either party to disburse funds into a charitable entity. The disbursing spouse will not get an income tax charitable contribution deduction because he or she is fulfilling a legal obligation.
- <u>No Required Disbursement From a Charitable Entity</u>. The Marital Settlement Agreement should not obligate either party to make a grant from the private foundation or supporting organization. Assets contributed to charity are not the property of either spouse. Neither the private foundation nor the supporting organization is or should be a party to the Marital Settlement agreement. Thus, a spouse, acting in his or her individual capacity (as in the Marital Settlement Agreement) cannot commit to a transfer from a private foundation or a supporting organization.

Provisions that parties <u>may</u> include in a Marital Settlement Agreement:

- <u>Causing Private Foundation to Take Action</u>. If the spouses control a private foundation, they can agree to cause the foundation to take certain actions. That is, the spouses can agree to cause the foundation to make a grant to a qualified charity recipient, or to cause the foundation to terminate and distribute its assets to one or more

other charities. Thus in the Marital Settlement Agreement, the spouses can agree to cause the private foundation to distribute one-half of its assets to a donor advised fund over which one spouse has advisory privileges. As a separate matter, the spouses, now in their capacities as directors of the private foundation, can take the necessary corporate actions so that the private foundation makes a grant to the donor advised fund.

- Agreement on Continued Board Service to a Supporting Organization. If the spouses are on the board of a *supporting organization*, unless they want to continue to serve together, one of them could agree to step off the board.
- Agreement to Divide Donor-Advised Fund. If the spouses are advisors to a *donor-advised fund*, the sponsoring charity may be willing to separate the fund into two separate funds so that each spouse can advise a separate fund. The spouses would need to discuss this with the sponsoring charity to see whether the charity is willing to split the fund. Agreeing to do this might be within the scope of the Marital Settlement Agreement, but neither spouse has the authority to require the sponsoring charity to agree. Thus, the practitioner must first obtain permission from the fund sponsor before including such a provision in the Marital Settlement Agreement.
- Agreement to Divide or Terminate Charitable Remainder Trust. If the spouses are each entitled to a portion of an income stream of a *charitable remainder trust*, they can retain the status quo (although if one of the spouses is acting as trustee, they may prefer to appoint a neutral trustee). Generally, they can also split the trust into two separate charitable remainder trusts. The income recipients of the former trust would each be named a sole income recipient of one of the newly created trusts. The spouses can also terminate the trust early by distributing a pro-rata share of the present value of the income stream to the individuals and the remainder to the charitable remainder beneficiary.

Conclusion

Dividing a couple's philanthropic assets can be a complicated financial transaction and should be done with care. A family law practitioner is well-advised to consult with counsel specializing in the areas of tax, estate planning, and non-profit law to fully understand, analyze, and ultimately "divide" the spouses' control over charitable entities on dissolution of marriage.

Endnotes

1 Other states have variations of the nonprofit public benefit corporation, such as not-for-profit and nonstock corporations. In addition, instead of the corporate form, charities can also be formed as trusts. A discussion of the distinctions between a trust and corporate form charity is beyond the scope of this article.

2 A number of variations of a charitable remainder trust exist, such as the unitrust, annuity trust, and net-income trust, in addition to a lead trust that pays the current income stream to the charity and the remainder to one or more named individuals. A discussion of the distinctions between the types of charitable remainder trusts is beyond the scope of this article.