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THE PRIVATE BRIEF · NONPROFIT GOVERNANCE

The Self-Dealing Rules a Family Board Must Know

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IN BRIEF

- Section 4941 of the tax code taxes many kinds of transactions between a private foundation and its insiders, called disqualified persons, and the regulations say it does not matter whether the deal helped or hurt the foundation.
- Disqualified persons include substantial contributors, directors and officers, owners of more than 20 percent of a contributing company, their spouses, ancestors, descendants and descendants' spouses, and entities those people control by more than 35 percent.
- The tax falls on the people involved: 10 percent of the amount involved for the insider and 5 percent for a manager who knowingly took part, rising to 200 percent and 50 percent if the act is not corrected, with a manager's share capped at $20,000 per act for each tier.

The foundation needs an office. Your mother owns a building with an empty suite on the second floor, and at the board meeting she offers it to the foundation for a dollar a year. Everyone at the table smiles. It is generous, it saves the foundation real money, and under federal tax law it is an act of self-dealing.

That surprises almost every new family board, so it is worth understanding why before the first generous idea reaches the agenda.

The rule in one sentence

Section 4941 of the Internal Revenue Code imposes a tax on certain transactions, which the law calls acts of self-dealing, between a private foundation and the people closest to it. Whether the deal was fair, or even a bargain for the foundation, generally does not matter. The Treasury regulations say it plainly: “it is immaterial whether the transaction results in a benefit or a detriment to the private foundation.”

The rule is structural, not moral. It exists so that nobody has to argue, case by case, about whether a particular insider deal was fair. The transaction either happened or it did not.

Who counts as an insider

The law’s word for an insider is a disqualified person, and the IRS’s summary of the definition in section 4946 includes:

- **Substantial contributors:** anyone who has given or left the foundation more than $5,000 in total, if that is more than 2 percent of all the gifts and bequests it has received by the end of the year in which the person’s gift arrives.
- **Foundation managers:** officers, directors and trustees, and anyone who regularly exercises general authority to make administrative or policy decisions for the foundation.
- **Twenty percent owners:** people who own more than 20 percent of a company, partnership or trust that is itself a substantial contributor.

- **Family members** of all of the above: spouses, ancestors, children, grandchildren and further descendants, and the spouses of those descendants. Legally adopted children count.
- **Controlled entities:** corporations, partnerships, trusts and estates in which those people together hold more than 35 percent.

Notice who is not on the family list: brothers and sisters. A sibling becomes a disqualified person by being something else, such as a director. On a family board, that is usually the case anyway. In practice the class is very nearly the whole family, plus the family business and the family's partnerships and trusts. Boards that keep a written list, and update it when a child marries or a new company is formed, make every later question easier.

What the rules reach

The IRS's list of transactions that are generally acts of self-dealing comes down to these:

1. Selling, exchanging or leasing property
2. Lending money or extending other credit
3. Providing goods, services or facilities
4. Paying compensation or reimbursing expenses to a disqualified person
5. Transferring the foundation's income or assets to, or for the use or benefit of, a disqualified person
6. Certain agreements to pay money or property to government officials

The rules also reach indirect self-dealing, including transactions routed through an organization the foundation controls.

Where family boards actually get caught

Pay. Paying a disqualified person is generally self-dealing, with an important exception: payments for personal services "that are reasonable and necessary to carry out the foundation's exempt purposes," and never excessive. The exception is real and widely used. Its edges are where the trouble lives: the services must be personal services, and the amount should be set and documented as reasonable before it is paid, not justified afterward.

Foundation money for a family purpose. The IRS says “A grant or other payment made by a foundation to satisfy the legal obligation of a disqualified person is an act of self-dealing.” If you personally signed a binding pledge to your university, the foundation should not be the one to pay it. The same goes for the foundation paying an excise tax imposed on an insider. There is a sensible limit: the IRS treats public recognition a substantial contributor receives from the foundation’s charitable work as an incidental benefit, not self-dealing on its own.

Loans. A foundation lending to a director is plainly out. A director lending to the foundation is the case people assume must be fine because it is generous. The IRS allows it only if the loan is “without interest or other charge” and the money is used exclusively for charitable purposes. A loan at a below-market rate is treated as self-dealing to the same extent as a loan at the market rate.

The transaction either happened or it did not.

The bargain lease, and the better answer

Back to the dollar-a-year office, a composite rather than any one family.

The IRS says “The leasing of property between a disqualified person and a private foundation is an act of self-dealing.” The low rent does not fix it. There is one exception: a lease from a disqualified person to the foundation is not self-dealing “if the lease is without charge.” A dollar is a charge.

So the better answer is to let the foundation use the space for nothing. The IRS adds that the lease still counts as without charge even if the foundation pays its own janitorial, utility or other maintenance costs, as long as none of that money goes, directly or indirectly, to a disqualified person. Separately, it is not self-dealing when a disqualified person provides goods, services or facilities to a foundation without charge and they are used exclusively for charitable purposes. The economics are almost identical to the dollar lease. The legal character is not.

That is the shape of most self-dealing problems: there is usually a lawful way to do the generous thing, and it is rarely the way the family would have written it up on its own.

What the tax looks like

The tax falls on people, not on the foundation, and it escalates. The IRS describes it this way:

- **First tier.** The self-dealer owes 10 percent of the amount involved for each year or part of a year in what the law calls the taxable period, which runs until the act is corrected or the IRS formally acts on it, whichever comes first. A foundation manager who knowingly took part owes 5 percent, unless the participation was not willful and was due to reasonable cause.
- **Second tier.** If the act is not corrected within that period, the self-dealer owes a further 200 percent of the amount involved, and a manager who refused to agree to the correction owes 50 percent. The IRS will not assess that second tier, or will abate it, if the act is corrected during the correction period that follows.
- **Caps.** A manager's first-tier tax is capped at $20,000, and the second-tier tax at another $20,000, for any one act. There is no cap for the self-dealer.

Two features are worth sitting with. First, the first-tier tax runs year by year, so a lease left in place is not a single event. Second, correction has a defined meaning: under the regulations, undoing the transaction to the extent possible, and leaving the foundation in no worse a position than if the insider had dealt with it "under the highest fiduciary standards." It is not an apology.

What the board should do

- Keep a written, current list of disqualified persons and circulate it before every meeting.
- Send any proposed transaction with anyone on that list to counsel before it is agreed, not after.
- If anyone is paid, set the pay in advance, with evidence of what comparable organizations pay.

- Follow the conflict of interest policy New York requires. Section 715-a of the Not-for-Profit Corporation Law says “the board shall adopt” one, and the policy must keep the person with the conflict out of the discussion and the vote and record the outcome in the minutes.
- Treat “but it is a good deal for the foundation” as a reason to slow down, not a reason to proceed.

The governance documents in the firm’s Foundation Launch engagement are drafted for a family-governed board, so that this record is produced as a matter of routine; the scope and published fee are on the Foundation Launch page.

Where to start

This week, write the list. Every director and officer. Everyone who has given more than $5,000, if that is more than 2 percent of what the foundation has received. Their spouses, parents, children and grandchildren, and the children’s spouses. Every company, partnership or trust in which that group holds more than 35 percent. Circulate it before the next meeting and ask each director to check their own line.

This is general information about the private foundation self-dealing rules, not legal or tax advice about any transaction. Whether an arrangement is self-dealing depends on its facts, and the IRS, not the board, has the last word.

WRITTEN BY

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Anthony is the Managing Partner of Clemenza Law Group and serves as general counsel to a wide range of companies and philanthropic organizations. Nearly every essay here began as a real question from a real client: the contract that landed at 4 p.m., the board that meets on Thursday. He writes them the way he would answer you across the table, plainly and with care.