Council of Michigan Foundations

ASK CMF

A Technical Assistance Service of the Council of Michigan Foundations

WHAT BOARDS AND EXECUTIVES NEED TO KNOW ABOUT SELF-DEALING

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This information is provided by Ask CMF, a technical assistance service of the Council of Michigan Foundations, for educational purposes only and does not constitute legal advice.

Board members and staff of philanthropic institutions regularly reach out to CMF to learn more about self-dealing. While private foundations have strict rules for self-dealing among disqualified persons, many of these rules are well-established best practices for other grantmakers and public charities. As public charities, all 501(c)(3) organizations are intended to serve the public good and should not be used for private or individual benefit.

The "What Boards and Executives Need to Know" series of resources is designed to address questions of interest to board members and senior leaders of grantmaking organizations. These resources may be particularly useful for orientations, board trainings and general professional development and provide better understanding of key concepts that are necessary for the success of the governance and management of foundations in the field.

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The Council of Michigan Foundations leads, strengthens and supports Michigan's community of philanthropy by emboldening and equipping Michigan philanthropy in the relentless pursuit of equitable systems and inclusive diversity, fortifying the field through public policy action, fostering the growth of current and future philanthropy leaders and advancing exemplary philanthropic practices and field expertise.

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Essential Definitions

All 501(c)(3) organizations are prohibited from providing private benefit. Prohibited excess benefits transactions mainly apply to public charities, while private foundations are strictly prohibited from engaging in self-dealing. Donor Advised Funds (DAFs) face even more restrictive rules related to automatic excess benefits transactions[1] (see Donor Advised Funds section below). Oftentimes, an organization will use internal policies, such as a conflicts of interest policy (See "What Boards and Executives Need to Know About Conflicts of Interest"), compensation policy, or travel and expense reimbursement policy to assist staff and board members with navigating potential self-dealing situations.

Self-Dealing

Self-dealing is defined as any direct or indirect:

(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;
(B) lending of money or other extension of credit between a private foundation and a disqualified person;
(C) furnishing of goods, services or facilities between a private foundation and a disqualified person;
(D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;
(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and
(F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946(c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating their government service within a 90-day period.[2]

[1] Internal Revenue Code (IRC) 4958 defines excess benefit transactions as "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit."

[2] Note that this category of self-dealing includes staff members who are engaged in government service (with some exceptions). Foundations with staff entering government service at the local, state, or federal level should review the situation with legal counsel before proceeding.

Disqualified Persons

Per Internal Revenue Code (IRC) 4946, disqualified persons, in general, are those who are “in a position to exercise substantial influence over the affairs” of the foundation, including substantial contributors (including a related corporation), trustees, directors, officers, other foundation managers, the family members of all of them and certain other entities.

Disqualified persons include:

1. Substantial contributors to the foundation*;
2. Foundation managers (directors, officers, certain key employees);
3. Owner of more than 20 percent interest of certain organizations that are substantial contributors;
4. Family members of persons described above (in 1-3);
5. Corporations in which persons described above (in 1-4) hold more than a 35 percent voting power;
6. Partnerships in which persons described above (in 1-4) hold more than a 35 percent profit interest;
7. Trusts or estates in which persons described above (in 1-4) hold more than a 35 percent beneficial interest;
8. Certain private foundations which are effectively controlled by the person or persons in control of the foundation in question; and
9. Governmental officials.

**Substantial contributors of the foundation include the main donors (oftentimes the named donors), as well as others who meet the following two requirements: (1) A person/entity that contributes at least $5,000 and (2) the total amount contributed exceeds 2% of the total contributions ever received by the foundation by the end of the tax year in which the donation was made.*

Definitions of disqualified persons may vary in certain circumstances. For example, in the case of foundations, disqualified persons who are family members are restricted to lineal individuals (i.e., grandparents, children, including by adoption, and their spouses). In the case of donor advised funds, disqualified persons also include siblings of donors, advisors, etc.

A foundation and its disqualified persons together can only hold up to a certain amount (typically 20%) of the voting shares or membership interests in a business enterprise, with a limited amount of time to divest their excess holdings. Private foundations are required to ask their disqualified persons about their holdings in any securities in which the foundation owns more than 2% of the overall voting shares or membership interests. Excise taxes may result in a foundation for violating these rules.

Prohibitions on self-dealing apply even if a transaction is financially beneficial to the foundation. There are certain exceptions to self-dealing, such as a 0% loan from a disqualified person to the foundation or the disqualified person permitting the foundation to use property or facilities at no charge (with some potential ability to cost-share on a pro rata basis if the costs are paid to an independent third party vendor that is not a disqualified person). Disqualified persons may make grants to the foundation, but in most cases, they may not be encumbered (such as a donation of property subject to a mortgage) because that would involve the foundation assuming an obligation of a disqualified person, which is prohibited self-dealing.

CMF recommends that foundations concerned about potential self-dealing issues consult with qualified legal counsel who regularly work with foundations before entering into any arrangements between the foundation and a disqualified person.

Donor Advised Funds

Self-dealing rules also apply to disqualified persons associated with donor advised funds (DAFs), as well as the investment advisors for the sponsoring organizations that hold DAFs. These individuals are prohibited from receiving more than an incidental benefit from the DAF, which is even more strict than the self-dealing rules applicable to private foundations, which do contain some narrow exceptions (such as reasonable compensation for personal services that are necessary to the foundation's work).

Pursuant to IRC 4958, DAFs have an automatic excess benefit transaction restriction, which go beyond private foundations' self-dealing rules. This restriction includes any grant, loan, compensation or similar payment from the DAF to:

A. Any donor or anyone designated by the donor to have advisory privileges;
B. A member of the family of any of them;
C. Any entity, 35% of which is controlled by the persons noted above; and
D. An outside investment advisor to the DAF sponsoring organization.

These restrictions are the reason that donors and advisors may not be reimbursed directly by the DAF for amounts they have expended in fundraising for the DAF.

Penalties for Self-Dealing

An excise tax of 10% of the amount involved in the act of self-dealing is imposed on the disqualified person. An excise tax of 5% of the amount involved is imposed on a foundation manager who knowingly participates in an act of self-dealing, unless due to reasonable cause (which includes reliance upon a "reasoned opinion" of counsel). These taxes escalate if the self-dealing is not corrected in a timely manner. If more than one person is liable for the initial and additional taxes, all parties will be jointly and severally liable[3] for those taxes. A foundation may not indemnify a self-dealer, and most director and officer liability policies exclude coverage for these wrongdoing activities. However, if such a policy does cover them, then the *pro rata* portion of the premium of such policy may need to be claimed as income by the applicable directors and officers, and the foundation should issue them 1099s. Self-dealing must also be disclosed on the foundation's IRS Form 990-PFs, which is a publicly available document.

[3] This legal terminology refers to the fact that any one person that is liable could be liable for the full amount of the fines and penalties. "Jointly and severally liable" means that the person claiming an amount is owed can pursue all of the people or any one of the people involved and collect from them the amount that is due from the whole group.

Common Exceptions to Self-Dealing

Private foundations have several situations that offer exceptions to self-dealing rules.

The payment of reasonable compensation for personal (professional and managerial) services are allowable. These must be conducted by a qualified professional and must be managerial in nature, not simply administrative. Foundations should also be careful when a single employee works for both the foundation and another entity connected to a disqualified person (such as family offices, corporations and other related entities), ensuring that there are proper procedures and internal controls in place.[4]

A disqualified person may provide goods, services or facilities to a private foundation without charge. However, they must be used exclusively for charitable purposes. Similarly, a disqualified person may provide an interest-free loan to the foundation for charitable purposes.

The foundation may provide goods, services or facilities to a disqualified person, under certain conditions. Specifically, the disqualified person may receive these benefits on a basis no more favorable than would be available to the general public and such benefits must relate to the foundation's charitable purpose.[5] For example, if a foundation manages and/or funds a park that is open to the public, the disqualified person can also visit the park, but they may not have any preferential treatment regarding use of the park. Similarly, if a foundation publishes a magazine that relates to its charitable purposes, then disqualified persons may purchase the magazine on the same terms as the general public.

Special Issues for Family and Private Foundations

Private foundations, including family foundations, are strictly prohibited from engaging in self-dealing.

Attending Fundraisers or Foundation-Sponsored Events

Attending a foundation-sponsored event is a clear tangible economic benefit to a disqualified person, which is considered a form of self-dealing. However, there is an exception that allows for reasonable compensation to those individuals who are providing personal services necessary to carrying out the charitable purposes of the foundation. Specifically, a disqualified person that has an official position with the foundation (and not just the related corporation) may be able to attend an event to monitor how the foundation's funds are being spent, allowing for the use of tickets provided by the foundation. However, this exception does not apply to personnel's spouses or family members. Additionally, the IRS has indicated that a foundation cannot avoid self-dealing by splitting the cost of the ticket between the foundation and personnel (i.e., requiring that individuals cover the cost or fair market value of their meal and entertainment and the foundation covering the charitable portion of the ticket), nor may the

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[4] See, for example, the "Roadmap Ruling," Private Letter Ruling (PLR) 9312022. While Private Letter Rulings are not binding precedent, they do give us an idea of how the IRS views a particular situation.

[5] Note that there are particular regulations that apply to a bank foundation receiving services from its related bank. See Treasury Regulation 53.4941(d)-2(c)(4).

disqualified person reimburse the foundation for use of a few tickets if the foundation is required to purchase an entire table.

Using the “fun test” can be helpful to determine if the individual should be using tickets provided by the foundation. If the event is of the type that people generally pay to attend (such as an orchestra performance or an exhibit at an art museum), use of the ticket provided by the foundation could be self-dealing – especially if the tickets are to a series of performances, as opposed to a single performance.

As a result of these challenges, foundations have used different strategies and policies to navigate related self-dealing concerns. Some organization choose not to support events or refuse to accept tickets for events they sponsor. Alternatively, individuals may purchase their tickets, or they may be considered compensation (income) to the disqualified person.

Family members or affiliated corporations may sponsor events and use tickets in any way that they wish without self-dealing concerns.

Excessive Compensation

Foundations are permitted to provide compensation to disqualified persons for personal services considered to be “reasonable and necessary” to carrying out the charitable purposes of the organization. Personal services must be “professional and managerial” in nature. The IRS has ruled that legal, accounting and investment advising qualify for the exception, as do certain other services, but that janitorial services do not. Foundations should seek advice from knowledgeable counsel before engaging with disqualified persons for services.

The IRS defines reasonable compensation as the value that would ordinarily be paid for like services by like enterprises under like circumstances, based upon all the facts and circumstances.

Reasonable Expenses and Reimbursements

Foundations are permitted to reimburse or pay for the expenses of employees and trustees if such expenses are considered necessary to carrying out the foundation’s exempt purposes, and the amount must be considered reasonable. Generally, reimbursement of expenses are restricted to individuals serving the foundation in an official capacity (not their spouses or other family members).

Board members and staff should not use a foundation credit card for personal expenses. Even if they provide a reimbursement back to the foundation, it is still considered a loan and a case of self-dealing.

Foundations should adopt a travel and reimbursement policy to clarify permissible expenses and outline the process for reimbursement. For example, self-dealing has been found when a board member charged the foundation for a hotel movie while traveling on foundation business, and it was also found when a board went golfing together as part of a foundation retreat. As another example, first class travel should only be paid for by the foundation if a doctor has opined that it is medically necessary.

Personal Pledges

Foundations are not allowed to make a grant to satisfy a disqualified person's binding pledge of a donation to a charitable entity. In such situations, the individual donor must make the contribution, otherwise the foundation would be considered to be using its funds to cover a personal debt/obligation of the disqualified person.

Confusion has arisen on this issue from IRS Notice 2017-73. While a DAF still may not be used to fulfill a binding pledge of a disqualified person, the proposed rules (which may be relied upon until their final adoption) no longer require DAF sponsors to be the arbiter to determine when a binding pledge might exist (so long as a binding pledge is not referred to in the gift agreement and certain other conditions exist).

Special Issues for Corporate Giving Programs and Foundations

Corporate foundations that are classified as private foundations (as opposed to public charities, which is somewhat rare) are also strictly prohibited from engaging in self-dealing. A number of unique issue arise in this area.

Attending Fundraisers or Foundation-Sponsored Events

As noted in the Family and Private Foundations section (above), attending a foundation-sponsored event can be considered a form of self-dealing for disqualified persons. However, corporations and corporate giving programs have much more flexibility regarding the purchase and use of event tickets than a corporate foundation.

Disaster Relief

Corporate giving programs and corporate foundations may be able to provide assistance to individual employees as part of disaster relief efforts. However, there are differing rules and restrictions for federally qualified disasters versus state or local disasters or individual employee hardship. Typically, employee hardship funds cannot be managed or funded by a corporate foundation. For more information, see CMF's resources, "Frequently Asked Questions About Disasters" and "Choosing a Corporate Philanthropy Approach."

Scholarship Programs

Companies and other employers may offer scholarships that benefit employees and their children. However, self-dealing rules require a special set of rules be followed for these programs. For more information, see CMF's resources, "Navigating Scholarships and Grants to Individuals" and "Choosing a Corporate Philanthropy Approach."

Rent

The foundation cannot pay rent to a disqualified person. Instead, the company/family must either cover the rent or the foundation must have a separate lease from a landlord who is not a disqualified person. The foundation may reimburse an independent vendor (not a disqualified person) for its pro rata portion of expenses.

Sharing Employees

The law is not particularly clear regarding sharing employees between a private foundation and a disqualified person. There have been several private letter rulings over the decades since the IRS adopted the private foundation rules in 1969, but some of them are contradictory, and private letter rulings are highly fact-specific and are not binding precedent. Rather, such rulings give us an idea of how the IRS would likely view a situation.[6] Whenever possible, employees should be separately employed by each entity and detailed time records should be kept to make clear that time paid for by the foundation was incurred only for foundation business. Foundations should review these situations with qualified tax and legal counsel before implementing sharing arrangements between private foundations and disqualified persons.

Sharing Office Space, Supplies, and Services

As with sharing of employees (discussed above), the law is not particularly clear regarding the sharing of office space, supplies and services. A disqualified person (family office or company) can provide office space, supplies and services to the foundation without charge for the foundation's charitable purposes. Alternatively, the foundation can pay for its share of office-related services and equipment. However, in most cases, those payments must be directed to the service provider and cannot be directed to the disqualified person (i.e., the family office or company).

To Learn More

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Council of Michigan Foundations. "Navigating Scholarships and Grants to Individuals." 2021. https://www.michiganfoundations.org/resources/navigating-scholarships-and-grants-individuals.

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About Ask CMF

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[6] See, for example, Private Letter Ruling 9312022, commonly known as the "Roadmap Ruling."

Oertel, outside legal counsel to CMF. CMF members can find answers to their most pressing questions through CMF's Knowledge Insights division, including Ask CMF, the Knowledge Center and the Sample Documents Hub. Ask CMF is a free service to CMF members, available through the "Ask CMF" link on the CMF homepage or by visiting https://www.michiganfoundations.org/practice/ask-cmf.