Private Foundation K-Net Podcast Script
Disqualified Persons

Text version for assistive readers who prefer a text version of this course

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Introduction

Thank you for joining me for this presentation on Disqualified Persons. I have a few announcements before we get started.

The information contained in this presentation is current as of the day it was presented, and should not be considered official guidance.

Any stories, names, characters, and incidents portrayed in this production are fictitious. No identification with actual persons (living or deceased), places, buildings, and products is intended or should be inferred.

This program is being recorded and will be maintained in accordance with federal record keeping laws.

Now let's get started.

So why am I discussing a disqualified person? After all, the IRS has an Issue Snapshot which explains everything you need to know, right? Well, while this is an excellent document, this presentation allows us to focus on disqualified person and give you some examples. Let's have a quick review of a disqualified person.

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Importance of §4946

A basic concept of the private foundation laws is that of the disqualified person (disqualified person). An understanding of who the disqualified persons are is critical in any chapter 42 analysis. Determining who or what is a disqualified person can have an effect on other sections including:

- Section 4941 which pertains to self-dealing and
- Section 4943 on excess business holdings.

A disqualified person is a person that includes:

- An individual
- Corporation
- Partnership
- Trust
- Estate
- Or other private foundation

standing in one or more particular relationships with respect to a private foundation, its trustees, and it founders.

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§4946 – What is a Disqualified Person?

Section 4946 has a list of disqualified persons with respect to a private foundation.

There are seven categories of disqualified persons. The following list identifies who constitutes a disqualified person for purposes of the statute.

a) Substantial contributors
b) Foundation managers
c) Certain 20% owners
d) Family members
e) Corporations, partnerships or trusts or estates in which persons in (a) through (d) hold more than a 35% interest
f) A private foundation which is effectively controlled by the person or persons in control of the foundation in question (for purposes of §4943 only)
g) A government official (for purposes of §4941 only)

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Substantial Contributor

One category of disqualified person is a substantial contributor to a private foundation.

Generally, this is any person who contributed or bequeathed an aggregate amount of more than the greater of:

1. $5,000 to the private foundation.
2. Two percent of the total contributions and bequests the foundation received from its creation to the close of its tax year in which it received the contribution or bequest from that person.

A donor is a substantial contributor as of the first date when he/she exceed the $5,000/or 2%.

Here is an example:

On 1/1/ 2015, Sue gives to Z Private Foundation a first time gift of $3,000. As of 1/1/2015, Z Private Foundation has received, throughout its existence, gifts totaling $200,000. Is Sue a substantial contributor? Sue's gift is less than $5,000 and is also below the 2% floor (2% of $200,000 equals $4,000) – therefore, Sue is not a substantial contributor.

Sue makes an additional gift of $3,000 in 2015. (Remember – she already made one gift of $3,000 on January 1). Is she a substantial contributor? Sue, now becomes a substantial contributor because her second gift causes her cumulative gifts totaling $6,000 to exceed the $5,000 threshold.

Can you stop being a substantial contributor?

No. The one exception that causes a person's status as a substantial contributor to terminate is, after 10 years, he/she has no connection with the private foundation.

To become disconnected, three factors must be present during the 10 year period.

- One – the person did not make any contributions to the private foundation
- Second – neither the person, nor any related person, was a foundation manager of the Private Foundation
- Third – the IRS determines the aggregate contributions the person made are insignificant compared to the aggregate amount of contributions to that foundation by one other person

Here is an interesting fact about trusts:

For a trust, the term substantial contributor also means the creator of the trust not considering amounts donated.

Here is an example:

If X created a trust with less than $5,000, is he considered a disqualified person? The answer is yes. The creator of the trust is a disqualified person regardless of amount he contributed.

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Foundation Managers

A foundation manager is generally an officer, director or a trustee of a private foundation. An individual is also considered an officer under the regulations if an individual regularly exercises general authority to make administrative or policy decisions on behalf of the foundation. However, independent contractors acting in the capacity as lawyers, accountants and investment managers and advisors are not foundation managers.

So Let's talk about examples of foundation managers

- The first example involves a lawyer or an accountant – are they foundation managers? Generally, independent contractors such as lawyers, accountants and investment managers and advisors acting in that capacity are also not managers or officers of a private foundation.
- In some situations, a bank or similar financial institution and investment advisors can be foundation managers but they have to regularly exercise authority of the private foundation. In one scenario, a private foundation purchased property from a testamentary trust. A banking institution was the trustee of both the private foundation and the trust. The purchase was not an act of self-dealing merely because the banking institution was the trustee of both the private foundation and the testamentary trust because the trust was not a disqualified person.
- If a foundation manager submits his or her resignation to the private foundation, does this terminate their status as a disqualified person? The answer is yes. The foundation manager is presumed able to exert influence on a private foundation only because he or she occupies a position of authority with the foundation. Once that relationship is severed, the presumption must fail.

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Certain 20% Owners

Certain 20 percent owners are persons who own more than 20 percent of the voting power, profits interest, or beneficial interest of an entity that is a substantial contributor to the foundation. These entities can be a corporation, a partnership, a trust, or an unincorporated enterprise.

Here's an example:

An employee stock ownership trust was not a disqualified person with respect to a private foundation. The trust held 30 percent of the stock of a corporation that was a substantial contributor to the foundation. The participating employees directed the manner in which the trust voted shares. Therefore, to the extent the trust had any voting power, it merely held the voting power as trustee and not as owner of the stock. Therefore, the trust was not a disqualified person.

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Family Member

Now, I'd like to go over certain family members of disqualified persons who are considered disqualified persons themselves because of that relationship.

The types of family members which are disqualified persons include

- Spouse
- Ancestors
- Lineal descendants (children, grandchildren etc.)
- Spouses of lineal descendants
- The legally adopted child of an individual is his/her child.

What are lineal descendants? Well think of the family being basically in a straight line so lineal descendants would include: your children, your grandchildren below them, and your great- grandchildren.

Please note that a person's brother, sister, aunt or uncle isn't a family member for IRC 4946

Here's an example:

On January 1, 2008, David Graves donated $5,000 to Y, a private foundation that is on a calendar year basis. Y is incorporated in the state of New York. The total amount of contributions that Y received throughout its existence as of December 31, 2008, was the $5,000 contributed by Mr. Graves. During the audit, you determine that David Graves is the father of Michael Graves, who is the President of Y. David Graves, is not a substantial contributor since he did not contribute more than $5,000 to Y. However, he is a disqualified person since he is an ancestor of a foundation manager.

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Trusts or Estates or Corporations or Partnerships

A corporation, partnership, trust or estate is a disqualified person if more than 35% of the total combined voting power in the corporation or more than 35% of the beneficial interest in the trust or estate is owned by:

- Substantial contributors
- Foundation managers
- 20% owners
- Members of the family

Here's an example:

Partnership A is a substantial contributor to a private foundation B; partnership C has a 25% profit interest in partnership A; therefore C is a disqualified person of B.

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Private Foundation is a Disqualified Person

For purposes of excess business holdings under §4943 only, a private foundation is a Disqualified Person with respect to the foundation in question if:

- It is effectively controlled by the same people who control the foundation, (So for example they share the same board members) or
- Substantially all the contributions to it were made by the people who make substantially all the contributions to the foundation in question and these people are in §4946(a)(1)(A), (B), (C), or (D) with respect to the foundation in question

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Government Official

The last type of disqualified person is a government official and this pertains only for the purposes of self-dealing under§4941, a government official is a disqualified person based on the following factors.

A government official is one who:

- Holds an elective public office in U.S. Gov't:
    - Executive or legislative branch
    - Or judicial branch of a State, possession of the U.S., any political subdivision of that State or possession or the D.C. and whose gross annual compensation is $20,000 or more (can also be appointee)

Government officials may be a disqualified person with respect to a private foundation, but only for the self-dealing rules (not for purposes of other private foundation restrictions).

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A government official is one who holds one of the following positions:

- In the U.S. Government's executive, legislative, or judicial branch listed in the Civil Service Rules, schedule C of rule VI, or

- The compensation for which is equal to or greater than the lowest rate of basic pay for the Senior Executive Service under section 5382 of title 5 United States Code

Holds a position as:

- An employee under the U.S. House of Representatives or Senate with gross annual compensation of $20,000 or more,
- A personal or executive assistant or secretary to any of these government officials.

A government official is one who:

- Is appointed by the President to an office in the executive or judicial branch of the U.S. Govt.

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.

A government official also includes a member of the IRS Oversight Board per 4946(c)(7).

As an example:

The elected member of the state legislature received a salary of less than $15,000 per year and an expense allowance of a fixed amount. However, the salary and expenses together were more than $15,000 per year. The ruling held that since the individual's gross compensation from public office is greater than $15,000 per year, the individual was a disqualified person by virtue of being a government official.

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Conclusion/Summary

- One important fact to remember for disqualified persons is: An act of self-dealing doesn’t include a transaction where the disqualified person status arises only as a result of the transaction. Reg. 53.4941(d)-1(a).
- As an example, the regulations indicate that a bargain sale of property to a private foundation is not an act of self-dealing if the seller becomes a disqualified person only as a result of the seller becoming a substantial contributor due to the bargain element of the sale.
- Can a person be a disqualified person under several categories? Yes, a person can be a disqualified person under different categories such as a foundation manager and substantial contributor.
- Now to summarize what we just discussed:

- We went over the importance of §4946 which discusses disqualified persons
- Please remember there are five categories and two special categories of disqualified persons and it's important to identify which persons are considered disqualified persons when dealing with private foundation excise taxes.

Thank you for listening to this presentation. I hope the information we presented is useful.