



**YIKES!**  
**FINDING AND FIXING**  
**SELF-DEALING (WITH EXAMPLES)**

Presented May 02, 2016

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# **YIKES! FINDING AND FIXING SELF-DEALING (WITH EXAMPLES)**

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# YIKES! FINDING AND FIXING SELF-DEALING (WITH EXAMPLES)

## I. Introduction to Self-Dealing

For purposes of this paper, self-dealing is the execution of a *prohibited transaction* (to which the excise tax imposed by Internal Revenue Code (IRC) §4941 applies) between a *disqualified person* and any one of the following charitable entities: a private foundation (PF), a charitable remainder trust (CRT),<sup>1</sup> a charitable lead trust (CLT)<sup>2</sup> or a pooled income fund (PIF).<sup>3</sup> In general, references in this paper to foundations, PFs, CRTs, CLTs or PIFs are intended to include an implicit reference to the other gift planning tools unless specifically noted. This paper will use case studies and examples to help the reader identify an act of self-dealing and implement the appropriate corrective action.

The self-dealing rules impose severe penalties for and place restrictions on the kinds of transactions into which private foundations and disqualified persons can enter. Merely entering into a prohibited transaction triggers a first-tier excise tax on the amount involved and requires that the parties correct the act. Failing to correct the act of self-dealing within the allotted time triggers a significant, second-tier “additional tax”.<sup>4</sup> Neither the arms-length nature of a transaction nor good intentions nor charitable intent is an acceptable excuse for engaging in an act of self-dealing.<sup>5</sup>

*Self-Dealing prohibits certain transactions between a Disqualified Person and charitable entities including Private Foundations, Charitable Remainder Trusts, Charitable Lead Trusts and Pooled Income Funds.*

The self-dealing excise tax and required corrective acts often impose a harsh penalty on the disqualified person and the foundation manager that seems excessive compared to the potential for harm. In fact, some acts of self-dealing can be highly beneficial for the foundation. However, private foundations, CRTs and CLTs are essentially private charities with minimal, if any, review or monitoring of their transactions by the general public. The self-dealing excise tax institutes safeguards to make the charity whole, to ensure that the charity is thoroughly restored from any harm caused by the transaction and to

prohibit transactions, which could provide an improper or unfair benefit to insiders.

<sup>1</sup> IRC §4947(a)(2), Treas. Reg. §53.4947-1(c)(1)(i). A charitable remainder trust is described at IRC §664 and the regulations thereunder.

<sup>2</sup> IRC §4947(a)(2), Treas. Reg. §53.4947-1(c)(1)(i). A charitable lead trust must also meet the requirements of one or more of IRC §§170(f)(2)(B), 2055(e)(2)(B), and 2522(c)(2)(B).

<sup>3</sup> IRC §4947(a)(2), Treas. Reg. §53.4947-1(c)(1)(i). A pooled income fund is described at IRC §642(c)(5) and the regulations thereunder.

<sup>4</sup> IRC §4941(b).

<sup>5</sup> Prior to the Tax Reform Act of 1969, “arms-length” was the applicable standard in determining whether a transaction was classified as a prohibited transaction. However, the “arms-length” standard was harder to enforce than the current “highest fiduciary” standard that is designed to impose an excise tax on all acts of self-dealing.

Each act of self-dealing that involves a private foundation generally must be self-disclosed under penalty of perjury by answering yes or no to a series of questions on Form 990-PF *Return of Private Foundation*. Acts of self-dealing that involve a CRT, CLT or PIF must be self-reported on Form 5227 *Split-Interest Trust Information Return*. In addition, by answering “yes” on the Form 990-PF or Form 5227 for any act of self-dealing, then Form 4720 *Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code* must be filed to describe the act, to describe the corrective action taken and to compute the excise taxes due.

## II. Disqualified Persons

Disqualified persons are defined at IRC §4946. Disqualified persons may include both individuals and entities. A key exception is that a public charity is never a disqualified person regardless of its relationship to the foundation.<sup>6</sup> This includes all charities described in IRC §509(a)(1), (2) and (3) and their wholly-owned subsidiaries such as chapters, branches and disregarded LLCs.<sup>7</sup> There are five categories of disqualified persons: (1) substantial contributors; (2) foundation managers; (3) family members of substantial contributors or foundation managers; (4) certain related entities; and (5) government officials.

A. *Substantial Contributor*. A substantial contributor is a disqualified person. A substantial contributor is:

- If a PF is structured as a trust, the creator of the trust; and<sup>8</sup>
- A person that contributes or bequeaths, in the aggregate, more than \$5,000, where that contribution or bequest represents more than 2% of the total contributions and bequests ever received by the foundation through the end of the foundation’s taxable year.

*Example #1:* During 2015, Susan contributed \$75,000 to the Jonas Foundation, a calendar year foundation. The total contributions received by the Jonas Foundation from its inception to the end of the Foundation’s 2015 tax year totaled \$750,000 (including Susan’s contribution). Because Susan’s contribution was greater than \$5,000 and represented more than 2% of the Jonas Foundations total contributions, Susan is a substantial contributor.

Contributions are valued as of the date received by the foundation.<sup>9</sup> However, the 2% calculation is not performed until the end of the foundation’s taxable year.<sup>10</sup> An individual is deemed to have also made any contributions or bequests made by his or her spouse.<sup>11</sup>

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<sup>6</sup> Treas. Reg. §53.4946-1(a)(7).

<sup>7</sup> Treas. Reg. §1.507-6(a)(2).

<sup>8</sup> IRC §4946(a)(2) and IRC §507(d)(2).

<sup>9</sup> IRC §507(d)(2)(B)(i).

<sup>10</sup> Treas. Reg. §1.507-6(b)(1). See also Example (3) at Treas. Reg. §1.507-6(b)(2).

<sup>11</sup> IRC §507(d)(2)(B)(iii).

*Disqualified  
Persons include  
donors, board  
members,  
trustees, family  
members and  
related entities.*

Once a person is a substantial contributor, that person is a substantial contributor for all subsequent periods<sup>12</sup> except in the rare instance that all of the following three tests are satisfied:

- The person made no contributions during the 10-year period beginning at the end of the taxable year of the foundation in which he or she last made a contribution and ending at the close of the tenth subsequent taxable year of the private foundation;
- At no time during the 10-year period the person (or a related person) was a foundation manager; and
- The aggregate contributions made by the person (and related persons) are deemed by the Secretary of the Treasury to be insignificant when compared to the aggregate contributions by at least one other person.<sup>13</sup>

Related persons are defined for this purpose to be disqualified persons described at IRC §4946.<sup>14</sup> Note, however, that in the case of a corporation that is a substantial contributor, a related person includes individuals who are officers and/or directors of the corporation.<sup>15</sup>

*Example #2:* John contributed \$25,000 to the Cancer Charity's pooled income fund (PIF) on June 1, 2006 and the total contributions for the life of the PIF through December 31, 2006 were \$1,000,000. Because John gave over \$5,000 and he gave more than 2% of the total contributions through the end of the year of his gift, John is a substantial contributor (and therefore a disqualified person) with respect to Cancer Charity's PIF.

Cancer Charity's PIF is a calendar year taxpayer. The earliest moment in time at which John can no longer be a substantial contributor is January 1, 2017. However, if John was a trustee of Cancer Charity's PIF at any time during the 10-year period ended December 31, 2016, the 10-year clock will not start until the end of the year in which John is no longer a trustee.

Finally, even if both 10-year rules are met, at least one other donor must make a contribution to Cancer Charity's PIF that is large enough that the Treasury Secretary deems John's \$25,000 contribution to be insignificant.

Where a corporation, partnership, trust or unincorporated enterprise is a substantial contributor, then an owner of more than 20% of the *voting* power, profits interest, or beneficial interest (respectively) is a disqualified person.

*Example #3:* Loco Corp. created and funded a corporate private foundation, Loco Foundation. Marcus owns 22% of Loco Corp.'s voting stock. Loco Corp. is a substantial contributor to Loco Foundation. Because Marcus owns more than 20% of the voting stock of Loco Corp, Marcus is also a substantial contributor with respect to Loco Foundation.

*Example #4:* Loco Corp. created and funded a corporate private foundation, Loco Foundation. Tom owns 19% of Loco Corp.'s voting stock. Loco Corp. is a substantial

<sup>12</sup> IRC §507(d)(2)(B)(iv).

<sup>13</sup> IRC §507(d)(2)(C)(i).

<sup>14</sup> IRC §507(d)(2)(B)(ii).

<sup>15</sup> IRC §507(d)(2)(C)(ii).

contributor to Loco Foundation. Because Tom does not own more than 20% of Loco Corp.'s voting stock, Tom is not a substantial contributor with respect to Loco Foundation as a result of his ownership of Loco Corp.

Note, however, that in Example #4 above, Tom could be a substantial contributor as a result of his direct contributions if he contributed to Loco Foundation enough from his personal assets to meet the \$5,000 and 2% tests previously discussed in this paper.

B. *Foundation Manager.* A foundation manager is a disqualified person. A foundation manager is:

- An officer, director, or trustee of the foundation;
  - An individual having the powers or responsibilities of an officer, director, or trustee of the foundation; or
  - With respect to any act, any employee of the foundation having the authority or responsibility with respect to an act (or failure to act).

Parties who regularly exercise general authority to make administrative or policy decisions on behalf of the private foundation are foundation managers.<sup>16</sup> The trustee of a charitable remainder trust, charitable lead trust, or pooled income fund is a foundation manager.<sup>17</sup>

*Example #5:* Donald creates a CLT naming his three nephews, Hubert, Louis, and Dawes, as trustees. As the trustees of the CLT, Hubert, Louis, and Dawes are each foundation managers and, therefore, are disqualified persons with respect to Donald's CLT.

C. *Members of a Substantial Contributor or Foundation Manager's Family.* In addition to a substantial contributor or a foundation manager, certain members of these persons' families are also disqualified persons. These members include:

- Current spouse;
- Ancestors;
- Children, grandchildren and great-grandchildren; and
- Spouses of children, grandchildren and great-grandchildren.<sup>18</sup>

A legally adopted child is treated the same as a child by blood.<sup>19</sup> The implication is that step-children and foster children who are not legally adopted are not considered disqualified persons under this rule.

*Example #6:* Rhonda establishes a charitable remainder unitrust (the Help Me Family CRUT) naming herself as trustee. Rhonda funds the Help Me Family CRUT with 75% of the

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<sup>16</sup> Treas. Reg. §53.4946-1(f)(2)(ii).

<sup>17</sup> Treas. Reg. §53.4946-1(f)(1)(i).

<sup>18</sup> IRC §4946(d) and Treas. Reg. §53.4946-1(h). Note there is a discrepancy between the language of IRC §4946(d) and Treas. Reg. §53.4946-1(h) that dates to 1984 when IRC §4946(d) was amended to limit "descendants" to no further than great-grandchildren. Prior to January 1, 1985, the IRC included **all** lineal descendants and their spouses.

<sup>19</sup> Treas. Reg. §53.4946-1(h).

outstanding stock of Help Me Corp. As trustee, Rhonda subsequently sells that stock to two other parties:

- Brian (who is Rhonda's brother), and
- Steve and Joy Ride (who are Rhonda's son and daughter-in-law).

Rhonda (as the trust's creator and also as the current foundation manager), Steve Ride (as Rhonda's child), and Joy Ride (as the spouse of Rhonda's child) are all disqualified persons with respect to the Help Me Family CRUT. Brian, on the other hand, is not a disqualified person, because his only relationship to the CRUT is that he is Rhonda's brother.

D. *Entities in which a Disqualified Person owns more than 35%.* A corporation, partnership, trust, estate or unincorporated enterprise in which a disqualified person owns a greater than 35% profits interest is a disqualified person.<sup>20</sup>

1) A *corporation* is a disqualified person if greater than 35% of the *voting power* of the corporation is owned by a substantial contributor or a foundation manager.<sup>21</sup> The rules governing the determination of ownership of the voting power in a corporation are very complex.<sup>22</sup> In short, for purposes of determining whether an individual's ownership of the voting power of a corporation exceeds 35%, the stock of the corporation directly owned by a substantial contributor or foundation manager is augmented by:

- Stock in the subject corporation, owned directly or indirectly by a corporation, partnership, estate or trust of which the substantial contributor or foundation manager is an owner, in proportion to the substantial contributor or foundation manager's ownership interest;<sup>23</sup> and
- Stock owned by a member of the substantial contributor or foundation manager's family (as described above in Paragraph 2.B).<sup>24</sup>

Example #7: Bill Chambers owns 75% of the outstanding voting stock of Car Care, Inc. and Bill is the sole donor to the Chambers Family CRAT. Because a substantial contributor to the CRAT owns more than 35% of the outstanding voting stock of Car Care, Inc., that company is a disqualified person with respect to the CRAT.

Example #8: Martin Cray creates and funds the Cray Family Foundation. Martin is a substantial contributor to the Cray Family Foundation. Martin also owns 15% of the outstanding voting stock of Crawdad Research, Inc. as well as 20% of Bullfrog Holdings LLC. Bullfrog Holdings LLC owns 70% of the outstanding voting stock of Crawdad Research, Inc. Martin's daughter, Carrie, owns an additional 10% of the outstanding voting stock of Crawdad Research, Inc.

To determine if Crawdad Research, Inc. is a disqualified person with respect to the Cray Family Foundation, the following computation is necessary:

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<sup>20</sup> IRC §§4946(a)(1)(E), (F), (G) and Treas. Reg. §§53.4946-1(a)(1)(v), (vi), and (vii).

<sup>21</sup> IRC §4946(a)(1)(E) and Treas. Reg. §53.4946-1(a)(1)(v).

<sup>22</sup> Treas. Reg. §53.4946-1(d).

<sup>23</sup> IRC §267(c)(1).

<sup>24</sup> IRC §4946(a)(3). See also, IRC §4946(d) and Treas. Reg. §§53.4946-1(d)(1)(i) and (h).

|  |            |
|--|------------|
| Martin's Direct Ownership                | 15%        |
| Martin's Indirect Ownership (20% of 70%) | 14%        |
| Carrie's Direct Ownership                | 10%        |
| Total Ownership Attributed to Martin     | <u>39%</u> |

Because more than 35% of Crawdad Research, Inc.'s outstanding voting stock is directly or indirectly attributable to Martin, Crawdad Research, Inc. is a disqualified person with respect to the Cray Family Foundation.

Voting power held by an individual in his or her capacity as a director or trustee is not included in determining the voting power owned.<sup>25</sup> Voting power that is obtainable (e.g., through the exercise of options or conversion of a security to voting stock), but not yet obtained is not included in determining the voting power owned.<sup>26</sup> Double-counting of stockholdings is not required where an individual's stock ownership is deemed owned directly or constructively.<sup>27</sup> If a limited liability company (LLC) chooses to be taxed as a corporation, these rules also apply to the LLC.

- 2) A *partnership* is a disqualified person if over 35% of the *profits interest* of the partnership is owned by a substantial contributor or a foundation manager.<sup>28</sup> The rules governing the determination of ownership of the profits interest in a partnership are similar to those used to determine the voting power in a corporation.<sup>29</sup> This includes the rules related to family ownership. If a limited liability company (LLC) chooses to be taxed as a partnership, these rules also apply to the LLC.
- 3) A *trust* or *estate* is a disqualified person if more than 35% of the *beneficial interest* of the trust or estate is owned by a substantial contributor or foundation manager.<sup>30</sup> An individual's beneficial interest in a trust or estate is determined in proportion to the individual's actuarial interest in the trust or estate.<sup>31</sup> In most other respects, the rules governing the determination of ownership of a beneficial interest in a trust or estate are similar to those used to determine the voting power in a corporation.<sup>32</sup>

E. *Government Officials*. Certain government officials are disqualified persons by virtue of their employment.<sup>33</sup> A government official is a person who, at the time of the prohibited act, holds any of the following offices or positions:

- 1) An elective public office in the executive or legislative branch of the U.S. Government;

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<sup>25</sup> Treas. Reg. §53.4946-1(a)(5).

<sup>26</sup> Treas. Reg. §53.4946-1(a)(6).

<sup>27</sup> Treas. Reg. §53.4946-1(d)(1)(ii).

<sup>28</sup> IRC §4946(a)(1)(F) and Treas. Reg. §53.4946-1(a)(1)(vi).

<sup>29</sup> IRC §4946(a)(4) and Treas. Reg. §53.4946-1(e).

<sup>30</sup> IRC §4946(a)(1)(G) and Treas. Reg. §53.4946-1(a)(1)(vii).

<sup>31</sup> Treas. Reg. §53.4946-1(a)(4).

<sup>32</sup> IRC §4946(a)(4) and Treas. Reg. §53.4946-1(e).

<sup>33</sup> IRC §4946(c) and Treas. Reg. §53.4946-1(g).



- 2) A Presidentially-appointed office in the executive or judicial branch of the U.S. Government;
- 3) A position in any branch of the U.S. Government (a) which is listed in schedule C of rule VI of the Civil Service Rules, or (b) the compensation for which is at least the lowest GS-16 salary;
- 4) A position under the U.S. House of Representatives or Senate at an annual salary of at least \$15,000;
- 5) An elective or appointive “public office” in the executive, legislative or judicial branch of the government of a state, U.S. possession, or political subdivision or area of either, or of the District of Columbia, at an annual salary of at least \$20,000; and
- 6) A position as personal or executive assistant or secretary to any of the above.

Part of the analysis of the government official rule is to consider whether the person has a policy-making role and also to review the total compensation of the official including expense allowances. The government official rule continues to apply even though the government official is on an unpaid leave of absence.

### III. Prohibited Transactions

Using a broad brush, the IRC and accompanying regulations prohibit the majority of transactions into which a private foundation might enter into with a disqualified person. The following list of seven such transactions is found at IRC §4941(d)(1):

1. Purchasing, Selling or Exchanging property;
2. Leasing property;
3. Making loans;
4. Furnishing goods, services or facilities;
5. Paying compensation;
6. Transferring or using a foundation’s assets; and
7. Making payments to government officials.

#### A. Purchasing, Selling or Exchanging Property.

- 1) In General. The sale or exchange of property is an act of self-dealing regardless of the dollar amount involved, the legitimacy of the value assigned to the property or the existence of a “bargain” element in favor of the private foundation.<sup>34</sup>

*Example #9:* If Alpha Foundation purchases office supplies from Alpha Depot, a disqualified person, then both Alpha Foundation and Alpha Depot have engaged in a prohibited act of self-dealing.

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<sup>34</sup> IRC §4941(d)(1)(A) and Treas. Reg. §53.4941(d)-2(a)(1).

Note: This example illustrates the lack of a *de minimus* standard in applying the self-dealing rules.<sup>35</sup>

The Service ruled that a private foundation's sale of some of its works of art at public auction to a disqualified person was an act of self-dealing.<sup>36</sup> The Service reached this conclusion despite the fact that sales were to be made to the highest bidder and despite the fact that the auction was conducted by a third party that announced and promoted the auction in such a manner as to obtain the widest possible attention of potential buyers. While all of the elements were present to ensure that the fairest possible market value would be obtained, the purchase by the disqualified person was still a prohibited act of self-dealing.

### *Prohibited*

#### *Transactions include:*

- 1. Buying, selling or exchanging property;*
- 2. Leasing property;*
- 3. Making loans;*
- 4. Furnishing goods, services or facilities;*
- 5. Paying compensation;*
- 6. Using a foundation's assets; and*
- 7. Making payments to government officials.*

2) Gifts of Mortgaged Property Treated as a Sale. The regulations provide that the transfer to a private foundation of property that is subject to a mortgage or similar lien is to be treated as a sale or exchange if 1) the private foundation assumes the mortgage or lien, or 2) a disqualified person placed the mortgage or lien on the property within the ten-year period ending on the date of transfer (the "old" half of the so-called "old and cold" rule).<sup>37</sup>

The Service ruled that the gift to a private foundation by a disqualified person of a life insurance policy that was subject to an outstanding policy loan made to the donor was an act of self-dealing.<sup>38</sup> The Service ruled that despite the fact that the insurance company would not demand repayment, but rather would reduce the death benefit by the amount of the loan and any accrued interest, meant that the policy loan met the definition of

a "mortgage or similar lien."

3) Certain Corporate Reorganizations. While most sales transactions between a disqualified person and a foundation are prohibited acts of self-dealing, there is a noteworthy exception for many types of corporate reorganizations.<sup>39</sup> The IRC lists two standards that apply to these transactions:

- All of the securities of the same class as that held by the foundation must be subject to the same terms, and
- The foundation must receive no less than fair market value.

The regulations explain that:

<sup>35</sup> Treas. Reg. §53.4941(d)-2(a)(1).

<sup>36</sup> Rev. Rul. 76-18, 1976-1 CB 355.

<sup>37</sup> Treas. Reg. §53.4941(d)-2(a)(2).

<sup>38</sup> Rev. Rul. 80-132, 1980-1 CB 255.

<sup>39</sup> IRC §4941(d)(2)(F) and Treas. Reg. §53.4941(d)-3(d).

[A]ll of the securities are not subject to the same terms unless, pursuant to such transaction, the corporation makes a bona fide offer on a uniform basis to the foundation and every other person who holds such securities.<sup>40</sup>

*Example #10:* Dan Patch creates the Patch Family CRUT and funds it with 40% of the outstanding common stock of Pacer Corp., a closely-held C-corporation. Dan and his children own the remaining 60% of the outstanding common stock of Pacer Corp. Because Dan and his children own over 35% of the voting stock of Pacer Corp., Pacer Corp. is a disqualified person with respect to the Patch Family CRUT.

The board of Pacer Corp. (of which Dan is the chairman) votes to extend a redemption offer for 15% of the outstanding common stock to all shareholders of Pacer Corp. All shareholders are duly notified of the offer. To determine the redemption price, the stock is appraised by a competent business appraiser. Dan, as trustee of the Patch Family CRUT, is the only shareholder to accept the redemption offer. The Patch Family CRUT surrenders 15% of its shares in Pacer Corp. and receives cash in return. This transaction will qualify for the exception for corporate reorganizations.

This example is analogous to the facts in the *Palmer* case<sup>41</sup> to which the IRS later acquiesced.<sup>42</sup>

If the foundation receives bonds (or a note) in exchange for the stock, while other shareholders of the same class receive cash, then an act of self-dealing has occurred.<sup>43</sup> A trap for the unwary exists if the foundation receives bonds (or a note) in a redemption transaction and continues to hold those bonds (or a note) beyond the end of that tax year. In this situation, the foundation will be treated as extending credit to the corporation, which is an impermissible act of self-dealing.<sup>44</sup>

In addition to redeeming its own stock, the following types of corporate reorganizations are also permitted:

- liquidation,
- merger,
- recapitalization, or
- other corporate adjustment, organization or reorganization.<sup>45</sup>

As a result, nearly any corporate change of ownership could qualify including stock buy-back programs, mergers, spin-offs and split-ups. This important exception can be used by a family as part of a plan to transfer control of the family business to the next generation. Nevertheless, these transactions must be structured properly with close attention paid to the requirements of the applicable Treasury Regulations.

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<sup>40</sup> Treas. Reg. §53.4941(d)-3(d)(1).

<sup>41</sup> *Palmer v. Commissioner*, 62 T.C. 684 (1974).

<sup>42</sup> Rev. Rul. 78-197, 1978-1 CB 83.

<sup>43</sup> Treas. Reg. §53.4941(d)-3(d)(1).

<sup>44</sup> IRC §4941(d)(1)(B) and Treas. Reg. §53.4941(d)-3(d)(2), Example (2). See also Paragraph C(3) in this paper.

<sup>45</sup> IRC §4941(d)(2)(F).

- 4) Special Exception for the First Transaction. An important exception is that a transaction is not self-dealing if the disqualified person became disqualified only as a result of the transaction.

*Example #11:* Somebody with no relationship to Christina Shelton created the Voice Foundation. Christina sells 55 acres of farmland appraised at \$500,000 to the Voice Foundation in a bargain sale for \$300,000. Prior to this bargain sale, Christina had no relationship with the Voice Foundation. Christina has made a gift of \$200,000 to the Voice Foundation, which makes her a substantial contributor and if a disqualified person sold property to the Voice Foundation, this would be an act of self-dealing. However, because Christina became a substantial contributor only because of this bargain sale, the act is not self-dealing.

*Example #12:* Assume the same facts as in Example #11 above; however, the Voice Foundation's payments to Christina under the bargain sale are split over multiple tax years in an installment sale. The payments made during the year of the sale are still excepted from self-dealing. However, any payment made during a succeeding year is an act of self-dealing.

## **B. Leases.**

In general, the leasing of property between a private foundation and a disqualified person is an act of self-dealing.<sup>46</sup>

*Exceptions:* A disqualified person is permitted to lease property to a foundation at no charge. However, the foundation is required to enter into separate arrangements with (non-disqualified) janitorial service providers, utility providers, maintenance workers and so forth for these services. For example, if a corporate private foundation leases space at no charge within the corporate headquarters building, that is not self-dealing. However, if the foundation reimburses the corporation for an allocable share of building expenses, that is self-dealing.<sup>47</sup> Further, lease payments for building services to a building management company that is a subsidiary of the disqualified corporation is also self-dealing.

Certain leases that were in effect on October 9, 1969 are excluded from treatment as an act of self-dealing if other requirements are met.<sup>48</sup>

## **C. Loans.**

The lending of money or other extension of credit between a foundation and a disqualified person normally constitutes an act of self-dealing.<sup>49</sup>

*Example #13:* Jay and Mary Johnson established the Johnson Charitable Foundation. At Jay's death, his brother Josh was appointed a trustee of the Johnson Charitable Foundation. Josh had no previous connection with the foundation. On July 1, 2015, Josh executed a promissory note borrowing \$15,000 from the Johnson Charitable Foundation at a fair market rate and with customary terms. Josh and the Johnson Charitable Foundation have

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<sup>46</sup> IRC §4941(d)(1)(A) and Treas. Reg. §53.4941(d)-2(b)(1).

<sup>47</sup> Treas. Reg. §53.4941(d)-2(b)(2).

<sup>48</sup> Treas. Reg. §53.4941(d)-2(b)(3).

<sup>49</sup> IRC §4941(d)(1)(B) and Treas. Reg. §53.4941(d)-2(c)(1).

now engaged in an act of self-dealing. Had Josh not been a trustee of the Johnson Charitable Foundation, he would not have been a disqualified person and this transaction would not have been prohibited.

The regulations clarify that inserting a non-disqualified “straw” person in the middle of a series of transactions in order to circumvent the prohibition against the lending of money or extension of credit to a disqualified person will not exempt an act from self-dealing.<sup>50</sup> This can create a trap for some clients.

*Example #14:* Jack is one of several trustees of the Tumbling Foundation. Jill, who has no relationship with the Tumbling Foundation, loans \$40,000 to Jack in his individual capacity. Sometime later, Jill, without Jack’s knowledge or consent, gives the loan to the Tumbling Foundation. Because of Jill’s gift, Jack and the Tumbling Foundation have now (perhaps unwittingly) committed an act of self-dealing, for which excise taxes are due and which must be reported and corrected.

A CRT’s failure to make unitrust or annuity payments in a timely manner can become an act of self-dealing as an extension of credit from a disqualified person to a CRT.<sup>51</sup> Similarly, the failure to recoup the overpayment of a unitrust or annuity amount within a reasonable period of time from a CRT or PIF income beneficiary should also be an act of self-dealing as an extension of credit from a CRT to a disqualified person.

While a foundation may not make a loan to a disqualified person, a disqualified person may make a loan to a foundation if:<sup>52</sup>

- The disqualified person does not charge interest;
- The foundation uses the loan to further its exempt purposes;<sup>53</sup> and
- The foundation repays the disqualified person with cash.<sup>54</sup>

*Example #15:* Helen Sullivan, a disqualified person with respect to the Anne Keller Foundation, made an interest-free \$50,000 loan to the Foundation for the purpose of funding scholarships. So long as the Foundation repays the loan with cash, no act of self-dealing will have occurred.

*Example #16:* On March 16, 2015, Reid Webster, a disqualified person with respect to the Building Literacy Foundation, made an interest-free \$72,000 loan to the Foundation, payable on March 16, 2016, for the purpose of purchasing books to be used in an inner-city literacy program. On March 16, 2016, the Foundation transferred securities valued at \$72,000 to Reid in satisfaction of the loan. The Service ruled that the transfer of stock in repayment of an interest-free loan was “tantamount to a sale or exchange of property” and therefore was a prohibited act of self-dealing.<sup>55</sup>

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<sup>50</sup> Treas. Reg. §53.4941(d)-2(c)(1).

<sup>51</sup> Treas. Reg. §1.664-2(a)(1)(i)(a) and (b). Treas. Reg. §1.664-3(a)(1)(i)(g) and (h).

<sup>52</sup> IRC §4941(d)(2)(B). See also Treas. Reg. §53.4941(d)-2(c)(2). Note the regulations omit the requirement that the loan proceeds be used exclusively to accomplish the foundation’s exempt purpose.

<sup>53</sup> IRC §4941(d)(2)(B).

<sup>54</sup> Rev. Rul. 77-379, 1977-2 CB 387.

<sup>55</sup> Rev. Rul. 77-379, 1977-2 CB 387.

Penalties and other charges (e.g., a late fee) assessed on an interest-free loan pose a hidden danger. Such charges are considered to be payments of interest, which means those payments will be an act of self-dealing.

Finally, although the loan must be interest-free to qualify for this exception from self-dealing, by not charging interest, the disqualified person is treated for income tax purposes as though the foundation paid interest to her and as though she made a cash gift to the foundation.<sup>56</sup> Therefore, she can claim an income tax charitable deduction for the imputed gift to the foundation, but must also report the imputed interest payment on her personal tax return.

*Example #17:* Mitt Ryan, a trustee of Bay Foundation, loaned \$30,000 to Bay Foundation at no interest for one year. The Bay Foundation used the loan proceeds for its charitable purposes and repaid the loan in cash with no interest or other charges. The appropriate amount of interest for such a loan is \$600. Mitt can claim a \$600 income tax charitable deduction for the forgiven interest as a cash gift to Bay Foundation. Mitt also owes income tax on \$600 of interest income.

A promise to make a future gift to the foundation, no matter how the promise is evidenced, is not an act of self-dealing to the extent that the promise is motivated by charitable intent and unsupported by consideration from the foundation.<sup>57</sup>

Certain general banking services provided by a bank or trust company are exempt from treatment as an act of self-dealing where banking services are reasonable and necessary to carry out the foundation's exempt purpose. Examples of these services include checking accounts (as long as no interest is imposed on overwithdrawals), savings accounts (so long as the foundation may withdraw funds upon 30-days or less notice) and safe-keeping services. The fee charged for any such service must not be excessive.<sup>58</sup>

#### **D. Furnishing Goods, Services or Facilities.**

The furnishing of goods, services or facilities between a private foundation and a disqualified person is normally an act of self-dealing.<sup>59</sup> The regulations list a number of goods, services or facilities that are prohibited, including:

- Office Space
- Libraries
- Parking Lots
- Automobiles
- Publications
- Secretarial Help
- Auditoriums
- Laboratories
- Meals

*Exceptions:* There are three key exceptions to the rule that the furnishing of goods, services or facilities is an act of self-dealing.

- 1) A disqualified person may provide goods, services or facilities to a private foundation at no charge without engaging in an act of self-dealing. Therefore, it is permissible for a disqualified person to make office supplies, janitorial

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<sup>56</sup> IRC §7872(a)(1).

<sup>57</sup> Treas. Reg. §53.4941(d)-2(c)(3).

<sup>58</sup> Treas. Reg. §53.4941(d)-2(c)(4).

<sup>59</sup> IRC §4941(d)(1)(C) and Treas. Reg. §53.4941 (d)-2(d)(1).

services or office space available to a private foundation at no charge. Under these terms, it is permissible for the private foundation to bear certain costs such as transportation, insurance or maintenance costs it properly incurs in obtaining or using the property so long as the payments are not made directly or indirectly to a disqualified person.

- 2) A disqualified person may provide personal services and charge a fee for such services so long as the service is necessary and the fee is not excessive.

*Example #18:* A law firm may charge a fee for providing legal services to a foundation even if the firm is a disqualified person.<sup>60</sup>

*Example #19:* The trustee of a CRT who is also a professional investment manager may charge a reasonable fee for managing the trust's investments.<sup>61</sup>

However, in the *Madden* case, the Tax Court limited the exception for personal services to professional and managerial services.<sup>62</sup> In *Madden*, a museum was organized as a private foundation. The museum's trustees also owned a 75% interest in a corporation that provided maintenance and janitorial services to clean and repair the museum's sculptures and other display pieces. The court held that maintenance and janitorial services did not fit the personal services exception because they were not "professional or managerial" in nature.<sup>63</sup>

In another instance, the Service ruled that the rental of a charter aircraft by a disqualified person to a private foundation was a prohibited act of self-dealing and did not constitute the performance of personal services.<sup>64</sup>

- 3) A foundation may provide goods, services or facilities to a foundation manager or employee (or a volunteer that would be an employee but for the fact that he or she receives no compensation) in recognition of his or her services if:
- The furnishing of the goods, services or facilities is reasonable and necessary to the performance of his or her tasks in carrying out the exempt purposes of the foundation; and
  - The value of furnishing the goods, services or facilities considered in conjunction with any other compensation is reasonable in amount.

## E. Paying Compensation.

With very limited exceptions, all compensation paid to a government official is self-dealing.<sup>65</sup> For disqualified persons other than government officials, a foundation's payment of compensation, payment of expenses or reimbursement of expenses is an act of self-dealing to the extent the payment exceeds what is reasonable and necessary to carry out the exempt purpose of the foundation.<sup>66</sup>

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<sup>60</sup> Treas. Reg. §53.4941(d)-3(c)(2), Example (1).

<sup>61</sup> Treas. Reg. §53.4941(d)-3(c)(2), Example (2).

<sup>62</sup> *John W. Madden Jr., et al. v. Commissioner*, TC Memo 1997-395, 2524.

<sup>63</sup> *John W. Madden Jr., et al. v. Commissioner*, TC Memo 1997-395, 2524, 2534.

<sup>64</sup> Rev. Rul. 73-363, 1973-2 CB 383.

<sup>65</sup> IRC §4941(d)(1)(F) and Treas. Reg. §53.4941(d)-2(g).

<sup>66</sup> IRC §4941(d)(1)(D) and Treas. Reg. §53.4941(d)-2(e).

## **F. Transferring or Using the Income or Assets of a Private Foundation.**

The transfer to, or use by or for the benefit of, a disqualified person of the income or the assets of a private foundation is an act of self-dealing.<sup>67</sup> For example:

- The foundation's payment of a legally-enforceable pledge made by a disqualified person is an act of self-dealing.<sup>68</sup>
- Using a private foundation's assets to manipulate the value of stock to the advantage of a disqualified person is an act of self-dealing.<sup>69</sup>
- The foundation's guaranteeing repayment to anybody of a loan made to a disqualified person is an act of self-dealing.<sup>70</sup>
- Displaying paintings owned by a private foundation in the private residence of a disqualified person is an act of self-dealing.<sup>71</sup>
- Paying the unitrust amount or annuity amount each year to the named beneficiaries of a CRT is not an act of self-dealing even if the beneficiary is otherwise a disqualified person.<sup>72</sup>

## **G. Making Payments to a Government Official.**

Payments by a private foundation to a government official are an act of self-dealing.<sup>73</sup> A number of exceptions to the self-dealing rules apply to government officials<sup>74</sup> all of which are beyond the scope of this paper.

## **IV. Self-Dealing Excise Taxes and Reporting Requirements**

Disqualified persons who participate in an act of self-dealing are subject to two tiers of excise tax: the "initial tax" and a potential "additional tax" if the self-dealing act is not corrected. Both of these taxes could be imposed on each act of self-dealing.

### **A. The Initial Tax<sup>75</sup>**

The initial tax applies whenever an act of self-dealing occurs.

In addition to the two-tier nature of the IRC §4941 excise tax regime, the tax is imposed on both the disqualified person(s) and the foundation manager(s) who acted on behalf of the foundation. However, the excise tax rate assessed is different for these two types of participants. The initial tax rate for a disqualified person is 10%<sup>76</sup> of the self-

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<sup>67</sup> IRC §4941(d)(1)(E) and Treas. Reg. §53.4941(d)-2(f)(1).

<sup>68</sup> Treas. Reg. §53.4941(d)-2(f)(1).

<sup>69</sup> Treas. Reg. §53.4941(d)-2(f)(1).

<sup>70</sup> Treas. Reg. §53.4941(d)-2(f)(1).

<sup>71</sup> Rev. Rul. 74-600, 1974-2 CB 385.

<sup>72</sup> IRC §4947(a)(2)(A) and Treas. Reg. §53.4947-1(c)(2)(i).

<sup>73</sup> IRC §4941(d)(1)(F) and Treas. Reg. §53.4941(d)-2(g).

<sup>74</sup> IRC §4941(d)(2)(G) and Treas. Reg. §53.4941(d)-3(e).

<sup>75</sup> IRC §4941(a) and Treas. Reg. §53.4941(a)-1.

<sup>76</sup> IRC §4941(a)(1) and Treas. Reg. §53.4941(a)-1(a)(1).



dealing amount with no maximum. The initial rate for a foundation manager is the smaller of 5%<sup>77</sup> of the self-dealing amount or \$20,000.<sup>78, 79</sup>

Where a foundation manager is also the disqualified person, both the tax on the disqualified person and the tax on the foundation manager are assessed against the same person.<sup>80</sup>

*Example #20:* Ralph Kramer, the trustee of the Kramer Family CLT, purchased a 5-acre tract of land from the CLT for \$250,000. At closing, he represented the CLT in his capacity as trustee. Ralph is liable for both the 10% initial tax as a disqualified person and the 5% initial tax as a foundation manager.

### **B. The Additional Tax<sup>81</sup>**

The additional tax is imposed where an act of self-dealing is not corrected within the taxable period.<sup>82</sup> However, if a tax determination is contested in court, the second-tier tax is not assessed until the judgment of the court is final. This means that if the correction is completed anytime before the judgment of the court becomes final, the second-tier tax is not assessed.<sup>83</sup>

The additional tax rate for a disqualified person is 200%<sup>84</sup> of the self-dealing amount with no maximum. The additional tax rate for a foundation manager is the smaller of 50%<sup>85</sup> of the self-dealing amount or \$20,000.<sup>86, 87</sup>

### **C. Joint and Several Liability**

Where more than one individual participates in the same act of self-dealing, the individuals are jointly and severally liable for the initial and/or the additional tax assessed.<sup>88</sup>

If two or more disqualified persons jointly participate in an act of self-dealing, then there is an act of self-dealing for each individual. However, if the disqualified persons are members of the same family, only one act of self-dealing will be deemed to have occurred. Where this exception applies, all such family members will be jointly and severally liable for the tax assessed.<sup>89</sup>

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<sup>77</sup> IRC §4941(a)(2) and Treas. Reg. §53.4941(a)-1(b)(1).

<sup>78</sup> IRC §4941(c)(2) and Treas. Reg. §53.4941(c)-1(b)(1).

<sup>79</sup> Before the Pension Protection Act of 2006, these rates were 5% on the disqualified person and 2½% on the foundation manager with a \$10,000 ceiling on the foundation manager's excise tax.

<sup>80</sup> Treas. Reg. §53.4941(a)-1(a)(1). Specifically, see the last sentence of that subparagraph.

<sup>81</sup> IRC §4941(b) and Treas. Reg. §53.4941(b)-1.

<sup>82</sup> IRC §4941(b)(1) and Treas. Reg. §53.4941(b)-1.

<sup>83</sup> IRC §4961 and Treas. Reg. §§53.4961-1 and 53.4961-2(e). See also *Kermit Fischer Foundation*, TC Memo 1990-300, 90-1412, 90-1416.

<sup>84</sup> IRC §4941(b)(1) and Treas. Reg. §53.4941(b)-1(a).

<sup>85</sup> IRC §4941(b)(2) and Treas. Reg. §53.4941(b)-1(b).

<sup>86</sup> IRC §4941(c)(2) and Treas. Reg. §53.4941(c)-1(b)(1).

<sup>87</sup> Note that although the Pension Protection Act of 2006 increased the excise tax rate on the disqualified person, increased the excise tax rate on the foundation manager and increased the excise tax ceiling on the foundation manager for the initial tax, the additional tax computations have remained at these levels since inception.

<sup>88</sup> IRC §4941(c)(1) and Treas. Reg. §53.4941(c)-1(a)(1).

<sup>89</sup> Treas. Reg. §53.4941(e)-1(e)(2).

*Example #21:* Cookie Foundation permits George and Martha Toll, both of whom are married to each other and disqualified persons, to use the Foundation's mountain cabin for a weekend getaway. The value of the use of the cabin for a weekend is \$400. Even though both George and Martha are each disqualified persons with respect to the Cookie Foundation, there is only one act of self-dealing. However, George and Martha are jointly and severally liable for the payment of any excise tax.

#### **D. Taxable Period**

The taxable period commences on the day the act of self-dealing occurs. The end of the taxable period is the earliest of:<sup>90</sup>

- The date of the mailing of a notice of deficiency under IRC §6212;
- The date on which the correction of the act of self-dealing is completed; and
- The date on which the initial tax is assessed.

#### **E. Participation**

- 1) *By the Disqualified Person.* A disqualified person is deemed to have participated in an act of self-dealing even if he or she had no knowledge at the time that the transaction was an act of self-dealing.<sup>91</sup> Participation need not be direct. An act of self-dealing may occur where a disqualified person takes part in an act of self-dealing with others or directs any person to do so.<sup>92</sup>
- 2) *By the Foundation Manager.* A foundation manager will not be held to have participated in an act of self-dealing if any one of the following three tests is met:<sup>93</sup>
  - a) *The foundation manager participated in the act of self-dealing not knowing that it was an act of self-dealing.* To "know" means that the foundation manager (1) had actual knowledge of sufficient facts, so that based solely upon those facts, the transaction would be an act of self-dealing; (2) was aware that the transaction described by these known facts may violate federal tax law governing self-dealing; and (3) either negligently failed to make reasonable attempts to ascertain that the transaction was an act of self-dealing, or actually was aware that it was an act of self-dealing.
  - b) *The foundation manager's participation was not willful.* For a foundation manager's participation to be willful, it must have been voluntary, conscious and intentional. To be found willful does not require that the participation be motivated by a desire to avoid the restrictions of the law or the incurrence of any tax. If the foundation manager did not meet the "knowing" standard, then he or she is deemed to have not acted willfully.

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<sup>90</sup> IRC §4941(e)(1) and Treas. Reg. §53.4941(e)-1(a).

<sup>91</sup> Treas. Reg. §53.4941(a)-1(a)(1).

<sup>92</sup> Treas. Reg. §53.4941(a)-1(a)(3).

<sup>93</sup> IRC §4941(a)(2) and Treas. Reg. §53.4941(a)-1(b). See also *John W. Madden Jr., et al. v. Commissioner*, TC Memo 1997-395, 2524, 2536.

- c) *Reasonable cause*. The foundation manager exercised his or her responsibility on behalf of the foundation with ordinary business care and prudence.

In addition, to this three-part test, a foundation manager that relies on a written, reasoned opinion of legal counsel (who has been apprised of all of the relevant facts) will not be considered “knowing” or “willful” and will ordinarily be considered to have acted with “reasonable cause.”<sup>94</sup>

## F. Reporting

Each year on the tax return,<sup>95</sup> the signer must either affirmatively state that no act of self-dealing has occurred or disclose that such an act has occurred. These returns must be signed under penalties of perjury by an officer or trustee of the foundation.

If an act of self-dealing is disclosed on the return, then Form 4720 *Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code* must also be completed and filed at the IRS Service Center at Ogden, Utah.

Note that Form 4720 is a non-masterfile form. As a result, most correspondence with the Service regarding this form requires special handling. In the author’s experience, processing delays are common.

## V. Determining the Self-Dealing Amount

The computation of the self-dealing amount is dependent on the nature of the act of self-dealing and whether the tax being assessed is the initial tax or the additional tax. Where the fair market value of an asset is used to compute the self-dealing amount, the fair market value on the date the act of self-dealing occurred is used to compute the initial tax.<sup>96</sup> However, the highest fair market value during the taxable period is used when computing the additional tax.<sup>97</sup>

### A. Sales and Exchanges

The self-dealing amount where a sale or exchange transaction has taken place is the greater of the cash and the fair market value of the property given or the cash and the fair market value of the property received.<sup>98</sup>

*Example #22:* Dave T., a disqualified person with respect to the Square Burger Foundation, pays \$5,000 to the Square Burger Foundation on June 15, 2014 to purchase 100 shares of stock in XYZ Corp. The fair market value of 100 shares of stock in XYZ Corp. on June 15, 2014 is \$4,800. Note that this results in a \$200 benefit to the Square Burger Foundation. The self-dealing amount for the initial tax is the greater of \$5,000 or \$4,800, which is \$5,000.

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<sup>94</sup> Treas. Reg. §53.4941(a)-1(b)(6).

<sup>95</sup> For Private Foundations, the self-dealing reporting part of the annual return is Form 990-PF *Return of Private Foundation* (Part VII-B). For Charitable Remainder Trusts, Charitable Lead Trusts, and Pooled Income Funds, the self-dealing reporting part of the annual return is Form 5227 *Split-Interest Trust Information Return* (Part VI-B).

<sup>96</sup> IRC §4941(e)(2)(A), Treas. Reg. §53.4941(e)-1(b)(3).

<sup>97</sup> IRC §4941(e)(2)(B), Treas. Reg. §53.4941(e)-1(b)(3).

<sup>98</sup> Treas. Reg. §53.4941(e)-1(b)(1).

Dave T. wanted to help the Foundation so he paid a higher price for the stock than its fair market value. However, this cost Dave T. because the self-dealing amount for the initial tax is based on the higher of the payment or the stock's fair market value.

*Example #23:* Start with the same facts as in Example #22 above. On December 20, 2015, Dave T. sold the stock for \$6,000 on the open market. Seven days later, on December 27, 2015, the IRS issued a notice of deficiency with respect to the initial and additional taxes, thereby ending the taxable period. Between June 15, 2014 and December 27, 2015 (the taxable period), the stock reached a high watermark value of \$6,700. The self-dealing amount for the additional tax is the greater of \$5,000 or \$6,700, which is \$6,700.

## **B. Leases.**

Where a lease is determined to be an act of self-dealing, the self-dealing amount is the greater of the amount paid to lease the property or the fair rental value of the property leased for the period for which the property is leased.<sup>99</sup> The computation is made for the period of time that the property is actually leased.

*Example #24:* Cecilia, a disqualified person with respect to the Gilliam Foundation, leases office space from the Foundation for \$36,000 for twelve months beginning on January 1, 2015. The fair rental value of the office space on January 1, 2015 is \$56,000. Note that Cecilia underpaid the foundation by \$20,000. The self-dealing amount is the greater of \$36,000 or \$56,000, which is \$56,000.

## **C. Loans.**

Similar to a lease, the self-dealing amount for a loan is the greater of the interest or other fee actually paid for the use of the money or other extension of credit or the fair market rate for such use or extension of credit.<sup>100</sup> The computation is made for the period of time that the loan is actually in effect.

*Example #25:* Bramlee, a disqualified person with respect to Phillips Foundation, borrows \$100,000 from Phillips Foundation at 6% annual interest. Both the principal and interest are to be paid one year from the date of the loan. Six months later, Bramlee repays the \$100,000 principal and 6 months of interest (\$3,000). The fair market rate for similar loans on the date of the loan is 10% per annum. The fair market value for the use of the money for the 6-month period is 10% times \$100,000 times ½ year = \$5,000. Therefore, the self-dealing amount is the greater of \$3,000 or \$5,000, which is \$5,000.

## **D. Furnishing of Goods, Services or Facilities.**

The self-dealing amount under these circumstances is the greater of the cash paid for the goods, services or facilities or their fair market value.<sup>101</sup>

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<sup>99</sup> Treas. Reg. §53.4941(e)-1(b)(2)(ii).

<sup>100</sup> Treas. Reg. §53.4941(e)-1(b)(2)(ii).

<sup>101</sup> Treas. Reg. §53.4941(e)-1(b)(2)(ii).

### E. Transfer or Use of the Income or Assets of a Foundation.

Where income is transferred to a disqualified person, the self-dealing amount is the income transferred. Where a disqualified person is allowed to use the assets of the foundation, the self-dealing amount is the greater of any cash paid for the use of the assets or the fair value of their use.<sup>102</sup>

*The Standard for Correcting an Act of Self-Dealing is the “highest fiduciary” standard. As a result, the disqualified person often must pay more to correct an act of self-dealing than (s)he received from engaging in an act of self-dealing.*

### F. Compensation

Where excess compensation is the subject of the act of self-dealing, the amount of the excess compensation is the self-dealing amount.<sup>103</sup> In addition to salary, compensation includes other forms of compensation such as health benefits, expense accounts, insurance premiums, etc.

*Example #26:* John, a foundation manager, is paid \$75,000 per year for his services. A review of John’s compensation determines that individuals in other similar size foundations, performing similar services, with a similar amount of experience and education, and having a similar degree of experience are generally compensated at a rate of \$50,000 per year. The self-dealing amount is the excess of the compensation

actually paid (\$75,000) over the maximum amount that should have been paid (\$50,000), which is \$25,000.

In order to determine that some compensation is “excess” compensation, we need to determine the amount of compensation that is proper. The regulations provide that compensation that is reasonable and necessary to accomplish the private foundation’s exempt purpose is proper.<sup>104</sup> A number of resources exist for gauging the appropriateness of compensation. Organizations such as GuideStar and the Council on Foundations publish salary surveys for foundations of various sizes and differing job descriptions. For trustees of CRTs, CLTs and PIFs, surveys of bank and trust company fees within a geographic region may be a useful tool to establish a starting point for determining the reasonableness of compensation.

As noted above, almost all compensation of any nature paid to a government official is self-dealing regardless of whether some or all of that compensation satisfies the reasonable and necessary standards.

The subject of compensation paid to a disqualified person is a matter of much controversy. As a result, those with an interest in this area should pay close attention to legislative action.

<sup>102</sup> Treas. Reg. §53.4941(e)-1(b)(2)(ii).

<sup>103</sup> Treas. Reg. §53.4941(e)-1(b)(2)(iii).

<sup>104</sup> Treas. Reg. §53.4941(d)-3(c)(1).

## G. Number of Acts of Self-Dealing

In general, when a transaction is determined to be an act of self-dealing there is deemed to be only one act of self-dealing.<sup>105</sup>

*Example #27:* Zeke, a disqualified person with respect to the Zephyr Foundation, purchased a parcel of land from the foundation. The purchase is one act of self-dealing.

However, where the transaction involves the use of money or property (e.g., the leasing of property, lending of money or other extension of credit, or payment of compensation), the transaction will give rise to one act of self-dealing on the day the transaction occurs plus another act of self-dealing on the first day of each subsequent taxable year within the taxable period.<sup>106</sup> Please do not confuse these additional or multiple acts of self-dealing with the “additional tax” of IRC §4941(b) when a self-dealing act is not corrected quickly enough.

*Example #28:* The Simple Simon Foundation leases a building to Jeremy, a disqualified person, for a term of 4 years beginning on August 1, 2011 through July 31, 2015 at an annual rental of \$120,000. The fair rental of the building for each month of the lease is \$10,000. Jeremy corrected the transaction on September 30, 2014.

| Act | Started  | Ended     | Number of taxable years or portions of a taxable year | Lease Amount          | Initial Tax on Disqualified Person (Jeremy) |
|-----|----------|-----------|---|-----------------------|---|
| 1   | 8/1/2011 | 9/30/2014 | 4   | 5 months = \$50,000   | 4 x \$50,000 x 10% = \$20,000               |
| 2   | 1/1/2012 | 9/30/2014 | 3   | 12 months = \$120,000 | 3 x \$120,000 x 10% = \$36,000              |
| 3   | 1/1/2013 | 9/30/2014 | 2   | 12 months = \$120,000 | 2 x \$120,000 x 10% = \$24,000              |
| 4   | 1/1/2014 | 9/30/2014 | 1   | 9 months = \$90,000   | 1 x \$90,000 x 10% = \$9,000                |

The total amount involved is \$200,000 + \$360,000 + \$240,000 + \$90,000 = \$890,000. With a 10% excise tax rate, the total initial tax due from the disqualified person under this example is \$89,000! The total initial tax due from the foundation manager is the lesser of \$44,500 or \$20,000, which is \$20,000.

In this example, the lease was for a 4-year period starting August 1, 2011 through July 31, 2015. As a result, as many as 5 separate acts of self-dealing could have been reported. The first act involves the use of the property between August 1, 2011 and December 31, 2011. The second, third and fourth acts involve the use of the property in

<sup>105</sup> Treas. Reg. §53.4941(e)-1(e)(1)(i).

<sup>106</sup> Treas. Reg. §53.4941(e)-1(e)(1)(i).

subsequent years beginning on January 1, 2012, January 1, 2013 and January 1, 2014, respectively. Luckily, the self-dealing act was corrected during 2014 so there was no act of self-dealing during 2015.

The calculation of the self-dealing amount is the number of months during the year that the self-dealing occurred times the greater of the actual rent paid or the fair rental value times the number of years or partial years until this act was corrected times the excise tax rate. Therefore, Jeremy's excise tax for leasing the building during 2012 is determined by:

| Item  | Analysis   | Result   |
|---|--|----------|
| Number of months during the year that the self-dealing occurred | During 2012, Jeremy leased the building the entire year.   | 12       |
| Greater of the Actual Rent Paid or the Fair Rental Value        | To make this example simple, the Actual Rent and the Fair Rent are both \$10,000 per month.                            | \$10,000 |
| Number of Years or Partial Years Until This Act Was Corrected   | Jeremy corrected this Act of Self-Dealing during 2014, so the 2012 Self-Dealing act continued for 2012, 2013 and 2014. | 3        |
| Excise Tax Rate   | The Excise Tax Rate for a Disqualified Person is 10%.  | 10%      |

In real life, the fair rental of the building would likely change over such a long period, so it needs to be determined as of the beginning of the lease (August 1, 2011) and again at the beginning of each tax year (January 1, 2012; January 1, 2013; January 1, 2014; and, if still not corrected, January 1, 2015). The fair rental of the building on these dates would need to be compared to the actual monthly lease payment of \$10,000 to determine the self-dealing amount.

Example #28 also highlights the cumulative nature of an ongoing act of self-dealing. Looking at the data, the self-dealing started in August of 2011 and the self-dealing amount for just that year would have been only the rent involved of \$50,000 times the excise tax rate of 10%, which is \$5,000. However, the fact that Jeremy did not correct this self-dealing until parts of 4 tax years later during 2014, means that the excise tax for that first year's self-dealing was not merely \$5,000 but \$20,000.

## VI. Correcting an Act of Self-Dealing

### A. Guiding Principle

In general, correcting a self-dealing transaction requires undoing what was done to the extent possible,<sup>107</sup> but in any case:

[the foundation must be placed] in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.<sup>108</sup>

In order to correct an act of self-dealing under this standard, the regulations place a significant emphasis on compensating the private foundation for the opportunity cost of rescinding, terminating or otherwise reversing the act of self-dealing. As a result, the disqualified person often must pay more to correct an act of self-dealing than (s)he received from engaging in an act of self-dealing. The charts in the Appendix visually illustrate the steps necessary to correct the most common acts of self-dealing.

### B. Correction Standards Vary Depending on the Act of Self-Dealing

Where property is sold to a foundation for cash, correction can be accomplished by returning the cash to the foundation and recasting the transaction as a gift.<sup>109</sup> Fortunately, the correction of an act of self-dealing is not itself an act of self-dealing.<sup>110</sup>

The requirements for correcting an act of self-dealing vary depending on the type of self-dealing at issue. For example, the corrective acts for a sale by a foundation to a disqualified person require a rescission of the sale if a disqualified person still owns the property.<sup>111</sup> The disqualified person receives the least of: the cash received as part of the original transaction; the fair market value of the property at the time of the original sale; and the fair market value of the property at the time of rescission. If the disqualified person cannot rescind the sale because (s)he sold the property in a *bona fide*, arms-length transaction to an unrelated third party (who is not also a disqualified person), then the disqualified person must pay to the foundation the greater of: (1) the excess of the fair market value of the property as of the correction date over the amount that would have been computed under the three-part test above; or (2) the excess of the sales proceeds received from the third party's purchase over the amount that would have been computed under the three-part test above. We are still not yet finished with determining the correction amount, since the disqualified person must also pay to the foundation the excess of the net profits received with regard to the property over any earnings the foundation received from the original purchase price.

On the other hand, the corrective act for the payment of excess compensation<sup>112</sup> to a disqualified person merely involves the return of the excess compensation to the foundation. The corrective act for the foundation's use of a disqualified person's

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<sup>107</sup> IRC §4941(e)(3) and Treas. Reg. §53.4941(e)-1(c)(1).

<sup>108</sup> IRC §4941(c)(3) and Treas. Reg. §53.4941(e)-1(c)(1).

<sup>109</sup> Treas. Reg. §53.4941(e)-1(c)(1).

<sup>110</sup> Treas. Reg. §53.4941(e)-1(c)(1).

<sup>111</sup> Treas. Reg. §53.4941(e)-1(c)(2).

<sup>112</sup> Treas. Reg. §53.4941(e)-1(c)(6).



property<sup>113</sup> requires the foundation to stop using the property plus the disqualified person must pay to the foundation the greater of: (1) the excess of the amount paid by the foundation to the disqualified person over the fair market value for the property's use (determined as of the beginning of the property's use); or (2) the excess of the amount paid by the foundation to the disqualified person over the fair market value for the property use (determined as of the correction date). Additionally, the disqualified person must pay to the foundation the excess of the fair market value of the property use (determined as of the correction date) for the period beginning at the correction date through the end of the contract period over the agreed upon contract payment for the same period.<sup>114</sup>

Please refer to the charts in the Appendix for the necessary steps to correct an act of self-dealing.

### **C. Final Notes Regarding Corrections**

It is important to remember that the act of self-dealing has not been corrected until it has been fully corrected. In other words, if the disqualified person returned payment to the foundation of the sale price but did not return the excess profits, then the act of self-dealing has still not been corrected. Also, because the analysis for correction is slightly different from the analysis for determining the self-dealing amount, the correction "amount" may be different from the self-dealing "amount" subject to the excise tax.

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<sup>113</sup> Treas. Reg. §53.4941(e)-1(c)(5).

<sup>114</sup> See Example 2 at Treas. Reg. §53.4941(e)-1(c)(5)(ii).

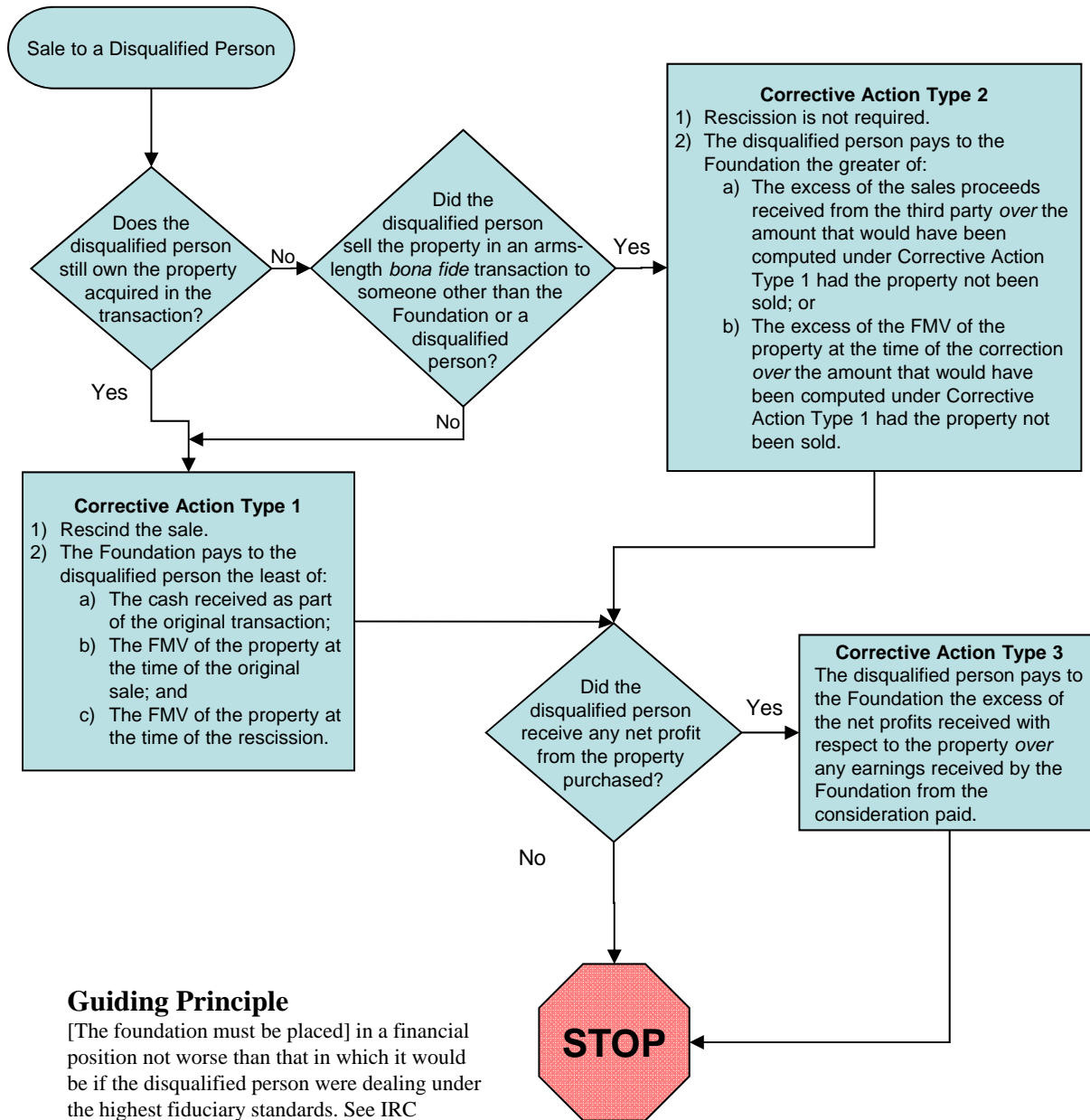
**YIKES!**  
**FINDING AND FIXING**  
**SELF-DEALING (WITH EXAMPLES)**

**Appendix**

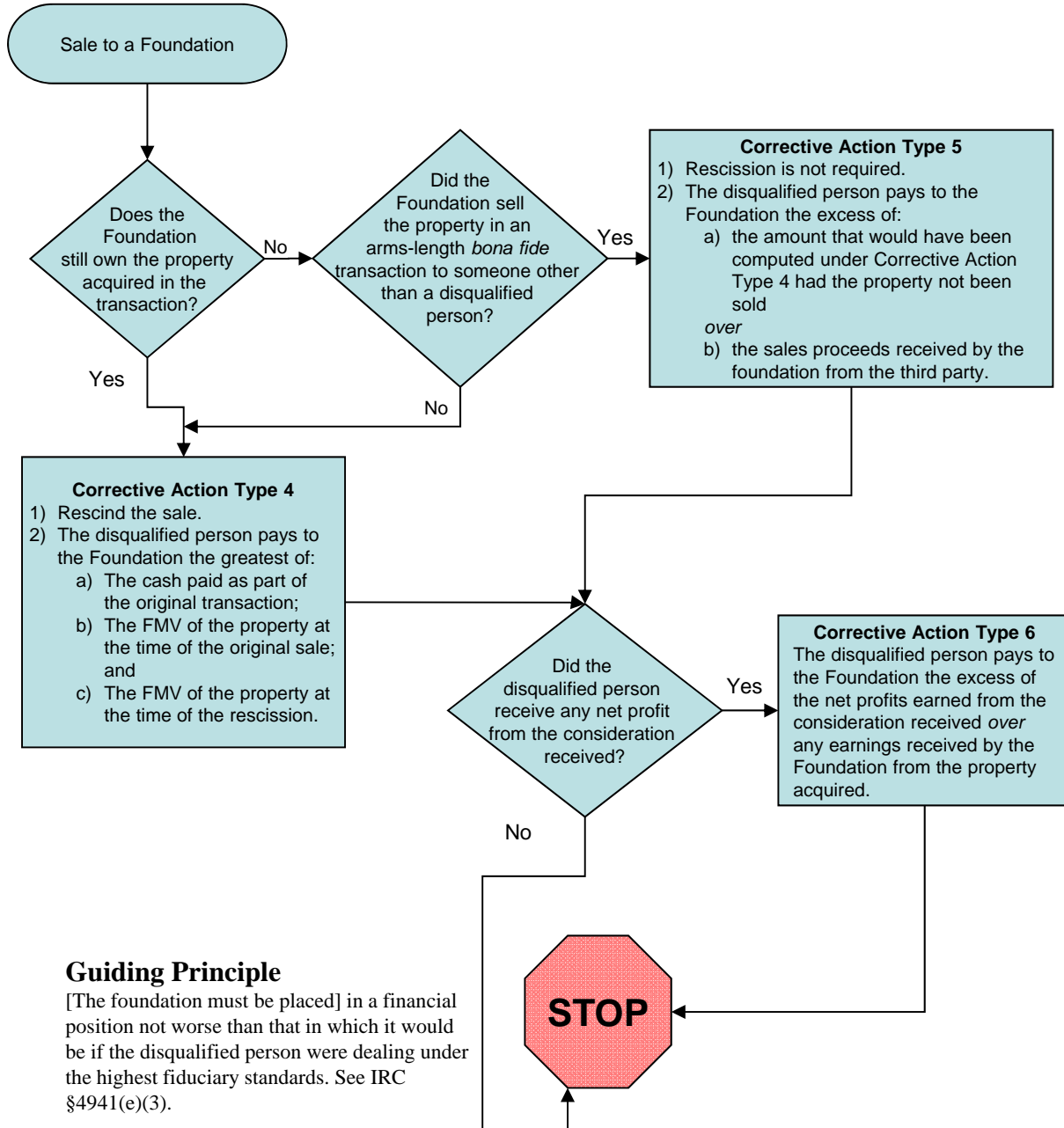
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Renaissance Administration LLC  
Indianapolis, Indiana

# Correction for a Sale to a Disqualified Person

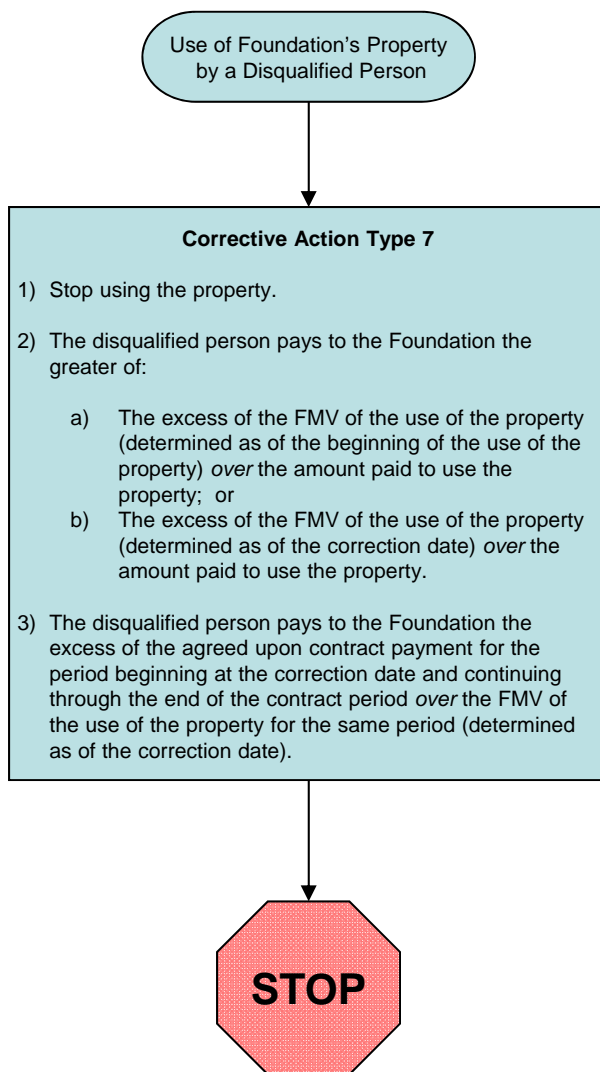
## Treas. Reg. §53.4941(e)-1(c)(2)



## Correction for a Sale to a Foundation Treas. Reg. §53.4941(e)-1(c)(3)



Correction for Use of Foundation's Property  
by a Disqualified Person  
Treas. Reg. §53.4941(e)-1(c)(4)

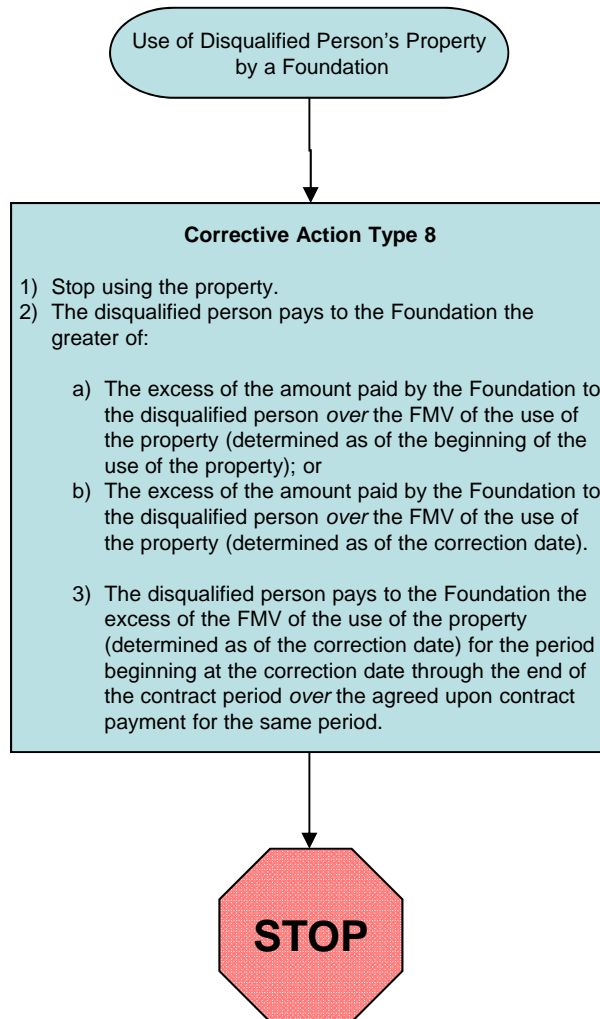


**Guiding Principle**

[The foundation must be placed] in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. See IRC §4941(e)(3).

# Correction for Use of Disqualified Person's Property by a Foundation

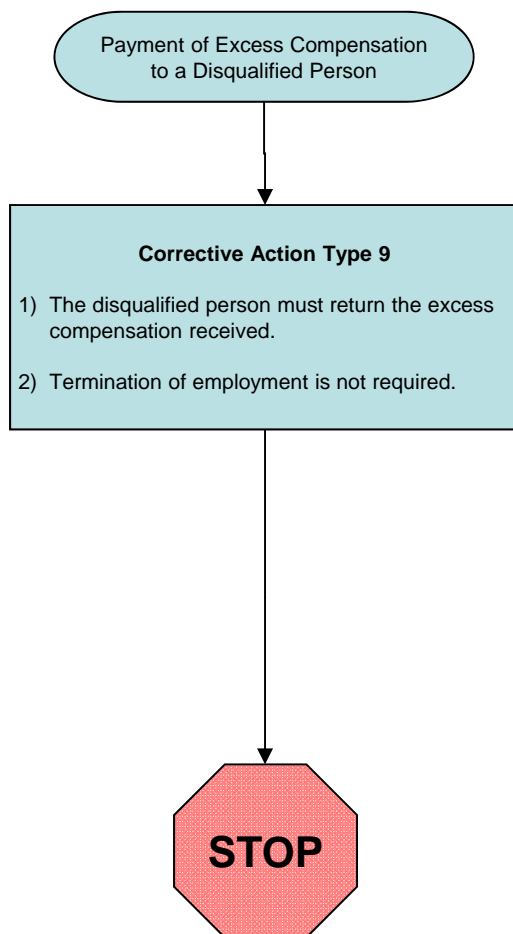
Treas. Reg. §53.4941(e)-1(c)(5)



## Guiding Principle

[The foundation must be placed] in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. See IRC §4941(e)(3).

Correction for Payment of Excess Compensation  
to a Disqualified Person  
Treas. Reg. §53.4941(e)-1(c)(6)



**Guiding Principle**

[The foundation must be placed] in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. See IRC §4941(e)(3).