Navigating the IRS's Self-Dealing Rules for Private Foundations

By Usman Mohammad and Emma Westerhof

The Donald J. Trump Foundation was undone by alleged acts of self-dealing involving its namesake, Donald J. Trump, who also allegedly used the foundation to promote his candidacy for president in 2016. The New York State Office of the Attorney General (OAG) alleged that the Trump Foundation violated New York's prohibition on self-dealing transactions involving private foundations. The OAG levied a $2 million fine against the Trump Foundation, filed a petition for its involuntary dissolution, and also referred the matter to the IRS for further investigation and sanctions (see June 14, 2018, Letter from NYS OAG to IRS Commissioner, available at https://bit.ly/32dm68D).

The trouble that befell the Trump Foundation is not unusual for private foundations. Private foundations are a popular vehicle for funding charitable causes, but many run into problems with "self-dealing" rules. IRC section 4941 prohibits nearly all financial transactions between a private foundation and individuals affiliated with the foundation, including substantial contributors, managers, entities in which these individuals have a substantial ownership interest, and their family members. Such individuals or entities are known as "disqualified persons," and transactions between the foundation and such persons that violate IRC section 4941 may result in monetary sanctions in the form of excise taxes; such taxes can comprise as much as 200% of the monetary value of the transaction. The tax is levied on the self-dealer and the foundation manager. Timely correction of an act of self-dealing can reduce the amount of the excise tax.

CPAs Can Help

Private foundations must navigate self-dealing concerns on a year-round basis, including when filing their tax returns. Foundations must formally attest to the fact that there were no self-dealing transactions during the year by filing IRS Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation.

Because of the complexity of Form 990-PF, tax preparers are regularly engaged to help foundations complete the form. But preparers may also be blamed when alleged acts of self-dealing go unreported. For example, in *United States v. Wright* [798 F. App'x 849 (6th Cir. 2019)], a taxpayer who was charged with, *inter alia*, willful failure to report self-dealing transactions with his private foundation asserted as a defense the taxpayer's purported reliance on the advice of the accountant that prepared Form 990-PF for the foundation. As a result, the accountant was required to testify about the information he sought and received from the taxpayer, and the accountant's thought processes in determining what should be reported as a self-dealing transaction on the form. This case illustrates that accountants are expected to spot self-dealing transactions that should be reported on Form 990-PF.

To prepare Form 990-PF accurately, accountants must be familiar with what constitutes self-dealing, the exceptions to self-dealing, and the more nebulous aspects of the self-dealing rules such as "indirect" self-dealing and "incidental and tenuous benefits."

Overview of the IRS Self-Dealing Rules

The general rule is that no financial transactions may take place between a private foundation and "disqualified

persons." IRC section 4946(a) defines disqualified persons as: 1) a foundation manager, including officers, directors, and trustees; 2) "substantial contributors" to the foundation; 3) individuals with a greater than 20% ownership interest in a corporation, partnership, or trust that is itself a substantial contributor to the foundation; 4) family members of a disqualified person; 5) corporations, partnerships, trusts, or estates in which a disqualified person has a greater than 35% ownership interest; and 6) certain government officials.

IRC section 4941(d) identifies six acts of prohibited self-dealing between a foundation and a disqualified person: 1) the sale, exchange, or leasing of property; 2) the lending of money or other extension of credit; 3) the furnishing of goods, services, or facilities; 4) payment of compensation, or reimbursement of expenses, by a foundation to a disqualified person; 5) transfer to, or use by or for the benefit of, a disqualified person of any income or assets of the foundation; and 6) an agreement by a foundation to pay money or assets to a government official.

The first three categories of transactions are prohibited regardless of which party is the payor or recipient. The remaining three categories prohibit transactions in which the private foundation is the payor or transferor. For all categories, it is immaterial whether the transaction results in a benefit or a detriment to the foundation.

Exceptions to Self-Dealing

IRC section 4941(d)(2) and the applicable regulations at Treasury Regulations section 53.4941(d)-3 recognize several exceptions to the self-dealing rule, such as: 1) a private foundation providing goods, services, or facilities to a disqualified person when they are made available to the general public on at least as favorable a basis; 2) a disqualified person providing goods, services, or facilities to a private foundation free of charge so long as they are used by the foundation exclusively for charitable purposes; 3) a private foundation paying compensation to a disqualified person for personal services that are reasonable and necessary to carrying out the exempt purpose of the foundation, so long as the compensation is not excessive; 4) a disqualified person making an interest-free loan to a private foundation so long as the loan proceeds are used by the foundation solely for charitable purposes; and 5) certain transactions between a private foundation and a corporation that is a disqualified person, pursuant to any liquidation, merger, redemption, recapitalization, or other corporate reorganization.

These exceptions appear to be strictly construed by the IRS. For example, in PLR 9325061, the IRS stated that a "conglomerate" of real estate management, brokerage, construction, marketing and advertising, and insurance brokerage services did not qualify for the "personal services" exception, resulting in the foundation's payments to disqualified persons for such services being treated as prohibited self-dealing.

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Indirect Self-Dealing

The six types of prohibited self-dealing transactions set forth in IRC section 4941(d) apply not just to transactions directly between a foundation and a disqualified person; they include indirect acts of self-dealing. Neither the code nor the regulations define the term "indirect self-dealing." The applicable regulations set forth at Treasury Regulations section 53.4941(d)-1 do, however, provide guidance by identifying what does not constitute indirect self-dealing and by providing examples of situations involving indirect self-dealing.

IRS private letter rulings provide further guidance on what constitutes indirect self-dealing. In PLR 9040063, the IRS stated that in general "indirect self-dealing occurs when a transaction is entered into between parties, none of whom is a private foundation, but to which a private foundation is indirectly a party, and which would constitute direct self-dealing if the private foundation were directly involved"; this "includes a transaction between a disqualified person and an organization controlled by a private foundation where such transaction, if entered into directly by the private foundation and the disqualified person, would be direct self-dealing."

Thus, indirect self-dealing generally involves a transaction between a disqualified person and an organization controlled by a private foundation. The regulations note that the "controlled" organization can be any type of exempt or nonexempt organization, including a school, hospital, operating foundation, or social welfare organization. The examples in the regulations illustrate that indirect self-dealing includes instances in which a foundation owns a controlling interest in a corporation and the corporation engages in a self-dealing transaction with a disqualified person or an entity controlled by the disqualified person. The IRS website notes that examples of indirect self-dealing include: 1) a grant by a private foundation to another organization controlled by the foundation, coupled with a transaction between the organization and a disqualified person; 2) contributions to public charities that are earmarked for the use of a disqualified person; and 3) the sale or exchange of property to a disqualified person while held by an estate or trust in which a foundation has an interest or expectancy.

Indirect self-dealing does not include the following: 1) transactions that fall within an exception applicable to direct self-dealing; 2) business transactions involving a disqualified person and an entity controlled by the foundation where the transaction arose from a business relationship established before the transaction would have been considered an act of self-dealing and the transaction was offered on the same terms to the public; and 3) transactions in the normal and customary course of a retail business engaged in with the general public, where the total annual amounts involved in all transactions with any one disqualified person is no more than $5,000.

Incidental and Tenuous Benefits

Another consideration is the exception for incidental or tenuous benefits. Although IRC section 4941(d) provides that self-dealing occurs when a private foundation transfers any of its income or assets to, or for the use or benefit of, a disqualified person, the regulations at Treasury Regulations section 53.4941(d)-2(f) provide that incidental or tenuous benefits are not self-dealing. The regulations do not define "incidental or tenuous"; rather, they provide examples as guidance. Some clear examples of an incidental or tenuous benefit include when a disqualified person receives incidental advertising as a result of the foundation's grants, or public acknowledgement by the foundation of a specific donation made.

Determining whether a benefit qualifies as incidental or tenuous is not always clear. There are several IRS private letter rulings and technical advice memos that need to be consulted on this gray area. For example, the display of foundation-owned artwork in the private residence of a disqualified person may or may not qualify depending upon the facts and circumstances. The IRS ruled in Revenue Ruling 74-600 and TAM 8824001 that if foundation-owned artwork is displayed at the private residence of a disqualified person, it may be considered self-dealing, because the general public is not able to tour the premises to view the artwork. The benefit to the disqualified person was not incidental and tenuous. But in PLR 8842045, the IRS ruled that a disqualified person and a foundation may jointly own artwork and rotate the display of such work between the foundation's offices and the private residence of the disqualified person without running afoul of the self-dealing rules. The joint ownership of the artwork appears to account for the difference in treatment.

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Steer Clear of Self-Dealing

CPAs that work with private foundations should be familiar with what constitutes self-dealing under IRC section 4941 and the related Treasury Regulations. Form 990-PF is highly complex and fishes for compliance failures related to self-dealing. Lacking the significant time and expertise required to understand the nuances of this law, fiduciaries of private foundations can easily run afoul of the IRS's stringent self-dealing rules—and become subject to substantial excise taxes as a result.■

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