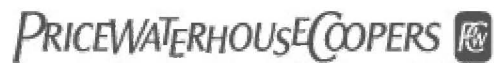




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Self-Dealing: A Concise Guide For Foundation Board and Staff

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This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding tax penalties that may be imposed on the taxpayer. Foundation board and staff members are strongly urged to consult experienced tax advisors for guidance on specific issues.

Introduction

The origin of the rules against self-dealing for private foundations stems from the enactment of Section 4941 of the Internal Revenue Code as part of the Tax Reform Act of 1969. The self-dealing rules were just one of a series of prohibited actions initiated by Congress at that time to address negative activities by private foundations. Prior to 1969, the only enforcement sanction available to the Internal Revenue Service (IRS) was removal of a foundation's tax-exempt status. Today, the IRS can levy excise taxes on the foundation and (in some cases) on foundation managers when various prohibited activities occur. The rules and regulations regarding self-dealing have remained relatively constant over the past 36 years.

Whether the donor to a private foundation is an individual, a family, or a for-profit company, it is important to understand that once cash or other assets are gifted (or bequeathed) to a private foundation, those assets then belong to a separate legal entity that is subject to many restrictions. Said as plainly as possible:

“It's not your money anymore.”

Many donors get into trouble by not understanding this important distinction and making the mistake of thinking that private foundation assets are simply another source of funds so long as any payment seems fair and charity benefits. Unfortunately, a private foundation payment can be completely fair, benefit charity, and still be an act of self-dealing.

Here are some “hot button” questions that reflect common foundation pitfalls in this area:

- Do you pay for (or reimburse) any travel (or other) expenses for spouses?
- Are foundation purchased tickets to fundraising events used by spouses?
- Do foundation grants ever satisfy the pledge of a board or staff member?
- How do you know if staff compensation and/or board fees are reasonable?
- Beyond compensation, are there any financial transactions between the foundation and any board or staff member?
- Are the foundation offices shared with any related parties (family, corporate)?
- Do you have an up-to-date Conflicts of Interest policy?

Definition of Self-Dealing

In basic terms, the rules against self-dealing are broad and far-reaching. They generally prohibit any *direct* financial transaction between the foundation and virtually all persons closely related to the foundation. Those persons are known as “disqualified persons” and are defined below. Even if the financial transaction is between the private foundation and an unrelated third party, the act can be a violation of the self-dealing rules if the transaction provides an *indirect* financial or economic benefit to a foundation insider.

The law and regulations specifically identify certain acts of self-dealing between a foundation and its disqualified persons including:

- Buying and selling property from or to a disqualified person, even on terms that are favorable to the foundation;
- Renting property to disqualified persons, or leasing property from disqualified persons except on a rent-free basis;
- Lending money or extending credit to disqualified persons, or borrowing money from disqualified persons except on an interest-free basis;
- Paying excessive compensation to disqualified persons;
- Paying (or reimbursing) unreasonable or unnecessary expenses of a disqualified person;
- Allowing disqualified persons to use a foundation’s income, assets or facilities, except for goods or services that are furnished to them on the same terms as are furnished to other members of the public;
- Satisfying the enforceable pledge of a disqualified person; and
- Making payments to certain government officials.

Foundation managers often mistakenly believe that a transaction with an insider is acceptable if it is fair or more than fair to the foundation. Unfortunately, this belief is usually wrong. There can be an act of self-dealing even if the transaction results in a significant benefit to the foundation (example: a member of the governing board rents out office space to the foundation at 50 percent below fair market value).

Definition of a Disqualified Person

In general, disqualified persons are individuals that are closely related to the foundation, sometimes referred to as insiders. The definition also includes certain legal entities (such as corporations, partnerships or trusts) where disqualified persons have significant interests. Said another way, these persons (and legal entities) are “disqualified” from entering into any financial transaction with the foundation.

The tax code is quite specific in defining which *individuals* are disqualified persons:

- Members of the foundation's governing board (trustees, directors)
- Officers of the foundation (CEO, treasurer, etc.)
- Other foundation managers, meaning any person (including any employee) who has authority to act on behalf of the foundation
- Substantial contributors to the foundation (see below)
- Family members of each person noted in the four bullets immediately above (including ancestors, spouses, children, grandchildren, great-grandchildren and the spouses of children, grandchildren or great-grandchildren). Note that siblings (brothers and sisters) of disqualified persons are not disqualified unless they become disqualified for a different reason (such as becoming a board member or a substantial contributor)
- Certain government officials (includes all elected executive or legislative persons and any person in the executive, judicial or legislative branch above a certain grade level).

In addition, certain legal entities fit within the definition of disqualified person:

- A corporation in which at least 35 percent of the voting power is owned by disqualified persons;
- A partnership in which 35 percent of the profits interest is owned by disqualified persons; and
- A trust or estate in which 35 percent of the beneficial interests are owned by disqualified persons

Most substantial contributors are the main donors to a private foundation – as an individual, a family or a corporation. However, any individual, corporation, partnership or trust can become a disqualified person if such person or legal entity meets the definition of a substantial contributor. There are two requirements for becoming a substantial contributor:

- The person or entity must contribute or bequeath (in the aggregate) at least \$5,000; and
- The total amount contributed by that person or entity must exceed two percent of the total contributions ever received by the foundation by the end of the foundation's tax year during which the donation was made.

Most Common Problem Areas

Excessive Compensation

Examples of excessive compensation (trustee fees and compensation to top level staff) have received extensive attention from the media. These reports led to increased examination by the Internal Revenue Service and legislative efforts by Congress to limit this type of abuse. A discussion paper issued by the staff of the Senate Finance Committee in June of 2004, recommended prohibiting trustee fees altogether. In its June (2005) report to the Finance Committee, the Panel on the Nonprofit Sector discouraged payment of compensation to board members by charitable organizations. No legislation on this matter has been introduced to date.

Reasonable Compensation Exception. The self-dealing restrictions are quite broad in their scope prohibiting virtually all financial transactions between the foundation and any disqualified person. But, for obvious reasons, it would be highly impractical to prohibit paying reasonable compensation to disqualified persons in every circumstance. For example, without the reasonable compensation exception to the self-dealing rules, it would be a violation for a private foundation to pay salary and benefits (no matter how reasonable) to hire a President and CEO (who would become a disqualified person as a foundation manager once hired).

Basic Rule. The self-dealing rules state that it is not a violation to pay compensation to a disqualified person for personal services which are reasonable and necessary in carrying out the exempt purposes of the private foundation. There are three key elements that must be satisfied to take advantage of this important exception: necessary, reasonable and personal services. Here is a closer look at each requirement:

- *Necessary.* In broad terms, the requirement that a service be necessary means that the activity is consistent with the charitable purpose and mission of the foundation. For example, if a foundation were to pay for investment services at a reasonable fee for the benefit of children of a board member, (while satisfying the reasonable and personal services requirements) such payment would be a self-dealing violation because providing such services in no way furthers the exempt purposes of the foundation and is not necessary.

- *Reasonable.* Compensation must be reasonable and not excessive. The IRS does not provide specific dollar amounts or an acceptable range of compensation levels. Rather, “reasonable” is defined as what would ordinarily be paid for like services by like enterprises under like circumstances. Many foundations hire independent firms to provide studies of comparable compensation for key positions. The annual Grantmakers Salary and Benefits Report of the Council on Foundations provides high, low, median and mean compensation levels for most positions typically found at foundations. When examining the issue of reasonable compensation, the IRS will look at the complete compensation package (salary, bonuses, fringe benefits, deferred compensation and any other benefits such as use of an automobile).
- *Personal Services.* Even if a service is necessary and the amount of compensation is reasonable, such payment will not qualify under the reasonable compensation exception unless the service provided is “personal.” Foundation governing board and normal staff positions are considered personal. However, the IRS limits what it considers “personal” to only those services that have been clearly identified in Treasury regulations or IRS rulings. Identified services include: general banking services (such as checking accounts, savings accounts and safe-keeping activities), legal services, accounting services, investment services, and the services of a broker acting as an agent (but not a dealer that buys from the foundation and resells to third parties). Examples of services that are not personal would include commercial property management services, interior decorating, information technology services and many other services provided by independent consultants.

Payment (Reimbursement) For Expenses

Another important exception to the self-dealing rules allows a private foundation to reimburse (or pay for) the expenses of a staff member (employee) or a member of the governing body (trustee, director, officer) so long as the expenses are necessary in performing the exempt activities of the foundation and the amount of the expense is reasonable.

Even if an expense is reasonable, a violation can occur if incurring the expense was not necessary. Common travel expenses are deemed necessary for such normal activities of a foundation such as attending a board meeting, conducting a site visit to an actual or potential grantee or attending a conference whose offerings are directly related to the charitable or investment interests of the foundation. Examples of expenses that could be considered unnecessary are paying for golf greens fees in conjunction with a board retreat or for movies in a disqualified person’s hotel room.

In addition, it is a violation for a foundation to pay the travel costs of a family member who is not an employee or board member unless that person has legitimate foundation responsibilities to perform. Spouses, children, children's spouses, grandchildren and grandchildren's spouses are all disqualified persons. If a family member has no duties or responsibilities for the operation of the foundation, paying such family member's travel expenses is a violation of the self-dealing rules – no matter how reasonable the costs may be. Foundation assets may not be used to finance a family reunion. In short, payment of the travel expenses of a non-involved family member is not necessary in performing the exempt activities of the foundation. However, there are two circumstances where such payments could be made and avoid a violation:

- *Delegated Duties.* When the governing board of a foundation delegates legitimate and responsible duties to disqualified persons, their reasonable expenses may be reimbursed. For instance, if a foundation establishes a committee of its governing board to review and recommend to the board grant recipients in a particular field of grantmaking, interested and qualified family members could be appointed to that committee. Reimbursement of their necessary and reasonable travel expenses would not be a violation.
- *Treat Travel Expenses as Compensation to Board or Staff Members.* As noted earlier, reasonable compensation is a major exception to the self-dealing rules. If the travel expenses of a family member (spouse, child, etc.) are treated as compensation to the board member or staff member whose family member is traveling, self-dealing can be avoided if the amount is reasonable and is treated as income to the board or staff member.

Example:

A board member of the foundation attends a conference on family foundations; the foundation pays for the reasonable travel expenses of the board member and the board member's spouse (\$1,000 for each). The \$1,000 spent by the foundation for the board member is reasonable and necessary and, therefore, not a violation. However, attendance by the spouse is not necessary, even though the expenses are reasonable. On the other hand, if the foundation treats the \$1,000 spent on the spouse's travel as compensation to the board member (normally by issuing a Form 1099 to the board member that includes such amount), and the resulting total compensation to the board member is still reasonable, no violation occurs.

It is also common for expenses to be challenged as unreasonable. The IRS has been reluctant to provide much guidance in this area preferring to examine each case based on its particular facts and circumstances.

Many problems arise when the expense involves travel costs. Media reports in recent years have called critical attention to first class travel, luxury accommodations and the use of private jets, chartered planes and limousines. In 2003, the House of Representatives passed legislation (H.R. 7) that would have discouraged certain types of travel. While this bill did not make such travel illegal, it said that any such expenses could not count as “qualifying distributions” in meeting a private foundation’s 5 percent payout requirement. The travel expenses so limited were any air travel that was not on a regularly scheduled commercial airline and that cost more than coach fare – thus limiting use of private jets or chartered airplanes and first class (or business) class tickets. Travel expenses continue to be a Congressional concern.

In the absence of clearer guidance, many foundations take a conservative approach to reimbursement of expenses and provide board members and staff with detailed guidance through board adoption of a foundation travel policy that often includes some version of an “accountable plan.” In the for-profit context, the tax deductibility of an employee’s business expenses depends upon whether the reimbursement or expense allowance is made pursuant to an accountable or nonaccountable plan. For a private foundation, adopting a travel policy that incorporates the accountable plan approach is a recommended practice. There are three required elements for such a plan:

- *Foundation Business Connection:* Payments are to be made in connection with the performance of services as an employee (or board member) of the foundation.
- *Substantiation:* The employee (or board member) generally is required to submit documentation, such as receipts, to support each claimed expense. The substantiation statement provided by the employee (or board member) must contain certain information, including the expense amount, the time, place, and description of expense.
- *Return Of Amounts In Excess Of Expenses:* An employee (or board member) must return amounts received in excess of those substantiated within a reasonable period of time.

Tickets To Fundraising Events

Most significant fundraising events typically provide some tangible, economic goods or services to the attending ticket holder (dinner, entertainment, receptions, greens fees, etc.). An individual or corporate taxpayer purchasing such a ticket may not claim a charitable deduction for the full price of the ticket. The deduction must be reduced by the value of the goods and services provided to the purchaser. When the ticket is purchased by a private foundation, there is a possible violation of the self-dealing rules. A violation occurs if assets of a private foundation are used to provide a tangible, economic benefit (dinner, entertainment) to a disqualified person, as discussed below.

Person Using the Ticket. A key factor with respect to fundraising events is who uses the ticket. In one case, the IRS has ruled that if a board member (or other manager) of a private foundation uses the ticket (where economic, tangible benefits are provided) and such person's attendance at the function was reasonable and necessary in the performance of his or her duties for the foundation (grantee oversight, evaluation, etc.), then no self-dealing occurs. However, if the ticket is used by a disqualified person who has no such duties (for example, use by the spouse or child of a board member), then the use of the ticket is a violation.

No Bifurcation. The IRS has also ruled that the foundation may not split up (or bifurcate) the cost of the ticket whereby the user of the ticket pays for the value of the tangible benefits received (such as a dinner) and the foundation pays the balance of the ticket price. The IRS position is that "but for" the foundation paying the balance of the ticket price, the ticket could not be purchased.

Enforceable Pledges

The self-dealing regulations explicitly prohibit a foundation from satisfying the enforceable pledge of a disqualified person. Whether or not a pledge is enforceable is determined by state law and may vary slightly from state to state, but signed, written pledges that a charity relies upon are likely to be viewed as enforceable. The theory here is that an enforceable pledge of a disqualified person is that individual's (or that entity's) personal debt or obligation and, therefore, such person should not be relieved of that personal debt through the use of funds belonging to a charitable foundation. Persons or corporations that prefer to have their foundation fulfill a pledge should make certain that the foundation is making the pledge, not the person or corporation.

Shared Office Space: Multiple Complications

It is not uncommon for a family business or a for-profit company to locate the family foundation or the company foundation within the same office space. No problems arise if the family or the company pays for all the expenses such as rent, utilities, copying, telephone, reception, etc. However, if the family foundation or the company foundation pays for some of these expenses, self-dealing violations can occur.

- *Rent.* The self-dealing rules make clear that a foundation may not pay rent (in any amount other than zero) to a disqualified person even if the amount is reasonable. Thus, if the foundation subleases from the family business or the corporation, a violation occurs. Simply reimbursing the family business or corporation for its share of the rent would also be a violation. Self-dealing may be avoided if the foundation enters into a separate leasing arrangement with a third party landlord (who is not a disqualified person).
- *Services Related to Rent.* It is possible for the foundation to share in related services such as janitorial, utilities or other maintenance costs by paying its fair share directly to the service provider (such as to the janitorial service company) rather than to the family office or the parent corporation. Careful documentation should be kept to justify the determination of fair share.
- *Leased Office Equipment.* Similarly, splitting up the costs of leased equipment (copying, fax machine, etc.) on an appropriate, fair share basis avoids self-dealing violations if the payment is made to a third party vendor that is not a disqualified person.
- *Main Exception in Sharing Situations.* The disqualified person (family business or for-profit company) may furnish goods, services, or facilities to the foundation when such provision is without charge and when the goods, services or facilities are used exclusively for a charitable purpose.

Overlapping Board Members: Grantor & Grantee

It is common for a foundation to make a grant to a public charity where a board member of the foundation (the grantor) is also on the board of the charity (grantee). The self-dealing regulations specifically state that a grant by a private foundation to a public charity will not be a violation “merely” because one of the public charity’s officers, directors or trustees is also a manager (director, trustee, etc.) of, or a substantial contributor to, the foundation. Even though no self-dealing violation occurs, some observers believe that such a grant decision presents a conflict of interest. Thus, many foundations incorporate a “best practice” approach to such a situation by adopting a conflict of interest policy that requires any board member of the foundation who has the conflict to disclose the details of the situation and not participate in the vote to award the grant.

Other Exceptions to the Self-Dealing Rules

In addition to the main exceptions to the self-dealing rules (reasonable compensation and payment of reasonable expenses), there are two other exceptions that should be noted:

Certain Corporate (or Partnership) Transactions. In enacting the self-dealing rules, Congress did not want to prevent certain, legitimate business transactions where all parties are given the same opportunities. Thus, any transaction between a private foundation and a corporation, or partnership, that is a disqualified person will not be an act of self-dealing if such transaction is pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization or reorganization so long as all of the securities (or partnership interests) of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value.

Transactions During the Administration of an Estate. Frequently, assets such as stock or partnership interests are bequeathed to a foundation and are under the administration of an estate prior to actual transfer to the foundation. Congress allowed for some extra flexibility here as well. There is no self-dealing violation where there is a transaction with respect to a private foundation's interest or expectancy in property held by an estate (or revocable trust, including a trust that has become irrevocable on a grantor's death), regardless of when title to the property vests under local law, if specific, detailed requirements are satisfied that include:

- The administrator or executor has the power to sell or reallocate the property
- The transaction is approved by the court having jurisdiction over the estate (or over the foundation)
- Such transaction occurs before the estate is terminated, and
- The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property

Penalties for Violations

While flagrant and repeated acts of self-dealing can lead to severe penalties for a private foundation (and even recovery of assets equal to the value of all tax benefits derived), the self-dealing rules are designed to provide a sanction where the penalty (in the form of an excise tax) is applied to the wrongdoer (or self-dealer) – or possibly to a foundation manager participating in the transaction – and is measured as a percentage of the amount involved. The foundation itself is not assessed for a violation of the self-dealing rules.

5% Initial Tax on the Self-Dealer. When a violation occurs, the disqualified person (individual or legal entity) who enters into the financial transaction with the foundation is the “self-dealer” and the excise tax applied to that person (or entity) is 5 percent of the amount involved (but see discussion of multi-year violations below). For example, if a foundation paid the travel expenses for the spouse of a board member (where the spouse had no foundation duties), the spouse could be assessed a tax equal to 5 percent of the expenses and would be required to repay the expenses to the foundation.

2.5% Initial Tax on the Foundation Manager. In addition, an excise tax of 2.5 percent of the amount involved may be assessed to any foundation manager (board member or employee) who participates in an act of self-dealing, knowing that it is such an act, unless such participation is not willful and is due to reasonable cause (such as reliance on written opinion of legal counsel). This tax on the foundation manager may not exceed \$10,000 for each act of self-dealing.

Correction. In addition to paying the excise tax, the self-dealer must correct (or undo) the transaction to the extent possible (such as paying back the travel expenses – see above) but in no case shall the resulting financial position of the foundation be worse than that which would be the case if the disqualified person were dealing under the highest fiduciary standards.

Potential for Multi-Year Penalties. Until an act of self-dealing is corrected, an excise tax can be applied to the self-dealer and to participating foundation managers for each year until such correction takes place. For example, for a disqualified person (self-dealer) with a tax year beginning on January 1, if an act of self-dealing occurs on February 1, 2005, and is not corrected until March 1, 2007, a 5 percent tax can be assessed on the self-dealer for tax years 2005, 2006 and 2007 – in effect, adding up to a 15 percent penalty. Moreover, Congress is considering legislation that would increase this initial tax to 25 percent for each year before correction.

Second-Tier Tax. In any case where an initial tax has been imposed on a self-dealer or on a foundation manager, an additional (or second tier tax) may be applied if the transaction is not corrected within a specified time period. The additional tax on the self-dealer is 200 percent of the amount involved. For foundation managers, the second-tier tax is 50 percent not to exceed \$10,000 with respect to each act of self-dealing. Second-tier taxes are rarely applied and normally occur when a self-dealer is unwilling to correct the transaction giving rise to the violation.

Recommended Steps for Foundations

Given the increased scrutiny of private foundation activities underway by Congress and the Internal Revenue Service, the following recommendations could help prevent problems from arising:

- Provide regular training for board members and staff.
- Adopt a conflict of interest policy if not currently in place.
- Adopt a travel policy if not currently in place.
- Develop annual disclosure forms to be completed regularly by board and staff to identify potential conflicts.
- Identify and regularly update a list of disqualified persons.
- Adopt a policy on the use of tickets to fundraisers detailing who may use them and under what circumstances.

Other Resources

Council on Foundations

- Publications (available for purchase at www.cof.org):
 - *Family Foundations and the Law: What You Need to Know*
 - *Company Foundations and the Self-Dealing Rules*
 - *Top Ten Ways Foundations Get Into Trouble*
- Articles:
 - “Tread Carefully When Sharing Board Members With Grantseekers” A summary of self-dealing issues that may arise when foundation board members also serve on the boards or staffs of grantseeking charities: www.cof.org/Content/General/Display.cfm?contentID=172
 - “Should Your Foundation Cover Travel Expenses of Family Members?” Guidance on the legal and ethical considerations regarding a foundation paying travel and related expenses for children and other family members who are not currently board members or staff. www.cof.org/Content/General/Display.cfm?contentID=3204

Forum of Regional Associations of Grantmakers

- “Conflicts of Interest at Foundations: Avoiding the Bad and Managing the Good” Teleconference and publication <http://www.givingforum.org/policy/accountability-coi.html>

Internal Revenue Service

- General resources: www.irs.gov/charities/index.html
- “Taxes on Self-Dealing” www.irs.gov/charities/foundations/article/0,,id=137678,00.html