SELF-DEALING—NOT JUST DO NO HARM, JUST DON'T DO IT

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An earlier version of this article appeared in the May/June 2020 issue of Taxation of Exempts.

Private foundations are subject to self-dealing rules that can be difficult to navigate. The difficulties arise, in part, because the self-dealing rules can be violated by transactions that provide a benefit to the foundation. Further, self-dealing transactions can occur even when there is not a direct transaction between the foundation and a related party. This article discusses the self-dealing rules and describes how to avoid potential violations.

Disqualified persons

Self-dealing is any transaction between a foundation and persons that are considered disqualified persons with respect to that private foundation.[1] All substantial contributors to the private foundation are categorized as disqualified persons.[2] In addition, any persons or other organizations that own a greater than 20 percent interest in a corporation, trust, or partnership that is a substantial contributor to a private foundation will also be considered disqualified persons.[3] Furthermore, all of the managers of the private foundation, including the officers, directors, and trustees, are categorized as disqualified persons.[4]

Certain members of the family of a disqualified person are also considered disqualified persons.[5] For this purpose, members of a person's family are limited to the person's spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of their children, grandchildren, and great-grandchildren.[6] Thus, the spouse, children, and parents of a director of a private foundation are disqualified persons with respect to the private foundation, while the brother of a director or substantial contributor of a private foundation would not be a disqualified person on that basis alone.

The disqualified person taint also extends to business entities in which disqualified persons own a greater than 35 percent interest.[7] For example, if a director of a private foundation owns 10 percent of the voting stock in a corporation and a substantial contributor to the foundation owns 26 percent of the voting stock of the same corporation, the corporation would be considered a disqualified person. Because of the fact that a business entity can be considered a disqualified person based solely on its owners, it is crucial for a private foundation to determine whether

disqualified persons own interests in the business entity before entering into a transaction with it.

Prohibited transactions

Self-dealing transactions include any direct or indirect:

- Sale, exchange, or leasing of property between a private foundation and a disqualified person;
- Lending of money or other extension of credit between a private foundation and a disqualified person;
- Furnishing of goods, services, or facilities between a private foundation and a disqualified person;
- Payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;
- Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and
- Agreement by a private foundation to make any payment of money or other property to a federal or state government official.[8]

It is important to note that these transactions are prohibited without regard to whether the foundation is harmed by the transaction. If Google is trading for $1,000 per share, and a disqualified person sells a share of Google stock to a private foundation for $100, the disqualified person has committed a prohibited act of self-dealing.

Exceptions to the self-dealing rules

There are some important transactions that would be self-dealing but are expressly permitted under the statute. For example, a disqualified person of a private foundation can provide facilities or services to the private foundation without charge even though leases between a disqualified person and a private foundation are generally prohibited.[9]

A disqualified person may also lend money to the private foundation without interest or any other charge if the proceeds are used for charitable purposes.[10]

If certain requirements are met, a private foundation is permitted to employ a disqualified person. If the payment of compensation to a disqualified person is with respect to personal services that are reasonable and necessary to carry out the charitable purposes of the foundation and the amount paid is not excessive, there is no self-dealing.[11]

Consequences

Once it has been determined that an act of self-dealing has occurred, the transaction must be corrected by undoing it and placing the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.[12] In general, this requires rescinding the transaction and the disqualified person returning to the private foundation any financial benefit received. The correction cannot make the foundation worse off, however, so if the transaction benefited the private foundation, the private foundation must keep the benefit.

In addition to correcting the self-dealing transaction, the disqualified person generally must pay a tax equal to 10 percent of the self-dealing transaction.[13] If the 10 percent tax is imposed and the act of self-dealing is not corrected, the disqualified person must pay a tax equal to 200 percent of the amount involved.[14] The tax is due for each year that the self-dealing transaction is uncorrected.

Thus, a disqualified person would face $50,000 of initial tax if a $100,000 self-dealing transaction remained outstanding for five years (10 percent of $100,000 times five years). Additional taxes can be imposed on the self-dealer under certain extenuating circumstances.[15]

Any foundation manager who participates in an act of self-dealing between a disqualified person and a private foundation, knowing that it is such an act, generally must pay a tax equal to five percent of the amount involved (not to exceed $20,000) with respect to the act of self-dealing, unless such participation is not willful and is due to reasonable cause.[16] If a foundation manager refuses to agree to part or all of the correction, the foundation manager

must pay a tax equal to 50 percent of the amount involved (not to exceed $20,000).[17] A foundation manager has not participated in a transaction if the manager voted against approval of the transaction.

Furthermore, the IRS can impose the termination tax if the transaction is never corrected. The termination tax applies if a private foundation conducts repeated and willful violations of the self-dealing and other sanctions under the Internal Revenue Code, with the amount of the termination tax being equal to the lower of all tax benefits it and its contributors have ever received or the assets of the private foundation.[18]

Advice of counsel

Private foundation managers can protect themselves from the five percent manager tax if they approved the transaction on the advice of counsel.[19] The advice must be a written opinion with detailed factual and legal analysis.[20] The opinion needs to be obtained by the private foundation managers before they approve the transaction and they must make full disclosure of the factual situation to legal counsel.[21] The advice of counsel does not relieve any disqualified person who participated in a self-dealing transaction of his or her liability for the 10 percent tax.

SELF-DEALING SITUATIONS FACED BY PRIVATE FOUNDATIONS

The types of acts that can be considered self-dealing are broad, and the exceptions can operate in counterintuitive ways. A better understanding of the self-dealing rules comes from looking at their application to a variety of different situations that may arise.

Sale or exchange of property

A disqualified person cannot buy property from the private foundation or sell property to the private foundation. A gift of property that is subject to a debt generally is treated as a sale and thus is self-dealing. There is a narrow exception, however, for a gift of property that is subject to debt that has been on the property for more than 10 years.[22] Under these rules, a disqualified person, for example, commits an act of self-dealing by donating to a private foundation an insurance policy subject to a policy loan that was placed on the policy within 10 years, even if the death benefit will satisfy the loan.[23]

Another exception to the prohibitions on a sale or exchange of property is a corporate redemption.[24] If a private foundation owns stock in a corporation that is a disqualified person, the corporation can redeem (i.e., purchase with corporate funds) the private foundation's stock subject to certain requirements. The private foundation must be paid the fair market value of its stock.[25] Further, the redemption must be offered on the same terms to the other holders of the same class of stock as the private foundation.[26]

Naming rights

A private foundation can make a grant that provides recognition of a disqualified person. For example, it is not an act of self-dealing for a private foundation to make a grant to a charity that names a building after a disqualified person.[27]

Pledges

A private foundation cannot satisfy a pledge that a disqualified person has made to another charity because doing so satisfies a legal obligation of the disqualified person.[28] Not all written gift agreements are enforceable pledges, however. A private foundation can make a payment that is applied to a disqualified person's non-binding letter of intent without engaging in an act of self-dealing.

Generally, for an agreement to make a charitable gift to be enforceable, the charity must either provide some consideration to the donor (such as naming) or take some action in reliance on the gift commitment (such as commencing construction of a building).[29] Signing an enforceable pledge to make a gift to a private foundation is not an act of self-dealing as long as the pledge does not become delinquent.[30]

Board service

It is permissible for a private foundation to make a grant to a charity where a disqualified person serves

on the board. It is advisable, though, that the disqualified person makes his or her position known to the private foundation board and that the disqualified person abstain from voting to approve the grant.[31]

Trading activities

It is an act of self-dealing for a private foundation to engage in trading in a public market to impact the price of a security to benefit a disqualified person who also is trading in the market.[32]

Using foundation assets for the benefit of disqualified persons

A disqualified person cannot use the private foundation's assets to enter into transactions with non-disqualified persons that have an ultimate benefit to the disqualified person. A lawyer who was the sole trustee of a private foundation engaged in self-dealing when he made loans to disqualified persons for the purpose of enhancing his own reputation.[33]

Loans to disqualified persons

It is an act of self-dealing for a private foundation to make a loan to a disqualified person.[34] This rule can be violated if a person makes a loan to a disqualified person and then gives that loan receivable to the private foundation.[35] The IRS has, however, issued two favorable rulings where an LLC held a note from a disqualified person, and non-voting units in the LLC were donated to the private foundation. The fact that the private foundation could not exercise any control over the LLC since it was manager managed, and the private foundation had no say in who was a manager, meant that there was no direct or indirect self-dealing.[36]

Gala tickets

A private foundation cannot pay for the deductible portion of a gala ticket and have the disqualified person pay for the non-deductible goods and services.[37] It may be permissible, however, for the private foundation to pay for the entire cost of a gala ticket and have foundation representatives attend the event on the foundation's behalf. The tickets, however, cannot be used for relatives of a disqualified person who have no role with the private foundation.

Sharing office space

A private foundation cannot lease or sub-lease office space from a disqualified person unless it is free of charge.[38] If utilities or janitorial services are provided by a third party, the foundation can pay its share of those costs if the payment is made directly to the third party and not to the disqualified person.[39] If a private foundation is using space within a disqualified person's office and the third party landlord will enter into a lease directly with the foundation, the lease payment by the foundation to the landlord is not an act of self-dealing.

A disqualified person cannot lease office space from a private foundation on any basis. This can be problematic for a private foundation that has large real estate holdings and a large community board. If the spouse of the grandchild of one of the directors is a 35 percent owner of a firm that leases space from the private foundation in one of its buildings, an act of self-dealing has occurred.

Sharing employees

It is permissible for a private foundation to share employees who perform personal services necessary for the exempt purposes with a disqualified person. For example, an employee may devote one-half of their time to a private foundation for exempt purpose activities and one-half of their time to working for a disqualified person. The disqualified person can be reimbursed by the private foundation for one-half of the direct out-of-pocket costs for salary and benefits like health insurance and retirement of the employee. The arrangement must be structured so the private foundation does not pay for any time that the employee is working on activities unrelated to the private foundation. These arrangements can give the private foundation employees access to better benefits that often come when a larger pool of employees is employed by the disqualified person.

Works of art

It is not uncommon for creators of private foundations to have substantial art collections. Interactions between the disqualified person and the private foundation regarding the art can raise self-dealing issues. It would seem a loan of art free of charge by a disqualified person to a private foundation would not raise issues, but because storing and insuring art is costly, that is not always the case. The IRS ruled it was not self-dealing for a disqualified person to loan art to a private foundation museum if the disqualified person paid for any insurance of the art and paid to pack and transport to and from the museum. The IRS ruled that the museum was displaying or otherwise using the art to carry out its exempt purpose and that the art would impose no costs on the museum.[40]

In another situation, a private foundation that owned art was allowed to display the art in public areas of a shopping mall owned by a disqualified person. The private foundation had a relationship with a museum that could not display all of the art owned by the foundation, and the shopping mall display promoted the museum. The shopping mall did not use the presence of the art for its own commercial promotion.[41]

But, as they say on television, do not try this at home. The IRS held that a private foundation could not allow its art to be hung in the home of a disqualified person even when several public tours of the home were conducted annually so that thousands of members of the public could see the art.[42]

A final note on art: If a disqualified person gifts art to a foundation (as opposed to just making a loan of the art), the disqualified person probably is not going to be able to get it back without engaging in an act of self-dealing. Even if the disqualified person is the high bidder at a public auction, the sale of the private foundation's art to the disqualified person is an act of self-dealing.[43]

Furnishing goods or services

Generally, a private foundation cannot furnish goods or services to a disqualified person and vice-versa. The disqualified person, however, can provide goods or services free of charge to the private foundation to use for its exempt purposes.[44] The private foundation also can provide goods or services to a disqualified person if done on a basis no more favorable than that which the private foundation makes the goods or services available to the general public.[45] For this exception to apply, the number of members of the public using the goods or services must be substantial compared to the number of disqualified persons.[46] Thus, a private foundation museum can admit a disqualified person for the same fee it charges the general public. A sale of a single asset, like a work of art, to a disqualified person would not meet the exception, even if the art was offered to the general public for purchase.[47] If a foundation makes a road on its property available to the public free of charge, a disqualified person can use the road to access the disqualified person's property when the road is open to the public.[48]

Banking

A disqualified person can provide banking and investment services for a private foundation.[49] Banking services include investment management services.[50]

Estate administration exception

If an individual leaves a gift to a private foundation in his or her estate, it is not unusual to find a potential self-dealing relationship could also be passing to the private foundation. During the donor's lifetime, it was fine that the donor's daughter leased office space from the donor. When the building passed to a private foundation, however, the arrangement was no longer acceptable. Also, the private foundation often is better off not owning certain assets of the donor's, like a minority interest in a business entity or real estate, because sometimes the best, or only, buyer for such assets may be a disqualified person. To address these issues, the regulations provide that a donor's estate may engage in transactions with disqualified persons that would otherwise be self-dealing transactions if several conditions are met. The conditions are:

- The estate administrator must have a power of sale, a power to allocate the property away from the foundation, or be subject to an enforceable option requiring a sale.
- The transaction must give the foundation at least the fair market value for its interest.
- The transaction must be completed before the estate is closed for income tax purposes.
- The transaction must be approved by a court in a proceeding to which the Attorney General is a party.
- The foundation must receive an interest at least as liquid as what it gave up, and must receive property it uses in its exempt purpose or receive payment under an enforceable option.[51]

The IRS has issued private letter rulings that allow the use of a promissory note to purchase a closely held business interest from an estate with the private foundation receiving and holding the note after the estate is closed.[52] The IRS currently has a no-rule policy with respect to the estate administration exception and promissory notes.[53]

The estate administration exception applies to an administration of a revocable trust after the death of the grantor.[54] The IRS has ruled that the exception also applies after the death of a spouse for a qualified terminable interest property trust.[55]

Indemnification and insurance

A private foundation may indemnify a disqualified person who is a foundation manager against expenses, including attorneys' fees, judgments, and settlement expenditures, if the expenses are reasonably incurred and the manager has not acted willfully and without reasonable cause with respect to the act or failure to act which led to such proceeding or liability.[56] The private foundation may pay for premiums for insurance to cover such costs.[57]

However, the foundation may not indemnify a disqualified person who is a foundation manager from taxes, including self-dealing taxes, penalties, or expenses of correction. A private foundation, though, may indemnify a manager for such costs or expenses not reasonably incurred by the manager if the payment is treated as compensation to the manager and does not result in the manager receiving more than reasonable compensation.[58] If the private foundation purchases insurance for such costs, the premiums must be included in the manager's compensation which, again, cannot be more than reasonable compensation.[59]

Indirect self-dealing prohibited

A private foundation cannot use a controlled intermediary to engage in an act of self-dealing. The self-dealing rules also extend to transactions with third parties that provide a benefit to a disqualified person.[60] Therefore, a private foundation cannot condition a grant to a charity on a requirement that the grantee purchases goods or services from a disqualified person. This is considered self-dealing because the corporation benefits from the imposition of the restriction. Similarly, if a foundation controls another for-profit or non-profit entity, it cannot use that entity to engage in a self-dealing transaction.[61]

It is not an act of self-dealing, however, if the private foundation makes a grant to another charity that the foundation does not control and the charity independently enters into a transaction without restrictions with a disqualified person.[62] For example, it was not an act of self-dealing for a private foundation to make a grant to a school where the independent board of the school decided to use the grant to repay a loan from a disqualified person.[63]

The state attorney general

The attorney general of the state in which a private foundation operates may take additional actions beyond any taxes imposed by the IRS for acts of self-dealing. For example, the New York attorney general has taken action against the Donald J. Trump Foundation requiring restitution of misused funds, dissolution of the foundation, and imposing restrictions on future activities.[64] Attorney general action is more likely when the act of self-dealing was detrimental to the private foundation. But the attorney general may hold private foundation managers

liable for legal and accounting costs related to an act of self-dealing and may object to reimbursements for taxes and penalties even in situations in which the IRS would allow such payments.

CONCLUSION

The consequences of an act of self-dealing can be costly for the disqualified person and any managers that approve the transaction. The costs get multiplied if the transaction is not identified for several years. Given the complexity of the rules and the sometimes unpredictable changes in the IRS's application of the rules, private foundation managers should familiarize themselves with the situations that might implicate the self-dealing rules. Once a situation is identified, the private foundation is best served by seeking professional guidance from lawyers or accountants who regularly advise on the rules.

Generally, for the foundation managers, the advice of counsel will protect them from the imposition of a tax even if a transaction is later determined to be an act of self-dealing. Counsel will be able to advise whether the situation fits into one of the exceptions to the rules or how to adjust the transaction to fit into the rules, if possible. Otherwise, if the proposed transaction is an act of self-dealing, a call for advice may save substantial taxation and grief for the disqualified person and the private foundation managers.

Notes

1 As discussed below, the self-dealing rules also apply to agreements by a private foundation to make any payment of money or other property to U.S. government or state official.

2 I.R.C. § 4946(a)(1)(A). A "substantial contributor" is defined as anyone that contributed or bequeathed an aggregate amount of more than $5,000 to a private foundation if such amount is more than two percent of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person. I.R.C. § 507(d)(2)(A) (incorporated by I.R.C.§ 4946(a)(2)).

3 I.R.C. § 4946(a)(1)(C).

4 I.R.C. § 4946(a)(1)(B).

5 I.R.C. § 4946(a)(1)(D).

6 I.R.C. § 4946(d).

7 I.R.C. § 4946(a)(1)(E), (F), (G). With respect to corporations, the rule applies if disqualified persons own more than 35 percent of the total combined voting power of the corporation. I.R.C. § 4946(a)(1)(E). With respect to partnerships (or limited liability companies, which are generally treated as partnerships for tax purposes), the rule applies if disqualified persons own more than 35 percent of the profits interests. I.R.C. § 4946(a)(1)(F). With respect to trusts, the rule applies if disqualified persons own more than 35 percent of the beneficial interest in the trust. I.R.C. § 4946(a)(1)(G).

8 I.R.C. § 4941(d)(1).

9 Treas. Reg. § 53.4941(d)-2(b)(2).

10 I.R.C. § 4941(d)(2)(B).

11 I.R.C. § 4941(d)(2)(E).

12 I.R.C. § 4941(e)(3); Treas. Reg. § 53.4941(e)-1(c)(1).

13 I.R.C. § 4941(a)(1).

14 I.R.C. § 4941(b)(1).

15 I.R.C. § 6684.

16 I.R.C. § 4941(a)(2).

17 I.R.C. § 4941(b)(2).

18 I.R.C. § 507.

19 Treas. Reg. § 53.4941(a)-1(b)(6).

20 Id.

21 Id.

22 I.R.C. § 4941(d)(2)(A).

23 Rev. Rul. 80-132, 1980-1 CB 255.

24 I.R.C. § 4941(d)(2)(F).

25 Treas. Reg. § 53.4941(d)-3(d)(1).

26 Id.

27 Treas. Reg. § 53.4941(d)-2(f)(2).

28 Treas. Reg. § 53.4941(d)-2(f).

29 Enforcement is determined under local law, so requirements vary in different states.

30 Treas. Reg. § 53.4941(d)-2(c)(3).

31 However, it is not permitted for a private foundation to make a grant to a supporting organization controlled by disqualified persons. See I.R.C. § 4943(f)(3)(B).

32 Treas. Reg. § 53.4941(d)-2(f)(1).

33 Tech. Adv. Mem. 8719004.

34 Treas. Reg. § 53.4941(d)-2(c).

35 Id.

36 Priv. Ltr. Ruls. 201723005 and 201723006.

37 Priv. Ltr. Rul. 9021066; see Notice 2017-73.

38 Treas. Reg. § 53.4941(d)-2(b).

39 Id.

40 Priv. Ltr. Rul. 201423032.

41 Priv. Ltr. Rul. 201029039.
42 Rev. Rul. 74-600, 1974-2 CB 385.
43 Rev. Rul. 76-18, 1976-1 CB 355.
44 I.R.C. § 4941(d)(2)(C).
45 I.R.C. § 4941(d)(2)(D).
46 Treas. Reg. § 53.4941(d)-3(b)(2).
47 Rev. Rul. 76-18, 1976-1 CB 355.
48 Rev. Rul. 76-459, 1976-2 CB 369.
49 Treas. Reg. § 53.4941(d)-2(c)(4).
50 Priv. Ltr. Rul. 9535043.
51 Treas. Reg. § 53.4941(d)-1(b)(3).
52 See, e.g., Priv. Ltr. Rul. 201129049.
53 Rev. Proc. 2011-4, 2011-1 IRB 123, § 6.19.
54 Treas. Reg. § 53.4941(d)-1(b)(3).
55 Priv. Ltr. Rul. 201831009.
56 Treas. Reg. § 53.4941(d)-2(f)(3)(i).
57 Treas. Reg. § 53.4941(d)-2(f)(3)(ii).
58 Treas. Reg. § 53.4941(d)-2(f)(4)(i).
59 Treas. Reg. § 53.4941(d)-2(f)(4)(ii).
60 I.R.C. § 4941(d)(1)(E).
61 Treas. Reg. § 53.4941(d)-1(b)(1).
62 Treas. Reg. § 53.4941(d)-1(b)(2).
63 Priv. Ltr. Rul. 200443045.
64 See https://ag.ny.gov/press-release/2019/ag-james-secures-court-order-against-donald-j-trump-trump-children-and-trump/.