

RECOGNIZING AND AVOIDING SELF-DEALING: BOTH DIRECT AND INDIRECT

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RECOGNIZING AND AVOIDING SELF-DEALING: BOTH DIRECT AND INDIRECT

I. INTRODUCTION

In recognition of the societal benefits achieved as a result of the work of the independent sector, the laws of the United States provide various benefits to specific types of philanthropic organizations, benefits ranging from liability immunity for volunteers to favorable postage rates. Chief among those benefits is exemption from federal income tax for organizations that meet specific requirements as set out in the Internal Revenue Code of 1986 (I.R.C. or the "Code").¹ For organizations formed for more narrowly defined purposes (including religious, charitable, scientific, and educational purposes among others) federal tax law provides what amounts to a double subsidy—exemption from federal income tax along with the ability to receive donations that are deductible from the personal income tax obligations of the donors.²

Section 509 of the Code further categorizes organizations that are exempt from federal income tax as a result of being described in Section 501(c)(3) into the categories of public charities and private foundations. More specifically, the Code presumes that organizations described under Section 501(c)(3) are private foundations unless they are able to show that they are public charities as a result of their activities (traditional public charity activities such as churches, hospitals and schools), the source of their revenue (i.e. that such organizations are publicly supported), or because they support other public charities (supporting organizations).³ Because private foundations do not attract broad public support and thus allow donors (at least in theory) to retain more control over the assets placed in the private foundation, Congress has imposed certain prohibitions that apply specifically to private foundations. Those prohibitions are found in Sections 4941 – 4945 of the Code.⁴ These prohibitions include prohibitions on self-dealing, failing to distribute income, maintaining excess business holdings, investing in ways that jeopardize the charitable purposes of the organization, and making taxable expenditures.⁵ This paper will focus on the self-dealing prohibition found in Section 4941 of the Code.

Section 4941 of the Code prohibits acts of self-dealing between a private foundation (both private non-operating foundations as well as private operating foundations) and persons who are disqualified with respect to the private foundation. Because there can be no self-dealing if there is no participation by a disqualified person in the transaction, the starting point for any analysis of potential self-dealing requires defining who constitute disqualified persons with respect to the foundation.

II. SELF-DEALING: THE RULES

A. *Disqualified Persons*

Section 4946 of the Code defines the term "disqualified person" with respect to private

¹ In many states, such as in Texas, recognition of exemption under various sections of the Code carries with it the right to exemption from various state taxes as well.

² I.R.C. §§ 170; 501(c)(3).

³ I.R.C. § 509(a).

⁴ Private foundations are also subject to a tax on net investment income as set forth in § 4940 of the Code.

⁵ I.R.C. §§ 4941-4945.

foundations.⁶ A disqualified person with respect to a private foundation, is:

1. A substantial contributor to the foundation;⁷
2. A foundation manager, that is any officer, director, or trustee, or a person having responsibility similar to such individuals;⁸
3. An owner of more than 20% of a corporation, partnership, trust or unincorporated enterprise which is a substantial contributor to the foundation;
4. A member of the family of anyone described in (1), (2), or (3) above (a member of the family includes ancestors, decedents, and spouses, but does not include siblings); and
5. A corporation, partnership, trust, or estate in which persons listed in (1) – (4) above own more than 35% of the total combined voting power (more than 35% of the profits interest of a partnership or more than 35% of the beneficial interest of a trust).⁹

Notwithstanding the foregoing rules, for purposes of Section 4941, organizations described in Section 501(c)(3) of the Code (other than an organization described in Section 509(a)(4)—public safety organizations) are not considered disqualified persons.

B. Self-Dealing Transactions

After identifying the universe of disqualified persons with respect to a private foundation, it is necessary to understand the breadth of transactions that the Code categorizes as self-dealing. Specifically, Section 4941 provides a list of six specific acts between a disqualified person and a private foundation that constitute self-dealing:

1. Sale or exchange, or leasing, of property between a private foundation and a disqualified person;
2. Lending of money or other extension of credit between a private foundation and a disqualified person;
3. Furnishing of goods, services, or facilities between a private foundation and a disqualified person;
4. Payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;
5. Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and
6. Agreement by a private foundation to make any payment of money or other property to a government official (as defined in Section 4946(c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90 day period.

⁶ It should be noted that the definition of disqualified person with respect to a foundation differs from the definition of a disqualified person with respect to a public charity which in turn differs from the definition of a disqualified person with respect to a donor advised fund.

⁷ Section 507(d)(2) defines substantial contributor as any person who contributes an aggregate amount in excess of \$5,000 to the foundation, if his or her total contributions are more than 2% of the total contributions received by the foundation (since its inception) before the close of the taxable year of the contribution.

⁸ Treas. Reg. § 53.4946-1(f).

⁹ Attribution rules apply in computing ownership percentages. Treas. Reg. § 53.4946-1(d)(e).

The prohibited acts identified above apply with equal force where the transaction takes place through an intermediary, such acts being defined as indirect self-dealing. Specifically, indirect self-dealing covers transactions from the foregoing list between a disqualified person and an organization controlled by a private foundation absent certain exceptions that will be discussed below.

Treasury Regulation 53.4941(d)-1(b)(v) provides two tests for determining that an organization is "controlled" by a private foundation:

1. If the private foundation or one or more of its managers (acting only in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction that if a disqualified person engaged in with the private foundation, would constitute self-dealing; or
2. If a disqualified person (together with one or more persons who are disqualified persons because of their relationship) may, only by aggregating their votes or positions of authority with that of the private foundation, require the organization to engage in such transaction.

The controlled organization can be any type of entity. Furthermore, control exists even where the aggregate voting power is less than 50% if the private foundation or one or more of its disqualified persons has the right to exercise veto power over the actions of the organization relevant to any potential acts of self-dealing.¹⁰

A review of the rules set forth above demonstrates the draconian nature of the self-dealing rules. Virtually every transaction involving a disqualified person in a private foundation falls within the six types of self-dealing regardless of the knowledge of the self-dealer or of the foundation if the act constitutes self-dealing, regardless of whether such act is a violation of a fiduciary duty on the part of the self-dealer or other foundation managers, and regardless of whether the act is on fair terms or even beneficial to the foundation. The rules are applied mechanically and can lead to unexpected results. Fortunately, the Code and Regulations provide certain exceptions that serve to mollify the strict and all-encompassing nature of the rules.

C. The Exceptions

The Code sets out eight exceptions to the self-dealing rules that it calls "special rules."¹¹

1. A disqualified person may transfer indebted real or personal property to a private foundation if the foundation does not assume the mortgage or other debt or, if the foundation takes the property subject to a mortgage that was placed on the property by the disqualified person prior to a 10 year period ending on the date of the gift;¹²
2. A disqualified person may lend money to a private foundation so long as the

¹⁰ Treas. Reg. § 53.4941(d)-1(b)(5).

¹¹ I.R.C. § 4941(d)(2).

¹² The Code actually speaks of this in the context of what *is* an act of self-dealing—the transfer of real or personal property by a disqualified person to a private foundation where the property is subject to a mortgage or similar lien which the foundation assumes or where the property is subject to a mortgage or similar lien which a disqualified person placed in the property within the 10 year period ending on the date of the transfer. As such, the exception is derived from inverting the rule.

- loan is without interest or other charge and the proceeds of the loan are used exclusively for purposes specified in Section 501(c)(3) of the Code;
3. A disqualified person may furnish goods, services, or facilities to a private foundation so long as such furnishing is without charge and the goods, services, or facilities are used exclusively for purposes specified in Section 501(c)(3) of the Code;
 4. A private foundation may furnish goods, services, or facilities to a disqualified person if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public;
 5. Except in the case of a government official, a private foundation may pay compensation (and pay or reimburse expenses) to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purposes of the private foundation so long as such compensation (or payment or reimbursement) is not excessive;¹³
 6. Transactions between a private foundation and a corporation which is a disqualified person pursuant to liquidation merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization are not acts of self-dealing if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value;
 7. Certain prizes, awards, scholarships, fellowship grants, and annuity or like payments payable to certain government officials are treated as exceptions to self-dealing; and
 8. A disqualified person may lease space to a private foundation in a building with other unrelated tenants so long as such lease was binding on October 9, 1969 or pursuant to renewals of such lease, was not a prohibited transaction under former § 503; and has terms that reflect an arm's length transaction both with respect to the original lease as well as subsequent renewals.

In addition to these "special rules"/exceptions found in the Code, the Treasury Regulations provide for additional exceptions to indirect self-dealing.

1. Transactions between a disqualified person and an organization controlled by a private foundation or between two disqualified persons where the foundation's assets may be affected by the transaction are not indirect self-dealing if (a) the transaction arises in the normal and customary course of a retail business engaged in with the general public, (b) in the case of a transaction between a disqualified person and an organization controlled by a private foundation, the transaction is at least as favorable to the organization controlled by the foundation as an arm's length transaction with an unrelated person, and (c) the total of the amounts involved in such transaction with respect to any one of such disqualified persons in any one taxable year does not exceed \$5,000.
2. The transaction is between a disqualified person and an organization controlled by a private foundation where (a) the transaction results from of self-dealing, (b)

¹³ A determination of reasonable compensation is based upon what amount would ordinarily be paid for like services by like enterprises under like circumstances. Treas. Reg. § 1.162-7(b)(iii).

the transaction was at least as favorable to the controlled organization as an arm's length transaction with an unrelated party would be, and (c) either (i) the controlled organization could have engaged in the transaction with someone other than a disqualified person only at severe economic hardship to the controlled organization, or (ii) because of the unique nature of the product or services provided by the controlled organization, the disqualified person could not have engaged in the transaction with anyone else, or could have done so, only by incurring severe economic hardship.

3. The Regulations provide a further exception known as the "estate administration exception" which provides flexibility in avoiding self-dealing transactions during the period of administration of an estate or revocable trust if the following conditions are met: (1) the executor, administrator, or trustee must have authority to either sell the property or reallocate it to another beneficiary, or be required to sell the property by the terms of the trust or will; (2) a probate court having jurisdiction over the estate must approve the transaction; (3) the transaction must occur before the estate or trust is terminated; (4) the estate or trust must receive an amount equal to in excess of the fair market value of its interest or expectancy in the property at the time of the transaction, taking into account the terms of any options subject to which the property is acquired by the estate or trust; and (5) the foundation must receive (a) an interest at least as liquid as the one given up, (b) an exempt function asset, or (c) an amount of money equal to that required under an option binding upon the estate or trust.

D. Penalties

Any disqualified person who engages in an act of self-dealing (direct or indirect) is assessed an excise tax of 10% of the amount involved in the transaction for each year that the transaction is uncorrected. In addition, a foundation manager who willingly participates in the act, knowing it is prohibited, is subject to a tax of 5% of the amount involved (not to exceed \$20,000 for each such act) for each year that the transaction is uncorrected. If the transaction is not timely corrected, and the 10% initially assessed timely paid, the disqualified person is subject to being assessed an additional tax of 200% of the amount involved as a second tier tax. Any foundation manager who does not correct the transaction may also be subject to a second tier tax of 50% of the amount involved (up to \$20,000 for each act). If more than one foundation manager is liable under this section, such persons are jointly and severally liable (again, the \$20,000 per act limitation applies). A single person can be responsible for both the self-dealer tax as well as the foundation manager tax. If the self-dealing continues uncorrected, a termination tax under Section 507 of the Code is effectively a third tier tax.¹⁴

Foundation managers may escape liability by showing that full disclosure of the facts of the transaction was made to counsel who provided a reasoned legal opinion and that the foundation manager relied upon that opinion. It should be noted that reliance upon a reasoned legal opinion only serves to show that an act was not "knowing" or "willful," meaning such reliance only protects a foundation manager and not the self-dealer who is subject to the penalty regardless of his knowledge that the act was an act of self-dealing. The first tier tax for self-

¹⁴ Under § 507, the termination tax is the greater of all tax benefits to the foundation and its contributors or all assets of the foundation.

dealing cannot be abated. The second tier tax may be abated if the self-dealer and foundation managers are successful in showing that the act was due to reasonable cause and not willful neglect and has been corrected.

E. Correction

Once it has been determined that an act of self-dealing has taken place, aside from paying the first tier penalty tax, the self-dealing must be corrected. Uncorrected self-dealing leads to a second tier tax as addressed above and, if remaining uncorrected, can ultimately lead to imposition of the termination tax. To correct an act of self-dealing, the self-dealing transaction must be "undone."

Section 4941(e)(iii) provides that the term "correction" and "correct" mean, with respect to any act of self-dealing, undoing the transaction to the extent possible, but in any case placing the private foundation in a financial position not worse than that it which it would be if the disqualified person were dealing under the highest fiduciary standards. The correction required depends upon the nature of the self-dealing transaction. For example, in a self-dealing transaction in which a transfer took place between the foundation and a disqualified person, the transaction should be rescinded. If the transaction is excess compensation, the excess compensation should be returned. Again, however, in each case, the foundation must be put in a position not worse than before the transaction.

III. CASE STUDIES

A. The Grantham Museum is a private operating foundation controlled by the Crawley family which displays various works of art in the town near their home. When the art is not on display, it is kept stored in a climate controlled building paid for by the private operating foundation. Cora Crawley has proposed that the art be placed at their home when not on display, so as to avoid paying extra for the storage.

B. Robert Crawley bequeathed a variety of sculptures to his family foundation. The sculptures will ultimately be moved to a place to be determined by the family foundation to showcase the art in accordance with its purposes. Currently the sculptures are at Downton, a private residence that Robert left to his surviving family. The private foundation inquires whether it is required to immediately move the sculptures or whether it can leave the sculptures at the residence of disqualified persons.

C. The Crawley family personally owns art that is of the type that their family foundation displays in the Grantham Museum. The Crawleys desire to loan the art to the Grantham Museum. They inquire whether they can make the loan and on what terms.

D. Violet Crawley, Robert's mother, created a revocable trust that co-invested with Richard Carlisle, an unrelated third party, in a limited partnership. The revocable trust owned the majority of the limited partnership interest as well as a .5% general partnership interest. Violet Crawley is also the sole trustee of the Violet Foundation, a charitable trust. Upon the death of Violet Crawley, the assets in the revocable trust are to be transferred to the Violet Foundation. Pursuant to the terms of the Violet Foundation Trust Agreement, Carlisle is to become one of three independent trustees upon the death of Violet. As a result of these

transactions, the foundation will be a .5% general partner and 85% limited partner while the foundation trustee (Carlisle) will be the owner of an entity that is a .5% general partner and 14% limited partner. The partnership has been funded over time through a series of partner loans. Can these partner loans continue? Is the structure itself self-dealing?

E. Violet Crawley made a loan to her son, Robert. Robert is continuing to pay on the note at the time of Violet's death. The loan passes as part of the residue of Violet's estate to the Violet Foundation. Does this create a self-dealing problem?

F. The Crawley Foundation (a private foundation) is the sole owner of an entity which owns commercial real estate. Tom Branson, the husband of Sybil Crawley (the daughter of a foundation manager) owns a management company that manages commercial real estate. Can Tom's management company provide management services to the Crawley Foundation controlled owner of the commercial real estate? Is there a difference if Tom's company is an investment management firm?

G. During life, Violet Crawley gifted a limited partnership interest to the Crawley Foundation. Mary, Edith and Sybil Crawley, granddaughters of Violet, control the general partner of the limited partnership. Upon the death of the Violet, the estate lacks liquidity to pay estate taxes and proposes to have the limited partnership loan funds to the estate. Is this permissible?

H. Edith Crawley, a trustee of the Crawley Foundation borrowed \$400,000 from the Foundation at a market rate for personal investment purposes. Upon discovering that self-dealing rules prohibit such a loan, Edith Crawley proposes to correct the self-dealing by transferring real estate (FMV is greater than \$400,000) that she purchased using the "borrowed" funds. Is this permissible?

I. Matthew Crawley serves as a foundation manager of two different private foundations. Private Foundation #2 has insufficient liquidity to meet its minimum distribution requirement. Matthew proposes to cause Private Foundation #1 to make a loan to Private Foundation #2 to allow it to meet its minimum distribution requirement. Is this self-dealing?

J. The Matthew Crawley Foundation owns an entity that owns and operates a series of nursing homes throughout the state. Matthew wishes to place his mother Isabel in one of the nursing homes under the same terms and conditions as is available to the general public. Is this permissible?

K. The Bates Foundation is a grantmaking foundation looking for new revenue streams. Johnny, Jr., the son of the substantial contributor and sole trustee, is a writer looking to author a series of children's books. John, Sr. proposes that The Bates Foundation compensate his son for 15 months to write the first book. Johnny, Jr. will retain all intellectual property, including copyright, but the Bates Foundation will receive 1/3 of royalties (if any) on any books in the series. Is this permissible?

L. Downton Library is a public charity with holdings available to its members, individuals who are holders of doctorates in a specialized field. Downton Library falls below the 10% support threshold and defaults into private foundation status. May the trustees (all holders

of doctorates and otherwise qualifying as members of the organization) continue to use the facilities of the library? Does the answer change if members also have the right to borrow books from the library at no charge?

M. The Crawley Foundation collateralized a loan to Carlisle Industries, an unrelated entity that operates a newspaper, by hypothecating a certificate of deposit in exchange for a fee. While the loan (and the guarantee) remains outstanding, Richard Carlisle, the owner of Carlisle Industries (the obligor) marries one of the board members of the private foundation.

N. The Branson family creates a family foundation through which they seek to undertake grantmaking. The family also owns a family business. It is proposed that the foundation and the family business share the services of Tom, Jr., the son of the substantial contributors, estimating that 75% of son's time will be on family business issues and 25% of son's time will be on foundation issues. The foundation and family business propose to pay Tom, Jr. on this basis (each bearing their percentage share of all employment costs) with a review after each quarter and an adjustment (on a prospective basis) and reconciliation (with respect to past time). Will this avoid self-dealing?

O. Matthew Crawley creates a private foundation. Matthew has other business interests, trusts, and personal interests. Matthew desires to use an investment manager who is a disqualified person, to serve as the investment manager for all of Matthew's business and personal interests, the Foundation, and the personal assets held by members of Matthew's family. Is this permissible?

P. A local hospital engaged in a fundraising campaign and Sybil Branson made a pledge of \$60,000. After making monthly for the first two months on the pledge, Sybil causes the Branson Foundation to make an unrestricted grant to the hospital in the amount of \$50,000. Sybil individually makes no further payments on the pledge. Self-dealing?

Q. Richard Crawley owns a book collection which he would like to make available to the public through the Crawley Foundation. However, Richard would like to recoup the appreciation realized by the collection over the past decade. Richard makes a donation of cash to the foundation so that the foundation can purchase the book collection from him at fair market value. Does this avoid self-dealing?

R. Violet Crawley sits on the board of the Violet Foundation, a private foundation. Violet also serves on the board of the local flower appreciation society, a public charity. Violet encourages the Violet Foundation to make an unrestricted grant to the flower appreciation society for this year's award show. Is this self-dealing? Does the answer change if Violet signed on to raise a specified amount to sit on the board (or to enter the flower show)? What if the money enables Violet to serve as Grand Mistress of the show?

S. The Branson Foundation makes a grant to the flower appreciation society for the awards show which entitles the Branson Foundation to a table at the show. Can Sybil Branson (a substantial contributor) and her mother, Cora, and two sisters, Mary and Edith, sit at the table at the show?

T. The Grantham Museum determines to have its annual board meeting in an exotic

vacation locale. Robert Crawley is on the board but his wife, Cora is not. May the Grantham Museum (a private operating foundation) pay for Robert's travel? Cora's?

IV. PLANNING TO AVOID SELF-DEALING

Because a case of self-dealing can result in significant penalties to the self-dealer, secondary penalties to foundation managers that participate in the act knowing it is prohibited, and potentially a termination tax if the penalties are uncorrected, foundations should plan to avoid self-dealing. Any effort to avoid self-dealing must begin with the ability to recognize the concepts. Being able to "issue spot" self-dealing transactions requires a familiarity with the rules—who are disqualified persons, what are the self-dealing transactions, what exceptions may apply? Foundations should provide their foundation managers with educational materials to drill in these concepts.

Second, foundations should keep track of their disqualified persons. As referenced in Section IIA, disqualified persons do not just include foundation managers. Rather, foundations must review any sources of donations to determine who are substantial contributors and add those individuals to the list of foundation managers. That list should then be expanded to include ancestors and decedents, spouses, and entities, trusts, or estates in which any of those people own more than a 35% interest. Foundations should strive to keep an updated list of disqualified persons for analysis of prohibited transactions, including self-dealing.

In addition to being able to "issue spot" self-dealing transactions and understanding the scope of disqualified persons with respect to the foundation, foundations should consider having appropriate policies to help avoid self-dealing transactions. Form 1023 as well as Form 990-PF include questions regarding whether or not the organization has a conflict of interest policy. While foundations are not required to have a conflict of interest policy, best practice is to have such a policy. The Internal Revenue Service has a form conflict of interest policy in the Instructions to the Form 1023 that the Service represents is an acceptable policy. However, foundations should take care in simply adopting the Service's policy. For example, the Service's conflict of interest policy does not include any provisions regarding self-dealing. While a transaction may satisfy a conflict of interest policy being arm's length and fair to the organization or even favorable to the organization (such as below market rent), that same transaction would violate the self-dealing rules. The definition of "Interested Persons" is not the same as disqualified persons for private foundations. Furthermore, the Service's policy anticipates that there will be disinterested directors who can make a decision in the event of a conflict. However, with respect to a family foundation, there are often no disinterested directors. Therefore, foundations should plan to have alternate procedures in the event there are no disinterested directors (such as having an appointed committee of advisors to consider alternative transactions that comply with the self-dealing rules and are reasonable—for example, reasonable compensation) and should incorporate provisions prohibiting self-dealing transactions (including non-pecuniary transactions that could be self-dealing).

In addition to a conflict of interest policy, foundations may wish to adopt other policies to assist in avoiding self-dealing such as an accountable reimbursement policy (i.e. a policy providing for reimbursement only upon adequate accounting of reasonable expenses incurred on behalf of the foundation or in furtherance of the person's duties to the foundation and

substantiated within a reasonable amount of time). It is also common in such a policy to address the use of foundation credit cards providing that personal expenses shall not be charged to the foundation credit card (thereby avoiding the loaning of foundation funds to a disqualified person).

Depending upon the foundation's activities, the foundation may wish to include other policies covering common instances of self-dealing. For example, the foundation, if it pays compensation, should consider a compensation policy requiring a determination of reasonable compensation by looking at what similarly situated foundations pay for similarly qualified individuals performing similar services. Foundations should take caution in simply relying upon the market survey and understand the data underlying the market survey to assess whether the qualifications and job duties are consistent with the qualifications and job duties described by the foundation. Foundations may wish to utilize employment agreements so as to clearly set out the job description for the individual and the qualifications required. For organizations that share office space, supplies and staff, the foundation should develop a policy that either allows for such sharing only to the extent that the space/supplies/staff are provided free of charge to the foundation or that the space and supplies are paid for separately by the foundation to an independent third party (i.e. separate leases and payment to separate vendors) and the staff is paid for based upon hourly records or a reasoned basis.

Not all self-dealing will fall under one of the categories identified above where a policy can help deal with the situation. In instances in which the foundation desires to enter into a transaction, but the question of whether the transaction is self-dealing is less clear cut, the foundation should consider whether it should obtain a reasoned tax opinion (remembering that such reasoned tax opinions only protect the foundation managers and not the self-dealer) or should seek a private letter ruling from the IRS.