

# Avoiding Conflicts of Interest and Self-Dealing for Family Foundation Boards

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*Federal law regarding conflicts of interest and self-dealing at foundations can be complex and confusing. Family foundation boards that are eager to comply with both the letter and spirit of the law should understand the legal definition of “disqualified persons” as well as the variety of rules for certain regulated activities. These rules prohibit the trustees themselves, certain family members, managers, and other “disqualified persons” from benefiting from the philanthropic activities of the foundation. Although far-reaching and pervasive, the rules do permit certain activities, such as purchasing investment services from a disqualified person for a fair price. The rules discourage most other business and financial dealings between a private foundation and its disqualified persons, no matter how fair or reasonable. When in doubt, prudent trustees should always consult legal counsel.*

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Federal law imposes a penalty tax on any disqualified person or foundation manager who engages in an act of self-dealing with a private foundation. Initially, the penalty is a tax of 10 percent of the amount involved and is levied against each disqualified person who is a party to the act of self-dealing—an additional tax of 5 percent of that amount can also be levied against the foundation manager. If the act of self-dealing is not corrected within an appropriate time period, however, an additional tax of 200 percent of the amount involved can be levied on the self-dealer, and an additional tax of 50 percent can be imposed on the foundation manager.

What is self-dealing? Who is a disqualified person? This new *Passages Issue Brief* is the latest in the National Center’s growing library of resource designed to help families pursue high practice in their philanthropic

endeavors. This Issue Brief includes a detailed history and descriptions of the self-dealing rules, with a particular focus on self-dealing as it relates to managing a foundation’s investments. The paper also features a collection of short vignettes on common questions and a one-page referral checklist for board members and staff.

## WHAT IS SELF-DEALING?

Self-dealing is defined to include almost all business and financial transactions between a private foundation and its “disqualified persons”—a broad category of foundation “insiders” that includes contributors to the foundation, its trustees and managers, and certain public officials. (See box for a full definition of disqualified persons.) Whether they occur directly or indirectly, the categories of transactions described below are treated as self-dealing. Federal tax laws prohibit both



indirect and direct self-dealing to prevent end runs around prohibited acts—that is, to prevent transactions that could not be accomplished directly between a private foundation and a disqualified person from taking place indirectly. Indirect self-dealing generally involves transactions between a disqualified person and an organization controlled by a private foundation. A disqualified person cannot sell or lease property to an organization controlled by a private foundation for the same reason that a disqualified person cannot sell or lease property to a private foundation.

### **The History of the Self-Dealing Rules**

The federal government established rules against self-dealing to prevent insiders and others in positions to control or otherwise influence the affairs of private foundations from benefiting improperly from business or financial dealings with those foundations. In general, rules against self-dealing prohibit the following transactions between private foundations and their disqualified persons:

- The sale, exchange, or lease of property;
- The loan of money or extension of credit;
- The furnishing of goods, services, or facilities;
- Compensation or payment of expenses by the private foundation to a disqualified person;
- The transfer to, or use by or for the benefit of, a disqualified person, of foundation income or assets; and
- Payments to government officials.

Congress enacted these rules with the Tax Reform Act of 1969 after concluding that trying to discourage self-dealing through the application of subjective arm's-length standards did not work. Under the previously existing prohibited transaction rules, determining what was fair and reasonable required too much enforcement effort and proved largely impractical and ineffective. As a result, current self-dealing prohibitions are absolute, rigid, and, to a degree, arbitrary. Moreover, they apply even if the transaction in

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question is fair and reasonable, and even if the private foundation benefits from the transaction.

Self-dealing rules are pervasive and apply to most business and financial transactions between private foundations and their disqualified persons, including both direct and indirect transactions. For instance, a number of questions (and hazards) concerning self-dealing restrictions can arise when a private foundation becomes involved in investing assets: Can a private foundation compensate investment managers who are disqualified persons without violating self-dealing rules? Can a financial institution, such as a bank or trust company that is a disqualified person, perform general banking services and trust functions for a private foundation? Can a private foundation and a disqualified person make joint investments or own undivided interests in the same property? And, can a disqualified person transfer mortgaged property to a private foundation? These questions are addressed in detail in Part II of this chapter.

### **Self-Dealing Misunderstandings and Myths**

Misunderstandings and misinformation surround self-dealing restrictions. The “right” answers to questions concerning self-dealing are not always obvious. Consider the following myth: “A private foundation cannot compensate a disqualified person for personal services performed for the foundation.” Although many believe that a family foundation cannot compensate a family member who is employed or otherwise engaged to provide services to the founda-

### WHO IS A DISQUALIFIED PERSON?

A transaction that involves self-dealing always has three elements: a private foundation, a disqualified person, and an act of self-dealing between the two. Understanding the meaning of the term “disqualified person,” is, therefore, key to understanding and applying self-dealing rules.

Basically, a disqualified person is a person—individual, corporation, partnership, trust, estate, or other foundation—that has one or more particular relationships with a private foundation. With regard to private foundations, such persons include:

***All Substantial Contributors to the Foundation.*** A substantial contributor is any person who has contributed or bequeathed more than \$5,000 to a foundation, when that contribution or bequest constitutes more than 2 percent of the total contributions and bequests received by the foundation from the date of its establishment through the close of the fiscal year in which the contribution or bequest was received. For a foundation organized as a trust, a substantial contributor includes the creator or grantor of the trust. However, the term does not include a governmental entity. A person classified as a substantial contributor generally remains so forever, notwithstanding the amount of subsequent contributions by others.

Under certain limited circumstances, however, a donor ceases to be a substantial contributor if he or she and certain “related persons” have no connection to the foundation for a 10-year period and aggregate contributions by the donor and the related persons are insignificant when compared with the aggregate contributions of one other person. Contributions by a donor and related persons generally will be considered insignificant in relation to the contribution of some other person if their contributions are less than 1 percent of the contributions made by the other person.

Private foundations must maintain a running tally of contributions and bequests from all persons, taking into account the attribution rules described below, to identify their substantial contributors.

***All Managers of the Foundation.*** Officers, directors, and trustees, as well as individuals with powers or responsibilities similar to those of officers, directors, or trustees of the foundation are viewed as a “foundation manager” and, therefore, as a disqualified person of the foundation. A person is considered an officer of a foundation if he or she is designated as such under the foundation’s governing instruments or regularly makes administrative or policy decisions on behalf of the foundation. In general, a foundation employee who has authority merely to recommend administrative or policy decisions, but must have approval from a superior to implement those decisions, is not an officer. Independent contractors—for instance, accountants, lawyers, and investment managers or advisors—acting in their capacity as such, are not considered officers of a foundation.

***Owners of Businesses that Are Substantial Contributors to the Foundation.*** A person who owns more than 20 percent of the total combined voting power of a corporation, the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise that is (during the ownership) a substantial contributor to a private foundation is included in the ranks of disqualified persons. Eliminating the business ownership interest eliminates the disqualified person taint.

***Family Members.*** Immediate family members of disqualified persons (i.e., a person who is a substantial contributor, a foundation manager, or a 20 percent owner) are also considered disqualified persons. This category includes the spouse, ancestors, children, grandchildren, great-grandchildren, and the spouses of children, grandchildren, and great-grandchildren, but not siblings.

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tion, a private foundation can in fact compensate almost anyone, including a disqualified person, for performing personal services for the foundation if two conditions are satisfied:

1. The personal services are “reasonable and necessary” to carry out the foundation’s exempt charitable purposes; and
2. The compensation is neither unreasonable nor excessive.

This misunderstanding stems from the broad definition of self-dealing, which specifies that compensation, or payment or reimbursement of expenses, to a disqualified person is a prohibited act of self-dealing. This definition includes an important exception—compensating and paying, or reimbursing, the expenses of a disqualified person (other than a government official) who is performing personal services that are reasonable and necessary to carrying out the foundation’s exempt charitable purposes are not treated as an act of self-dealing if the payment is not excessive or unreasonable. Thus, a private family foundation can employ a family member or other disqualified person to conduct the foundation’s business and manage its investment assets, provided that compensation for those services is reasonable.

### **Knowing the General Rules Against Self-Dealing**

To preserve the integrity of private foundations and to minimize the possibility of private abuse, federal tax laws impose a number of operational restrictions on private foundations that do not apply to public charities. For the most part, these restrictions do not involve the application of subjective arm’s-length standards and are not a function of fairness, equity, or reasonableness. Indeed, these restrictions involve inflexible rules and absolute prohibitions. Applied automatically, without regard to benefit or detriment to the private foundation, they afford little or no opportunity for the Internal Revenue Service or a private foundation to exercise judgment or discretion.

*Disqualified person, continued from page 3*

***Corporations Owned by Other Disqualified Persons.*** Corporations of which more than 35 percent of the total combined voting power is owned by substantial contributors, foundation managers, 20 percent owners, or members of the family of any of these persons meet the definition of disqualified persons.

***Partnerships Owned by Other Disqualified Persons.*** Like corporations, a partnership is a disqualified person if more than 35 percent of its profits interest is owned by substantial contributors, foundation managers, 20 percent owners, or members of the family of any of these persons.

***Other Entities Owned by Disqualified Persons.*** A trust, estate, or unincorporated enterprise is a disqualified person if more than 35 percent of its beneficial interest is owned by substantial contributors, foundation managers, 20 percent owners, or members of the family of any of these persons.

***Government Officials.*** A government official may be a disqualified person with respect to a private foundation, but only for purposes of the self-dealing rules (not for purposes of other private foundation restrictions). Government officials include all elected executive or legislative officials as well as any person in the executive, judicial, or legislative branch above a certain grade level.

A prohibition against self-dealing is among the restrictions that apply to private foundations. Under these rules, certain transactions are absolutely prohibited, even if the foundation will benefit from the transaction. These stringent rules reflect Congress’s concerns that certain private foundations had been operated for personal gain and that the IRS had difficulties in determining whether transactions between foundations and their donors, directors, or managers truly occurred at arm’s length. According to the legislative history of the self-dealing provisions of the Internal Revenue Code:

*General reasons for change—arm’s-length standards have proved to require disproportionately great enforcement efforts, resulting in sporadic and uncertain effectiveness of the provisions. On occasion sanctions are ineffective and tend to discourage the expenditure of enforcement effort. On the other hand, in many cases the sanctions are so great, in comparison to the offense involved, that they cause reluctance in enforcement, especially in view of the element of subjectivity in applying arm’s-length standards. Where the Internal Revenue Service does seek to apply sanctions in such circumstances, the same factors encourage extensive litigation and a noticeable reluctance by the courts to uphold severe sanctions.*

*Also, the committee has concluded that even arm’s-length standards often permit use of a private foundation to improperly benefit those who control the foundation. This is true, for example, where a foundation (1) purchases property from a substantial donor at a fair price, but does so in order to provide funds to the donor who needs access to cash and cannot find a ready buyer; (2) lends money to the donor with adequate security and at a reasonable rate of interest, but at a time when the money market is too tight for the donor to readily find alternative sources of funds; or (3) makes commitments to lease property from the donor at a fair rental when the donor needs such advance leases in order to secure financing for construction or acquisition of property.*

*To minimize the need to apply subjective arm’s-length standards, to avoid the temptation to misuse private foundations for noncharitable purposes, to provide a more rational relationship between sanctions and improper acts, and to make it more practical to properly enforce the law, the committee has determined to generally prohibit self-dealing transactions and to provide a variety and graduation of sanctions.*

***Sales or Exchanges of Property.*** No sale or exchange of property between a private foundation and a disqualified person is permitted, even if the exchange involves the sale of incidental goods, such as office supplies, and even if the goods are provided at market price or better. This prohibition also includes:

1. The sale of stock or other securities—even at below market cost;
2. The transfer of real or personal property if the foundation assumes a mortgage or similar

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lien that was placed on the property before the transfer, or accepts the property subject to a mortgage or similar lien that a disqualified person placed on the property at any time during the 10-year period ending on the date of the transfer; or

3. The transfer of an insurance policy—subject to policy loans—to a private foundation.

***Leasing of Property.*** The leasing of property between a disqualified person and a private foundation is an act of self-dealing. However, leasing property to a foundation is not an act of self-dealing if the lease is without charge. A lease will be considered without charge even though the foundation agrees to pay for janitorial expenses, utilities, or other maintenance costs it incurs—so long as no payment is made to a disqualified person.

***Loans and Mortgages.*** Although lending money or any other extension of credit from a private foundation to a disqualified person is prohibited, a disqualified person may lend money to a private foundation, without interest or other charge, if the proceeds of the loan are used exclusively for exempt purposes.

If, however, a third party buys property and assumes a mortgage, the mortgage of which is a private foundation, and then transfers the property to a disqualified person who either assumes liability under the mortgage or takes the property subject to the mortgage, an act of self-dealing has occurred. Under self-dealing rules,

### IS IT SELF-DEALING?

*The following fictional examples illustrate many of the most common questions regarding self-dealing. For additional guidance, see the reference chart on page 12.*

#### Grants to Organizations That Employ Family Members

Tom and Jane Fitzgerald founded the Fitzgerald Family Foundation ten years ago, and since the founding have invited 3 of their 4 adult children to join the board. The 4th child, Alex, has also become a dedicated advocate for charitable giving; three years ago, he joined the staff of a local arts center dedicated to working with at-risk youth and their parents. Alex is a program director at the center, supporting the center's ongoing programs and activities for children and parents. Alex has recently approached his older sister, Elizabeth, about an opportunity the center is pursuing to purchase larger and better located space. Alex has asked if Elizabeth and the board would consider a grant of \$200,000 to the center to serve as a matching grant to cover the acquisition costs of the property. *This will not be considered an act of self-dealing. The grant will not be used to compensate Alex, and no family member will receive any personal benefit from the grant.*

#### Tickets to Fundraisers and Performances

John Swanson was recently named the Executive Director of the Swanson Family Foundation after several year of service on the board. The Swanson Foundation has been a long-time supporter of the local ballet company, and in a further demonstration of support the foundation purchased two tickets to the 20th anniversary of the ballet for \$150 apiece. John intends to attend the anniversary gala on behalf of the foundation, accompanied by his wife, Jan. *This is an act of self-dealing. While in some cases foundation managers who have responsibility for evaluating and reviewing the activities of a grantee may use purchased tickets, under no circumstances may a disqualified person bring his or her spouse who does not have these responsibilities.*

#### Paying for Next Gen Board Expenses

Several years ago, The Philip and Amelia Fitzgerald Foundation launched a next-generation board for five college-age family members who have expressed interest in serving as future board members of the foundation. In their role as Next Gen board members, the five college students have travelled all around the country to meet, review grant proposals, and recommend grants to the governing board. Payment of the travel and related expenses of the next gen board members is not an act of self-dealing. Spouses and children of board members are disqualified persons. *If foundation assets are paid to them for travel or related expenses, the payment is an act of self-dealing. However, if the spouse or child has official duties that further the charitable purposes of the foundation, such as those of a next-generation board member, then reimbursement of reasonable expenses for foundation activities, such as travel, is not a violation of the self-dealing rules.*

#### Reimbursement for Child Care Expenses

The Wilson and Dolores Fester Foundation recently celebrated its 40th anniversary, and to mark the occasion they invited several members of the 3rd generation to join the board for the first time. Two of the new 3rd generation board members have very young children and have asked that the foundation pay for childcare so that they can attend board meetings. This is an act of prohibited self-dealing unless the payments are treated as taxable income to the board member. As with staff members, if an employer provides daycare or pays for it directly to a third party, it is generally considered taxable income. *If such payments are not reported as income on a Form 1099 or W-2, they would constitute self-dealing, and the foundation risks self-dealing penalties. Board members may not be reimbursed for the personal expenses that enable them to travel—including child care, kennel services, and house-sitting.*

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*Is it self-dealing, continued from page 6*

### **Fulfillment of Personal Pledges**

Elizabeth Ringer recently joined the board of her family's foundation, the Joan and Harold Ringer Family Charitable Trust. For years, Elizabeth has also been an active and loyal alumnus of the local community college, and recently she filled out a written pledge form to make a personal gift of \$10,000 to the college. At the following board meeting, Elizabeth requested that her annual board discretionary fund be directed to fulfill this pledge. *This is an act of self-dealing and is prohibited. If Elizabeth had not listed her name on the pledge form and instead had requested that the Foundation make the contribution from her discretionary grant fund, this would have been allowed.*

### **Payment of Salary and Fees to a Family Member**

Lawrence and Theresa Osten created the Osten Family Charitable Trust ten years ago with an initial gift of \$5 million, and have now decided to add an additional \$30 million to the endowment as a result of the recent sale of their business. They recognize that with the increased assets of the foundation there will be additional administrative and management needs, and with this in mind they have tapped their youngest child, Benjamin, to serve as the first ever Director of Programs at the foundation. Following a scan of the staffing models for other foundations in their asset range, and a careful review of Ben's proposed schedule and responsibilities, the foundation's board has set Ben's annual salary at \$60,000 based on a 30 hour per week schedule. Ben's older brother Kevin, who serves on the board and estimates that he dedicates approximately 3 hours per week to foundation duties, has asked for the foundation to consider paying him an annual fee of \$35,000 in recognition of his board service. *The payment of salary to Ben would very likely not be considered self-dealing, provided that the foundation keeps careful records of hours worked*

*and can demonstrate that his services are necessary for the operation of the foundation. Kevin's proposed board fee may be considered self-dealing, unless he can adequately demonstrate that this compensation is reasonable and necessary, based on a review of trustee fees at comparable foundations.*

### **The Sale, Exchange, or Lease of Property**

The Johnson Family Office was established in 1985 to manage a variety of interests of the Johnson family, including X,Y, and Z. The Family Office also serves as home of the Johnson Family Foundation, whose CEO works out of an office located next to the CEO of the Johnson Family Office. The Johnson Family Foundation pays no rent for the office space, or for utilities and maintenance. *This is not an act of self-dealing. However, if the family office had charged any rent or directly requested reimbursement for utilities or maintenance fees, this would likely have strayed into self-dealing territory.*

### **Commingling of Investments**

Jacob Willis is a board member of the Willis Family Foundation. In addition to his role on the board, he is an avid and knowledgeable personal investor who has participated in a variety of investment partnerships over the past 10 years. Jacob has recently learned about an opportunity to invest in a very successful hedge fund that has a minimum contribution of at least \$500,000. Jacob has invested his personal assets to meet the minimum contribution and has suggested to the foundation's investment committee that the foundation should "piggyback" on his contribution and invest an additional \$250,000 of the foundation's assets in the hedge fund. *This is not an act of self-dealing, because the disqualified person did not receive any tangible benefit from this arrangement. If, however, the foundation had invested the \$500,000 and Jacob had "piggybacked" on that investment with a \$250,000 personal investment, the disqualified person would have benefited inappropriately from the use of the foundation assets and thus engaged in self-dealing.*

the foundation is considered to have made a loan to the disqualified person in the amount of the unpaid indebtedness on the property at the time of the transfer.

***Providing Goods, Services, or Facilities.*** In general, a private foundation cannot provide goods, services, or facilities to a disqualified person, nor can a disqualified person provide goods, services, or facilities to a private foundation, including furnishing such items as office space and equipment, automobiles, auditoriums, secretarial help, meals, libraries, publications, laboratories, and parking lots.

As with leases and loans, however, no self-dealing occurs if these types of items are furnished without charge, and used for exempt purposes by the foundation. For example, a disqualified person can provide pencils, stationery, other incidental supplies, or even a building, if the private foundation is not charged and uses the goods in its charitable operations. (Goods or facilities are considered furnished without charge even if the private foundation pays for the transportation, insurance, or maintenance costs it incurs in obtaining or using the property, provided that no payment is made to a disqualified person.)

In addition, furnishing goods, services, or facilities to a foundation manager, employee, or unpaid volunteer in recognition of his or her service to the foundation is not considered self-dealing if whatever is furnished is reasonable and necessary to the performance of the manager/employee/volunteer's tasks in carrying out the exempt purposes of the foundation, and its value is not excessive.

***Paying Compensation.*** Compensating or paying or reimbursing the expenses of a disqualified person is viewed as self-dealing. If, however, such payments (other than payments to a government official) are for personal services that are reasonable and necessary to carrying out the exempt purpose of the foundation and are not excessive or unreasonable, they are permitted.

***Use of Income or Assets.*** Transferring a private foundation's income or assets, or permitting the use of foundation income or assets by a disqualified person, is not allowed. For example, a private

foundation cannot make grants or guarantee loans made to, or purchase fundraising tickets on behalf of, a disqualified person. In addition, a disqualified person is prohibited from displaying foundation artwork in his or her home or office. Moreover, a private foundation is not permitted to purchase or sell stock in an effort to manipulate the price of stock to the advantage of a disqualified person.

A private foundation's use of its income or assets in a way that confers only an incidental or tenuous benefit on a disqualified person is not, however, considered an act of self-dealing. For example, a private foundation is allowed to enhance the reputation or prestige of a disqualified person by acknowledging his or her contribution publicly or even naming a building or other facility or institution after him or her in recognition of the contribution.

***Payment to a Government Official.*** Private foundations are discouraged from practically all dealings with government officials. To that end, the term "self-dealing" is defined to include any direct or indirect agreement to make any payment of money or other property to a government official. A foundation can, however, agree to employ a government official for a period of time after his or her government service concludes, but only if the official is terminating government service within a 90-day period. Other exceptions to the general prohibition against payments to government officials exist. For more information on those exceptions, consult a qualified legal advisor.

### ***Attributing Ownership***

Complex attribution rules apply to how the combined voting power, profits interest, or beneficial interest of a person in a corporation, partnership, trust, or unincorporated enterprise are determined for purposes of identifying substantial contributors to a foundation. For example, in determining whether a person owns more than 20 percent of the total combined voting power of a corporation, profits interest of a partnership, beneficial interest of a trust, or unincorporated enterprise, stock, profits, or beneficial interests owned by a corporation, the rules specify that a corporation, partnership,



estate, or trust is considered as owned proportionately by its shareholders, partners, or beneficiaries. In addition, under self-dealing rules, an individual is deemed an owner of the stock of a corporation, the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise that is owned by members of his or her family. Thus, if a person owns, or is treated as owning, more than 20 percent of a business or trust that is defined as a disqualified person with respect to a private foundation, that person is also treated as a disqualified person. Similarly, if disqualified persons own, or are treated as owning, more than 35 percent of a business or trust, the business or trust is treated as a disqualified person.

### Penalty Taxes on Self-Dealing

Self-dealing restrictions are enforced through the imposition of penalty taxes on disqualified persons and foundation managers who participate in acts of self-dealing. In general, a penalty tax of 10 percent of the amount involved in each act of self-dealing is imposed for each year or partial year until the self-dealing is corrected in accordance with IRS requirements.

Correcting an act of self-dealing involves undoing the transaction—to the extent possible—and placing the foundation in a financial position that is no worse than it would have been in if the disqualified person had been dealing under the highest fiduciary standards. An additional penalty tax of 5 percent of the amount involved is imposed on any foundation manager—officer, director, or trustee—who knowingly, willfully, and without reasonable cause, participates in an act of self-dealing.

### Seeking Advice of Counsel

Seeking advice from counsel can reduce the risk of penalty taxes. If any proposed transaction might constitute an act of self-dealing, the parties to the transaction should seek and rely on the advice of legal counsel. In general, a person who, after full factual disclosure of a situation to legal counsel, relies on the counsel's written legal advice that the transaction is not an act of self-dealing under the law, will not be held liable for penalty taxes, even if the transaction is determined to be an act of self-dealing at a later date.

### How Foundation Investments relate to Self-Dealing Issues

How do self-dealing restrictions affect how private foundations invest their assets? Self-dealing rules have applications in several investment-related areas, including:

- Compensation of investment managers who are disqualified persons;
- Obtaining general banking services and trust functions from a bank or trust company that is a disqualified person;
- Joint investments and co-ownership of property by a private foundation and a disqualified person;
- The transfer of mortgaged investment property to a private foundation; and
- Sharing foundation office space with a disqualified person.

### Compensating Investment Managers Who Are Disqualified Persons

Although self-dealing rules prohibit compensating a disqualified person, private foundations can compensate a disqualified person for “personal services” that are reasonable and necessary to carrying out the foundation's exempt charitable purposes—provided the compensation is reasonable. Investment counseling and investment assets management are considered personal services that almost every private foundation requires to carry out its exempt purposes. A private foundation can, therefore, engage a family member or other disqualified person to manage its assets and provide reasonable compensation to that person without violating self-dealing restrictions.

IRS regulations include the following example: C, a manager of private foundation X, owns an investment counseling business. Acting in his capacity as an investment counselor, C manages X's investment portfolio for which he receives an amount which is determined to be not excessive. The payment of such compensation to C shall not constitute an act of self-dealing.

### Is the Compensation Reasonable?

According to the IRS, the amount of the investment manager's compensation is considered reasonable if a similar organization would pay such an amount for similar services under similar circumstances. For example, a private foundation that is a partner in an investment partnership managed by a disqualified person is not engaged in an act of self-dealing provided that the fees paid by the foundation are the same as those paid by other investors in the partnership and are comparable to what other investment managers in the industry receive.

To determine whether compensation is reasonable, the governing body, or a committee of the governing body, of the foundation should obtain comparability data on compensation, including:

- Data on compensation paid by similarly situated organizations, both taxable and tax exempt, for comparable positions or for comparable services;
- Data on the availability of similar services in the area;
- Independent compensation surveys compiled by independent firms; and/or
- Actual written offers from similar organizations competing for the services of the disqualified person.

Once sufficient information has been obtained to determine the reasonableness of the proposed compensation to a disqualified person for investment management services, the governing body or committee should set the level of compensation, and document the basis for its determination. In documenting that determination, the following should be noted:

- The terms and date of the approved transaction (compensation arrangement);
- The members who were present during discussion of the approved transaction and who voted on it;

- The comparability data obtained and relied on by the governing body or committee and a description of how the data were obtained;
- Actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the governing body or committee but had a conflict of interest with respect to the transaction; and
- Any determination by the governing body or committee that reasonable compensation is higher or lower than the range of comparable data obtained as the basis for the determination.

A member of the governing body or committee who has a conflict of interest of any kind with respect to the compensation transaction should recuse himself or herself from deliberations (other than to answer questions or to provide information) and from voting on the proposed transaction.

### Compensating Property Managers

The IRS position on property management services is that such services—as distinguished from investment management services—are not personal services for purposes of the self-dealing rules. Thus, if a private foundation owns an interest in a partnership that has real property managed by a disqualified person, compensating the disqualified person may be an act of self-dealing.

### Performing General Banking Services and Trust Functions

Lending money or extending credit to a disqualified person, or accepting the same from a disqualified person is an act of self-dealing. Under IRS regulations, however, a bank or trust company that is a disqualified person with respect to a private foundation may perform trust functions and certain general banking services for the private foundation without violating the self-dealing rules, provided the trust functions or banking services are reasonable and necessary to carrying out the exempt purposes of the foundation, and compensation for those services is not “excessive.”

General banking services that are allowed include:

1. Checking accounts—provided that interest is not charged on overdrafts;
2. Savings accounts that can be withdrawn on notice of 30 days or less without loss of interest;
3. Safekeeping and custodial activities;
4. Investment services;
5. Foreign exchange services; and
6. Common trust functions.

### Benefiting from Joint Investments

An act of self-dealing occurs when a disqualified person benefits more than incidentally from the use of the assets of a private foundation. What happens when a private foundation and a disqualified person make a joint investment, such as an investment in the same investment partnership? According to the IRS, joint investments may inappropriately benefit a disqualified person and thus result in self-dealing.

Assume, for example, a private foundation and a disqualified person invest in an investment partnership that has minimum investment requirements. The private foundation invests the minimum amount or more, and the disqualified person piggybacks onto that investment, thereby meeting the minimum that would otherwise not have been met. According to the IRS, under this scenario the disqualified person benefited inappropriately from the use of the foundation assets and thus engaged in self-dealing.

But what if the disqualified person invested the minimum amount necessary and the foundation relied on the disqualified person's investment to satisfy the minimum investment requirement? According to the IRS, under this scenario no self-dealing occurred. Although a private foundation may benefit from the use of a disqualified person's investment, the converse is not allowed.

### CO-OWNING PROPERTY

Co-ownership of property by a private foundation and a disqualified person can result in self-dealing

if the disqualified person has the right to use the jointly owned property. For example, co-ownership of a vacation home gives rise to self-dealing if, as a result of the co-ownership, the disqualified person has the right to use the vacation home.

Co-ownership of property for investment purposes is less likely to result in self-dealing if personal use or benefit is not an issue. The IRS found no self-dealing, for example, where a private foundation and a disqualified person jointly owned rental property because: the private foundation and the disqualified person acquired the property as co-owners at the outset (one did not acquire an interest in the property from the other); the property was leased to an unrelated third-party tenant; and the tenant paid rent directly to each of the co-owners (no money changed hands between the co-owners).

Still, co-ownership of property by a private foundation and a disqualified person can be a trap for the unwary. If the private foundation's ownership of an interest in the property confers a significant benefit to a co-owner who is a disqualified person, an act of self-dealing has occurred.

### Mortgaged Property Can Have Pitfalls

Mortgaged property can also have self-dealing pitfalls. As noted above, a private foundation that sells to, purchases from, or exchanges property with a disqualified person has engaged in an act of self-dealing. A disqualified person's transfer of property to a private foundation is treated as a sale or exchange—and, therefore, as self-dealing—if the property is subject to a mortgage or similar lien that the foundation assumes, or if the property is subject to a mortgage or similar lien that a disqualified person placed on the property within the 10-year period that ended on the date of the transfer. This sale-or-exchange treatment applies even if the transfer is called a gift or contribution. (The transfer of encumbered property to a private foundation by a disqualified person constitutes direct self-dealing unless the foundation does not assume the liability, or the encumbrance either was placed on the property by an owner who was not a disqualified person or was placed on the property 10 years before the date of the transfer.)

**COMMON QUESTIONS: IS IT SELF-DEALING?**

Action	Self-Dealing?	Comments and Explanation
Compensating board members	No	While compensating board members is not self-dealing, inappropriate or excessive compensation may result in a violation of the self-dealing rules.
Paying travel expenses for junior board members	No	See above.
Leasing property/office space to foundation for free	No	Leasing property to a foundation is not an act of self-dealing if the lease is without charge.
Compensating a family member to perform staff roles	Maybe	While compensating family to serve as staff is not self-dealing, inappropriate or excessive compensation may result in a violation of the self-dealing rules.
Paying travel expense for current board members	Maybe	Travel expenses must be reasonable and necessary; careful records and receipts of all board reimbursed travel should be maintained
Lending money from disqualified person to foundation	Maybe	If the money is lent at any interest rate above zero, this is self-dealing.
Accepting/receiving tickets to event or purchasing tickets to an event for a member of the board or other family member, including spouses	Maybe	While in some cases foundation managers who have responsibility for evaluating and reviewing the activities of a grantee may use purchased tickets, under no circumstances may they bring another disqualified person who does not have these responsibilities.
Approving grant to organization on which a foundation board or family member currently serves on the board	Maybe	This is not self-dealing unless the board or family member receives more than an incidental personal benefit as a result of the grant.
Approving grant to organization on which a foundation board or family member currently is a volunteer/ donor	Maybe	See above.
Approving grant to organization on which a foundation board or family member currently serves as an employee	Maybe	This is not self-dealing unless the board or family member receives more than an incidental personal benefit as a result of the grant; such would be the case if the grant was designated to pay the salary of the individual, in which case self-dealing is likely.
Paying travel expenses for family members not currently serving on the board or performing staff roles	Yes	This is self-dealing, unless the foundation can make the case that such expenses are necessary for the operations of the foundation.
Leasing property/office space to foundation for charge	Yes	If a foundation pays any type of rent to a disqualified person, even at below-market rates, this is considered self-dealing.
Lending money/extending credit to disqualified person	Yes	Foundations may not lend or extend credit to disqualified persons, even at rates that are considered to be far above the current market rate.
Payments of money or other property to a government official	Yes	A foundation can, however, agree to employ a government official for a period of time after his or her service concludes. Consult a qualified legal advisor
Paying rent for office space to family office or family business	Yes	Payment of rent of any amount to a disqualified person or entity is considered self-dealing, even if the amount paid is far below market price.
Approving a grant for a written personal charitable pledge of a family member or disqualified person	Yes	This is self-dealing, unless the pledge comes originally from the foundation itself.
Use of foundation credit cards for personal expenses	Yes	If a disqualified person uses a foundation credit card for personal expenses and later reimburses the foundation for the expenses, this is considered a loan and a form of self-dealing, even if the person reimburses the full amount within a month of the transaction.
Commingling investments: “piggybacking” on the foundation’s investment in a fund with a minimum required investment in order to access the fund	Yes	This is self-dealing because the disqualified individual has received a tangible benefit as a result of commingling of assets.

## FOUNDATION OFFICE SPACE

A private foundation cannot pay rent for office space owned by a family member or other disqualified person. The payment of rent to any disqualified person is self-dealing even if the rent charged is significantly below market rate and thus beneficial to the foundation. If the foundation leases space from a disqualified person but pays no rent, however, there is no self-dealing. So long as no rent is paid, the foundation can pay its fair share of utilities, janitorial services, insurance, or maintenance so long as the payment is not made directly or indirectly to the disqualified person. For example, the foundation should pay for its share of the janitorial services by making the payment directly to the firm providing those services.

**Can a private foundation and a disqualified person share office space and related expenses?** As indicated above, a foundation cannot rent space from a disqualified person unless the rent is zero. However, if the office space in question is owned by an unrelated person, it is possible (although complicated) for a foundation to share office space and related expenses with a disqualified person. In leasing shared office space from an unrelated person, the foundation and the disqualified person each should have a separate lease; and each should pay rent directly to the landlord.

**What about overhead expenses such as telephone, copying, computer, etc.?** According to the IRS, a private foundation can reimburse a related family office, family business, or other disqualified person for its fair share of overhead and other operating costs but not for rent. For example, a private foundation and a related family office or business (disqualified person) can enter into an agreement under which the private foundation pays or reimburses the family office and family business for all overhead and other operating costs, so long as there is no payment or reimbursement for rent.

## Summing Up

Self-dealing rules are intricate and complex, particularly as they relate to private foundation investing. Thus, they present numerous opportunities for inadvertent transgressions. No matter how inadvertent or unintentional, however, and regardless of whether the foundation has been harmed, violating the rules can result in onerous sanctions in the form of penalty taxes. Although self-dealing rules do not prevent private foundations from purchasing investment services from a disqualified person for a fair price, they do discourage most other business and financial dealings between a private foundation and its disqualified persons. In attending to the investment, business, and other financial affairs of a private foundation, it is therefore very important to keep in mind the restrictions and limitations imposed by self-dealing rules. When in doubt, it is always prudent to consult legal counsel.

## ADDITIONAL READING

- *Board Compensation: Reasonable and Necessary?* By Jason C. Born, National Center for Family Philanthropy, 2000.
- *Drafting a Conflict of Interest Policy: A Guide to Key Provisions*, Council on Foundations, June 2006.
- *Family Foundations and the Law: Answers to the Essential Questions, Fourth Edition*, by John A. Edie and Kelly Shipp Simone, Council on Foundations, 2012.
- *The Foundation Desk Reference*, by Benjamin T. White, Southeastern Council of Foundations, Third Edition, October 2008.
- *Self-Dealing: A Concise Guide for Foundation Board and Staff*, by John A. Edie, Forum of Regional Associations of Grantmakers, March 2008.
- “That’s the Ticket,” by Jane C. Nober, May/June 1998, *Foundation News & Commentary*.



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Named by Best Lawyers in America as the “2012 Atlanta Lawyer of the Year” in the exempt organizations area and as the “2013 Atlanta Lawyer of the Year” in the trusts and estates litigation area, Ben White’s practice emphasizes exempt organizations of all kinds, as well as estate and tax planning. Mr. White also maintains an extensive wealth planning practice, representing some of the wealthiest individuals and families in the Southeast and providing counseling to individual and institutional trustees, executors, personal representatives and other fiduciaries throughout the region.

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