SUMMARY OF THE PRIVATE FOUNDATION RULES AGAINST SELF-DEALING IN THE INTERNAL REVENUE CODE

Internal Revenue Code ("IRC") § 4941 sets forth the self-dealing rules for private foundations and defines self-dealing as any direct or indirect:

- "sale or exchange, or leasing, of property between a private foundation and a disqualified person;
- lending of money or other extension of credit between a private foundation and a disqualified person;
- furnishing of goods, services, or facilities between a private foundation and a disqualified person;
- payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;
- transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and
- agreement by a private foundation to make any payment of money or other property to a government official…, other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period."

IRC § 4946 provides the definition of a disqualified person for purposes of the rules applicable to private foundations. With respect to the self-dealing rules, a disqualified person includes anyone who is:

- a substantial contributor to the foundation;
- a foundation manager (which includes officers, directors, trustees, or other individuals who have similar powers or responsibilities);
- an owner of more than 20% of the combined voting power of a corporation, the profits interest of a partnership, or the beneficial interest of a trust which is a substantial contributor to the foundation;
- a family member of any such persons;
- a corporation, partnership, or trust of which any such persons own more than 35% of the total combined voting power, profits interest, or beneficial interest, respectively; or
- a government official.

If a private foundation enters into a self-dealing transaction with a disqualified person, both the disqualified person and the foundation managers who knowingly participated in the self-dealing transaction will be subject to taxes. However, there are exceptions and special rules that apply to the self-dealing restrictions that private foundations and potential disqualified persons should be aware of, including:

- **Gifts –** Although the furnishing of goods, services, or facilities by a disqualified person to a private foundation is typically considered an act of self-dealing, that will not be the case if the goods, services, or facilities are to be used exclusively for IRC Section 501(c)(3) exempt purposes and are provided to the private foundation without charge.
- **Compensation –** The payment of compensation or the reimbursement of expenses by a private foundation to a disqualified person (other than a government official) for personal services that are reasonable and necessary to carrying out the foundation's exempt purposes will not be considered self-dealing, so long as the compensation amount is not excessive. Although we don't have a clear definition of what constitutes reasonable and necessary personal services, the Regulations state that personal services include legal services, investment advice, commercial banking services, and the services of a broker serving as an agent for the private foundation. This exception does not apply to the purchase or sale of goods, even if services are a part of the process of producing the goods. A private foundation may also provide goods, services, or facilities (such as meals or lodging) to a foundation manager, employee, or volunteer without engaging in a self-dealing transaction if the value of the items provided is reasonable and necessary to the performance of the foundation's activities in carrying out its exempt purposes.
- **Loans –** A disqualified person may loan money to a private foundation without it constituting a self-dealing transaction if the loan is made without interest or other charge and if the proceeds of the loan are used by the private foundation exclusively for IRC Section 501(c)(3) exempt purposes. A loan by a disqualified person to a private foundation at below-market rates, however, will still be treated as an act of self-dealing to the same degree that a loan at market rates would be. The provision of general banking services, including checking and savings accounts (subject to certain conditions), will generally not be considered self-dealing.

- **Leases –** The lease of space by a disqualified person to a private foundation will not be considered an act of self-dealing if the lease is without charge. The lease will still be considered to be without charge even if the foundation pays for janitorial expenses, utilities, or other maintenance or administrative costs it incurs, so long as the private foundation does not make the payments directly or indirectly to a disqualified person (rather, the payments should be made directly to the utility provider, for example). There is also an exception for the leasing of office space to a private foundation in a building with other tenants who are not disqualified persons if the lease is pursuant to a binding contract that was in effect on October 9, 1969, or renewals thereof, and the lease reflects an arm's length transaction.
- **Publicly Available Services –** A private foundation may provide goods, services, or facilities to a disqualified person on a basis no more favorable than that on which the goods, services, or facilities are provided to the general public without violating the self-dealing rules. However, this exception only applies if a substantial number of persons other than disqualified person actually use the goods, services, or facilities in question.
- **Incidental Benefits** – The receipt by a disqualified person of an incidental or tenuous benefit from the private foundation's use of its income or assets is not sufficient in-and-of-itself to make the use an act of self-dealing. For example, if a substantial contributor gets public recognition for the activities of the foundation, that alone generally will not be sufficient to constitute self-dealing.
- **Recapitalization –** A transaction between a private foundation and a corporation that is a disqualified person is not self-dealing if it is pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization so long as all of the securities of the same class as those held by the foundation are subject to the same terms and the private foundation will receive no less than fair market value. In order for the securities to be considered subject to the same terms, the corporation must make a *bona fide* offer on an equal basis to the foundation and every other holder of securities of the same class.
- **Government Officials –** Certain payments to government officials, including certain prizes and awards, scholarships for educational study, incidental gifts or services, and reimbursement of domestic travel expenses, will not constitute self-dealing.

Unless an exception applies, the prohibition on acts of self-dealing for private foundations is absolute and, given the stiff penalty taxes that are imposed, private foundations are well-advised to understand these rules and to ensure that they refrain from violating them.