

THE EXEMPT ORGANIZATION WORLD ENCOMPASSES A LARGE VARIETY OF ENTITIES. BY FAR, THE MOST COMMON IS THE §501(c)(3) ORGANIZATION. OF THE APPROXIMATELY 1.5 MILLION TOTAL EXEMPT ORGANIZATIONS IN THE UNITED STATES, §501(c)(3) ORGANIZATIONS COMPRISE APPROXIMATELY 67%. WITHIN THE §501(c)(3) WORLD EXISTS TWO DIFFERENT TYPES OF ENTITIES; THE PUBLIC CHARITY AND THE PRIVATE FOUNDATION. THE BIGGEST FACTOR IN DETERMINING WHETHER A §501(c)(3) ENTITY IS A PUBLIC CHARITY OR A PRIVATE FOUNDATION IS WHETHER THE ORGANIZATION IS PUBLICLY SUPPORTED. IF A §501(c)(3) ORGANIZATION IS FUNDED BY THE GENERAL PUBLIC, THE ORGANIZATION IS MOST LIKELY CLASSIFIED AS A PUBLIC CHARITY. IF A §501(c)(3) ORGANIZATION IS FUNDED BY ONLY A LIMITED AMOUNT OF DONORS, IT WILL PROBABLY BE CLASSIFIED AS A PRIVATE FOUNDATION.

INTRODUCTION TO PRIVATE FOUNDATIONS

Because private foundations enjoy the benefit of being tax exempt, but, by definition are not supported by the broad public, they face more restrictions and scrutiny than their altruistic cousin, the public charity. One notable example of this is that charitable contributions thresholds and deductions for private foundations are limited as compared to public charities. Foundations also face a set of unforgiving excise taxes defined in IRC §4940 through §4945. Most private foundations are adept at dealing with the most common of the excise taxes: the 1 or 2% tax on net investment income. However, there are some additional and severe taxes, which more closely resemble penalties, that are imposed on certain prohibited transactions.

So what are these prohibited transactions?

Private foundations face restrictions on how they can invest. They could be taxed on certain excess business holdings (IRC §4943) and investments that could jeopardize charitable purpose (IRC §4944). The IRS also closely governs how foundations spend. Foundations are required to distribute a minimum amount every year for activities directly related to the foundations charitable purpose (IRC § 4942), but there are also restrictions on how the foundation can spend its money. A foundation's prohibition on taxable expenditures (IRC §4945) limits to whom the foundation can make grants and why. If a foundation grants money to any entity other than a qualifying domestic public charity, it will have to undertake additional detailed reporting on those grants. Furthermore, scholarships to individuals are prohibited without prior IRS approval. And yet another restriction - lobbying and political activities are simply prohibited. The final, and often most rigid, restriction on a private foundation is self-dealing (IRC §4941.)

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DEFINING SELF DEALING

Self-dealing occurs when a private foundation enters into a transactions with a disqualified person. But defining self-dealing can be a bit more complex than the sentence above. Who is a disqualified person and what types of transactions are they prohibited from undertaking?

DISQUALIFIED PERSON

Substantial contributor to the private foundation

A person (individual or entity) that has contributed greater than \$5,000 to a private foundation since its inception (if more than 2% of total accumulated contributions since formation)

~ Includes owners of businesses that are substantial contributors

SUBSTANTIAL CONTRIBUTOR NUANCES

The substantial contributor test is as of the last day of the tax year, but an individual becomes a substantial contributor when they first make the substantial contribution to the private foundation. A substantial contributor can lose its status as such if it does not make any contributions to the private foundation within a 10-year period and is not a foundation manager within the same 10-year period.

Foundation manager

Top management official of a private foundation

~ Similar to Executive Director of public charity

FOUNDATION MANAGER NUANCES

A foundation manager's classification as a disqualified person rests solely on that person's position as foundation manager. As soon as they are no longer employed in that position, they are no longer a disqualified person, and the same follows for any other related persons or entities (Rev Ruling 76-448)

Board Members

A voting member of the foundation's board of directors.

BOARD MEMBER NUANCES

An exchange between a private foundation and one of its former trustees did not constitute self-dealing because the former trustee ceased to be a disqualified person when she resigned from the private foundation's Board (PLR 201130008).

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DEFINING SELF DEALING (CONT.)

Family members

Any person related to a disqualified person (substantial contributor, foundation manager, or board member)

- ~ *Parents*
- ~ *Spouse*
- ~ *Children*

FAMILY MEMBER NUANCES

The description of family member differs from what it does for the disqualified person definition for public charities. It is actually less restrictive for a private foundation and it does not include siblings of disqualified persons. (See page 15 of IRS Publication 578)

Related entities (35% or more) owned by any disqualified persons

Entities owned by a disqualified person (including family members), if that ownership combines to be 35% or more

- ~ *Corporations (shares owned)*
- ~ *Partnerships (percentage of ownership)*
- ~ *Other entities (trust, estates, etc)*

RELATED ENTITY NUANCES

Attribution rules must be considered when figuring out whether or not an entity is a disqualified person, which means that if a single disqualified person does not own 35% or more, but that disqualified person does so in combination with other disqualified persons, the entity would be related.

Governmental officials

Government officials include all elected executive or legislative officials as well as any person in the executive, judicial, or legislative branch above a certain grade level.

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DEFINING SELF DEALING (CONT.)

TRANSACTIONS

Sales and Leases (Reg. §53.4941(d)-2(a) & §53.4941(d)-2(b))

A sale, exchange or leasing of property is not permitted between a private foundation and a disqualified person, in either direction.

Even sales, leases or exchanges that obviously benefit a private foundation are considered a prohibited transaction (i.e. deep discounts.)

EXCEPTIONS

If a disqualified person sells property to the foundation for \$0

Trap for the unwary: If property is sold to a private foundation for \$0, but there is an encumbrance on the property that the foundation assumes, that is self-dealing.

If a private foundation leases property from a disqualified person without charge

A private foundation can pay reasonable expenses associated with the leasing of properties, as long as the private foundation pays vendors directly.

Transactions (Reg. §53.4941(d)-2(d))

Private foundations and disqualified persons cannot provide goods, services, or facilities to each other.

This includes items such as office space and equipment, automobiles, auditoriums, secretarial help, meals, libraries, publications, laboratories, and parking lots.

EXCEPTIONS

A disqualified person may provide goods, services and facilities to a private foundation without charge if they're used for exempt purposes.

- *A private foundation can pay transportation, insurance, or maintenance costs associated with goods or facilities furnished, without charge, as long as it's not paid to disqualified persons.*
- *A private foundation can furnish goods, services, or facilities to a disqualified person only if what is offered to the disqualified person is made available to the general public on at least as favorable a basis as they are made available to the disqualified person, and if they are functionally related to the performance of the foundation's exempt purpose. (Reg. §53.4941(d)-3(b)(2))*

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DEFINING SELF DEALING (CONT.)

Compensation (Reg. §53.4941(d)-2(e))

The payment of compensation (or reimbursement of expenses) by a private foundation to a disqualified person, shall constitute an act of self-dealing.

EXCEPTIONS

Payment of reasonable compensation for personal services: (Reg. §53.4941(d)-3(c))

Reasonable Compensation: *To establish reasonable compensation, a foundation should follow the three requirements set forth in the Sec. 4958 rebuttable presumption of reasonableness, and discussed in our recent blog about reasonable compensation.*

- *Board approval of the disqualified person's compensatory arrangement*
- *Usage of salary surveys and comparability analysis*
- *Contemporaneous documentation of the entire process*

Personal Services: *Personal services are not specifically defined by the IRS, but they are essentially professional services. Examples provided by the IRS include:*

- *Legal and accounting*
- *Investment advisory*
- *Real estate services*
- *Advertising*
- *Reviewing of contracts*
- *Debt management*
- *Banking and trust services – provided no interest is paid*

Services not considered to be personal in nature include:

- *Janitorial/maintenance*
- *Landscaping*
- *Cleaning*
- *Property management.*

Private foundation can reimburse reasonable and necessary expenses incurred by disqualified persons. It is essential that the private foundation should have a written expense reimbursement policy to ensure contemporaneous documentation of business purpose so that the private foundation can fit within the reasonable compensation exception.

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DEFINING SELF DEALING (CONT.)

Loans (Reg. §53.4941(d)-2(c))

Private foundations and disqualified persons cannot lend money or extend credit to each other.

EXCEPTIONS

A disqualified person may lend money to a private foundation if it is without charge and if the proceeds of the loans are used for exempt purposes.

Use of or Benefits from Foundation Assets (Reg. §53.4941(d)-2(f))

A private foundation is prohibited from transferring foundation income or assets to, or for the use or benefit of, a disqualified person.

Common transactions seen are:

- *Payments by the private foundation of a disqualified person's expenses, including excise taxes or insurance policy for a disqualified person to protect the disqualified person*
- *Payment or guarantee of a disqualified person's loan*
- *Certain grants or other payments made by the private foundation to satisfy the legal obligations of a disqualified person.*

EXCEPTIONS

If the foundation's use of income/assets results in incidental or tenuous benefits to the disqualified person, then it is not self-dealing (Reg. §53.4941(d)-2(f)(2))

Example include a corporate foundation matching contributions of the corporate donor's employees and public acknowledgment of a contribution or naming of a building after a donor.

Transacting with Government Officials (Reg. §53.4941(d)-2(g))

Private foundations are discouraged from engaging with governmental officials, so as such direct or indirect agreement to make any payments to government officials is considered self-dealing.

EXCEPTIONS

Several exceptions exist for this section, including reasonable compensation and reimbursement for participation in a conference sponsored by the foundation, scholarships and fellowships used for study at an educational institution, prizes or awards selected by the general public, domestic travel expenses if it relates to a foundation's charitable purpose, and employment at the private foundation if the contract is entered into 90 days prior to termination of government services. (Reg. §53.4941(d)-3(e))

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CONSEQUENCES OF SELF DEALING

If a Foundation discovers that self-dealing has occurred, the first and most important thing to do is to correct that self-dealing through reversing or canceling a transaction. There are two important periods to note after self-dealing has occurred.

- The **taxable period** begins on the date when self-dealing occurred and ends on the date that the initial penalty has been assessed by the IRS.
- The **correction period** begins the date the self-dealing occurred and ends 90-days after the additional tax has been assessed

EXCISE TAX CALCULATION

All self-dealing transactions must pay the initial tax. If the transaction is then not remedied, then the second tier tax will be assessed by the IRS. While IRC § 4962 contains provisions to request excise tax penalty abatement, abatement is specifically not permitted for self-dealing excise taxes.

First Tier

Disqualified person – 10% of amount involved
No maximum penalty

Foundation manager – 5% of amount involved
Maximum penalty of \$20,000

Second Tier

(No correction within applicable time frame)

Disqualified person – 200% of amount involved
No maximum penalty

Foundation manager – 50% of amount involved
Maximum penalty of \$20,000

LAUREN HAVERLOCK
NONPROFIT TAX PRINCIPAL

LAUREN HAVERLOCK HAS OVER 11 YEARS OF EXPERIENCE IN PUBLIC ACCOUNTING AND HAS FOCUSED IN THE EXEMPT ORGANIZATION AREA FOR THE PAST SEVEN YEARS OF HER CAREER. SHE MAINLY FOCUSES ON PREPARING, REVIEWING, AND CONSULTING ON FEDERAL AND STATE RETURNS FOR PUBLIC CHARITIES, PRIVATE FOUNDATIONS, AND OTHER EXEMPT ORGANIZATIONS. HER EXPERIENCE IN THIS AREA VARIES FROM LARGE ORGANIZATIONS WITH BILLIONS IN ASSETS TO START UP ENTITIES. LAUREN HOLDS A BS IN ACCOUNTING FROM CALIFORNIA STATE UNIVERSITY, LONG BEACH AND A MASTERS IN SCIENCE, TAXATION FROM THE UNIVERSITY OF SOUTHERN CALIFORNIA.