Understanding The Self-Dealing Rules

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I. Brief History of the Private Foundation Excise Taxes.

A. Prior Law. Prior to enactment of the Tax Reform Act of 1969, the Internal Revenue Code (the "Code") did not distinguish between public charities and private foundations. All tax-exempt charitable organizations were prohibited from engaging in specific acts with individuals who are now considered to be disqualified persons. An arm's-length test was used to gauge the propriety of loans, payment of compensation, purchase transactions and use of the assets of the tax-exempt organization. The principal sanction for violation of these rules was the loss of the organization's tax-exempt status.

B. Tax Reform Act of 1969. For the first time, the concept of a private foundation as a separate class of tax-exempt charitable organizations was introduced into the Code as part of the sweeping 1969 tax reforms affecting tax exempt organizations and charitable giving. In addressing restricted or prohibited conduct by private foundations, Congress determined that the arm's-length standard under prior law required an unreasonable amount of enforcement resources and produced unpredictable results. The self-dealing rules, along with the other private foundation excise tax rules, represented an effort to replace an ambiguous standard with an outright prohibition on certain types of activity, and to devise sanctions (in the form of excise taxes) that would discourage the prohibited conduct without requiring the ultimate sanction of the loss of tax-exempt status.

II. Application of the Self-Dealing Rules to Charitable Trusts.

A. Charitable Remainder Trusts. Code Section 4947(a)(2) applies the self-dealing rules contained in Code Section 4941 to split-interest trusts. These trusts include charitable remainder trusts (CRTs).

B. Charitable Lead Trusts. Also included within the Code Section 4947(a)(2) definition of split-interest trusts are charitable lead trusts (CLTs). They are also subject to the self-dealing rules.

III. Three Elements of Self-Dealing.

A. Private Foundation. For this purpose, CRTs and CLTs are treated as private foundations (PFs).

B. Disqualified Person. A disqualified person (DP) is a person or entity that has a specifically defined relationship with the PF. See the discussion in Section IV below.

C. Self-Dealing Transaction. The act in question must be described in Code Section 4941 and the Regulations thereunder. See the discussion in Section V below.

IV. Disqualified Persons.

A. Substantial Contributors -- Code Section 4946(a)(1)(A).

1. Any person who contributed or bequeathed more than $5,000 to the PF, if that amount is more than 2% of total contributions and bequests received by the PF up to that point.

2. The creator of a CRT or a CLT is a DP. Treas. Reg. § 1.507-6(a)(1).

3. Prior to enactment of the 1984 Tax Reform Act, once a person became a substantial contributor, he or she retained that status forever, even if he or she might not be so classified if the determination was made at some later date. The 1984 Tax Reform Act changed this rule. Now, pursuant to Code Section 507(d)(2)(C), a substantial contributor can eliminate this "taint" by meeting EACH of the following three requirements.

a. The contributor must not make any contribution to the foundation for 10 years.

b. The contributor must not be a foundation manager of the foundation during the 10-year period.

c. The contributor's aggregate donations to the foundation are determined by the IRS to be insignificant when compared to the aggregate contributions of one other person with appreciation on contributions taken into account. Aggregate contributions are considered to be insignificant in comparison to the contributions of one other person if they are less than 1% of the contributions made by the other person - adjusted for growth.

Example. Donor A contributes $25,000 to the XYZ Foundation soon after it was created and more than 10 years ago. At that time the XYZ Foundation had received total contributions from all sources of $1 million. Donor A, therefore, is a substantial contributor. Donor A made no further contributions to XYZ Foundation which has since received contributions from Donor B in the amount of $5 million. On April 1, Donor A sells stock with a value of $100,000 to XYZ Foundation for $50,000. Assuming that Donor A hasn't contributed to the Foundation for more than 10 years, Donor A hasn't been a foundation manager during the 10-year period, and Donor A has made aggregate contribution to XYZ of less than 1% (½ of 1%) of Donor B's contributions, Donor A's status as a substantial contributor will terminate at the beginning, *i.e.* January 1, of the 11th year. As a result, Donor A should not be a disqualified person as of January 1 of year 11 and this bargain sale should not be a self-dealing transaction.

B. Foundation Managers -- Code Section 4946(a)(1)(B). An officer, director or trustee of a private foundation and a trustee of a CRT or a CLT are DPs.

C. 20% Owners -- Code Section 4946(a)(1)(C). The owner of more than 20% of a corporation, partnership or trust which is a DP is also a DP.

D. Family Members -- Code Section 4946(a)(1)(D). A member of the family of a substantial contributor, a foundation manager or a 20% owner is a DP. For this purpose, members of the family include the individual's spouse, ancestors, children, grandchildren, great grandchildren and the spouses of children, grandchildren and great grandchildren. Code Section 4946(d). Note that siblings are <u>not</u> included.

E. Corporations and Other Entities -- Code Section 4946(a)(1)(E),(F) and (G). Corporations and partnerships are DPs if more than 35% of the voting power or profits interest is owned by DPs. A trust or estate will be a DP if more than 35% of the beneficial interests are owned by DPs. It is generally safe to assume that an income beneficiary of a CRT is a DP.

F. Government Officials -- Code Section 4946(a)(1)(I).

G. Exceptions and Special Rules.

1. For purposes of the self-dealing rules, DPs do not include any charitable organizations. Treas. Reg. § 53.4946-1(a)(8).

2. For purposes of determining the voting power of a corporation, profits interest of a partnership and beneficial interest in an estate or trust, ownership attribution rules apply. Code Section 4946(a)(3) and (4).

3. A DP participates in an act of self-dealing, and is thus exposed to liability for the tax, if he or she takes part in the transaction, alone or with others, or directs any person to do so.

4. Participation includes silence or inaction of a foundation manager, as well as his or her affirmative acts. A manager has not participated when he or she has opposed the act in a manner consistent with fulfillment of his or her foundation responsibilities.

V. Self-Dealing Transactions.

A. Sale or Exchange of Property -- Code Section 4941(d)(1)(A).

1. Any sale or exchange of property between a DP and a PF is self-dealing. As with most of the defined categories of self-dealing, sales or exchanges of property are absolutely prohibited, rather than being judged by an arm's-length standard or eligible for a *de minimis* exception.

2. The transfer of property by a DP to a PF is treated as a sale or exchange if the PF assumes a mortgage or takes subject to a mortgage which was placed on the property within the 10-year period ending on the date of the transfer of the property to the PF. Treas. Reg. § 53.4941(d)-2(a)(2).

B. Leasing of Property -- Code Section 4941(d)(1)(A).

1. In general, any lease of property between a DP and a PF is self-dealing.

2. A lease of property by a DP to a PF without charge is not self-dealing. Treas. Reg. § 53.4941(d)-2(b)(2).

C. Extension of Credit -- Code Section 4941(d)(1)(B).

1. Generally, any extension of credit between a DP and a PF is self-dealing.

2. A loan without interest by a DP to a PF is not an act of self-dealing if the proceeds of the loan are used exclusively for purposes described in Code Section 501(c)(3). Code Section 4941(d)(2)(B).

3. An act of self-dealing occurs where a third party purchases property and assumes a mortgage, the mortgagee of which is a PF, and subsequently the third party transfers the property to a

DP who either assumes the liability under the mortgage or takes the property subject to the mortgage. Treas. Reg. § 53.4941(d)-2(c)(1).

4. An act of self-dealing occurs where a note, the obligor of which is a DP, is transferred by a third party to a PF which becomes the creditor under the note. Treas. Reg. § 53.4941(d)-2(c)(1).

D. Furnishing of Goods, Services or Facilities -- Code Section 4941(d)(1)(C).

1. The general rule is that furnishing of goods, services or facilities between a PF and a DP is self-dealing.

2. If the goods, services or facilities are furnished by a DP to the PF, self-dealing will not result if furnished without charge and used exclusively for Code Section 501(c)(3) purposes. Code Section 4941(d)(2)(C).

3. If these are furnished by the PF to a DP, it would not be self-dealing if furnished on a basis no more favorable than made available to the general public. Code Section 4941(d)(2)(D).

E. Payment of Compensation by a Private Foundation to a Disqualified Person -- Code Section 4941(d)(1)(D).

1. In general, the payment of compensation (or payment or reimbursement of expenses) by a PF to a DP is self-dealing.

2. Except for government officials, payment of compensation by a PF to a DP for personal services which are reasonable and necessary to carry out the exempt purposes of the PF is not self-dealing if the compensation is not excessive. Code Section 4941(d)(2)(E). The Regulations take a broad view of what services are reasonable and necessary to carry out the exempt purpose of the PF. Favorable examples include investment counseling services and legal services performed for PFs by DPs. Treas. Reg. § 53.4941(d)-3(c)(2), Example 2.

F. Transfer to, or Use by, a Disqualified Person of the Income or Assets of a Private Foundation - Code Section 4941(d)(1)(E).

1. Common Investment Situations.

a. The guarantee or indemnification by a PF of a loan made by a third party to a DP is an act of self-dealing. Treas. Reg. § 53.4941(d)-2(f)(1).

b. The purchase or sale of securities by a PF is self-dealing if the purchase or sale is made in an attempt to manipulate the price of the securities to the advantage of a DP. Treas. Reg. § 53.4941(d)-2(f)(1). On the other hand, if the DP owns the same class of securities or partnership interests as that owned by the PF, with the same voting and liquidation rights, this by itself should not be self-dealing. To be safe, it is best if the DP and the PF buy and sell their interests at the same time, to avoid any inference that the transaction by the PF is manipulating the price in a way that benefits the DP.

2. Co-Tenancy and Other Forms of Co-Ownership. GCM 39770 (1988) and PLR 9114025 created concern that co-ownership of property between a private foundation and a disqualified person could be self-dealing under Code Section 4941(d)(1)(E). This view, if correct, would have a negative impact on the popular strategy of dealing with a CRT to be funded with encumbered property by having the donor transfer a partial interest in the property to the CRT while retaining a partial

interest and indemnifying the CRT against any liability on the debt. To minimize the risk of self-dealing in this situation, the donor should enter into a written co-tenancy agreement with the trustee of the CRT in which the indemnity is documented and in which the donor/DP is prohibited from using the partial interest in the property which is held by the CRT.

3. CRT Funded With a Residence. More than one gift planning expert has observed that "you can't live in your CRT", meaning that if a CRT is funded with a residence, the use of the residence by the donor (*e.g.*, pending sale of the house) is self-dealing. Contrary to oft-repeated myth, there is no *de minimis* exception to this rule. For this reason, a residence is only an appropriate asset to be used to fund a CRT if the donor is prepared to move out *immediately*.

G. Exceptions and Special Rules.

1. Charitable Organizations. As noted above, for purposes of self-dealing rules, DPs do not include any charitable organization. For this reason, none of the acts or transactions described above will be self-dealing if the party involved with the PF or CRT is a charitable organization.

Example: A donor owns real property adjacent to a hospital campus which the hospital would like to acquire. The parties would like to use the property to fund a charitable remainder trust to provide income to the donor for his life with the remainder to the hospital. The hospital agrees to serve as trustee of the trust, and plans to purchase the real property from the trust. Even though the hospital would generally be a DP of the CRT due to its status as a "foundation manager", it is not treated as a DP for purposes of the self-dealing rules and, therefore, no self-dealing transaction will result from this plan.

VI. Indirect Self-Dealing.

A. Generally. A self-dealing transaction between a DP and an organization controlled by a PF is indirect self-dealing.

Example: A CRT owns a majority interest in a corporation which, in turn, owns and operates several apartment buildings. One of the apartments is occupied by the son of a substantial contributor. The son is a DP (because his dad is a substantial contributor). Therefore, the son's use of the apartment is an act of indirect self-dealing, even if the son pays rent to the corporation.

B. Control Tests -- Treas. Reg. § 53.4941(d)-1(b)(5). An organization is controlled by the PF if the PF, or one or more of its foundation managers, may require the organization to engage in a transaction which, if engaged in directly by the PF, would constitute self-dealing. An organization may also be treated as controlled by the PF in the case of a transaction between the organization and a DP if the DP, together with one or more persons who are also DPs due to their relationship with the DP, may require the organization to engage in the transaction.

1. Note that the controlled organization need not be a tax-exempt organization.

C. Exceptions and Special Rules.

1. Certain retail transactions with controlled entities involving $5,000 or less are exempt from the indirect self-dealing rules.

2. Any transaction in which the PF could have engaged directly, under the general self-dealing rules, will not be indirect self-dealing. For example, a controlled organization may pay reasonable compensation to a DP for personal services rendered.

3. A transaction with a controlled organization will not be an act of indirect self-dealing if:

a. The transaction results from a preexisting business relationship;

b. The transaction was at least as favorable to the controlled organization as an arms-length transaction with an unrelated party, and

c. Either:

(1) The controlled organization could have engaged in the transaction with someone other than the DP only at a severe economic hardship to the controlled organization, or

(2) Because of the unique nature of the product or services provided by the controlled organization, the DP could not have engaged in the transaction with anyone else. Treas. Reg. § 53.4941(d)-(1)(b)(1).

VII. Penalties.

A. Calculation of Penalties. The penalties for violating the self-dealing rules were increased by the Pension Protection Act of 2006.

1. Amount Involved -- Code Section 4941(e)(2). The taxes described below are imposed on the "amount involved" in the self-dealing transaction. Generally, this is the greater of the money or fair market value of other property given or the money or value of other property received.

a. For compensation paid to DPs (other than government officials), the amount involved is only the compensation in excess of that which would be reasonable, *i.e.*, the excessive portion.

b. When the use of property is involved, the amount involved is the greater of the payment or FMV for its use. For property, the FMV for its use is its rental value, and for money it is the interest that would reasonably be charged or earned in the circumstances.

Example: A DP borrows $100,000 from PF at 6% interest. The market rate for this type of loan is 10%. Six months later, DP repays the loan of $100,000 principal plus $3,000 interest (6% for ½ year). The amount involved with respect to the act of self-dealing is $5,000 (10% interest for ½ year).

2. Initial Tax.

a. Disqualified Person. Imposed at 10% of the amount involved for each year (or part thereof) in the taxable period (which begins on the date the transaction occurs and ends on the earliest of the date of mailing by the IRS of a notice of deficiency with respect to the initial tax, the date the initial tax is assessed or the date when correction of the transaction is completed). The initial tax may be imposed on a DP who had no knowledge at the time that the act was one of self-dealing.

b. Foundation Manager. Imposed at the rate of 5% of the amount involved on a foundation manager (*e.g.*, a trustee) who knowingly participates in the act of self-dealing. The tax paid by the foundation manager may not exceed $20,000.

3. Additional Tax.

a. Disqualified Person. If the initial tax is imposed, and the self-dealing act is not timely corrected, an additional tax in the amount of 200% of the amount involved is imposed. This tax must be paid by the DP who participated in the act of self-dealing. The additional tax is abated if the self-dealing act is corrected during the correction period, which ends 90 days after a deficiency notice for the additional tax is mailed.

b. Foundation Manager. An additional tax of 50% of the amount involved, up to $20,000, is imposed on a foundation manager who refuses to agree to part or all of the correction.

B. Correction. An act of self-dealing is corrected by undoing the transaction to the extent possible, but in any case placing the PF in a financial position no worse than that in which it would be if the DP was dealing under the highest fiduciary standards. Code Section 4941(e)(3).

Example: A DP is the son of the donor that funded a CRT with stock in a closely held family business. In 2014, the DP purchased the stock from the CRT for $1 million. In 2015, the DP sold the stock for $1,800,000. In anticipation of an IRS examination, DP wishes to correct the act of self-dealing in 2016, when the stock is worth $2,400,000. DP must pay the CRT $1,400,000 ($2,400,000, the fair market value at the time of correction, less $1,000,000, the amount which would have been returned to DP if rescission had been required).

1. Sale of Property. If the act of self-dealing is a sale of property by a PF to a DP for cash, a correction of the transaction would be a rescission of the sale, return of the cash to the PF and payment to the PF of any net profits realized from the property by the DP.

2. Use of Assets. In the case of a use of assets by a DP, a correction would be the termination of the use of the property and payment by the DP of the FMV for use of the property (or the excess of FMV for use of the property over the amount actually paid to the PF for use of the property).

3. Excess Compensation. Undoing the transaction requires the DP to pay to the foundation any compensation which is excessive. Termination of the employment (or independent contractor) relationship is not required. Treas. Reg. § 53.4941(e)-1(c)(6).

4. Correction is Not Self-Dealing. Action taken in the manner described in the Regulations to correct an act of self-dealing shall not by itself constitute a further act of self-dealing. Treas. Reg. § 53.4941(e)-1(c)(1). However, care must be taken in correcting acts of self-dealing:

Example: A DP intended to correct a self-dealing transaction in the form of a loan to the DP from a PF. The DP proposed to transfer to the PF a parcel of real estate with an FMV equal to the amount of the loan. The IRS has held that the transfer of property to the PF would constitute self-dealing since the DP's debt to the PF would be cancelled and the transaction would be treated as a sale of the property by the DP to the PF. The IRS further held that the minimum standard for correction would not be met because the PF would be left in a less advantageous situation, with property, than it would be if the loan were repaid with cash. Thus, the proposed correction was by itself an act of self-dealing. The IRS noted, however, that a transfer of property might be an acceptable correction of a self-dealing loan if the property had substantially appreciated in value and could be easily converted into an amount of cash in excess of the debt and accrued interest. See, Rev. Rul. 81-40, 1981-1 CB 508.