

Issue Podcast Script – Self-Dealing Exception for Compensation to Disqualified Persons

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

SLIDE 1: Introduction

Thank you for joining me for this presentation on self-dealing exception for compensation to disqualified persons. I have a few announcements before we get started.

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

Now let's get started.

In this podcast, I'll talk about self-dealing under Code Section 4941 and the exception for compensation to disqualified persons. I'll first go over the general self-dealing rules and then talk more specifically about the exception and conclude with the rebuttable presumption of reasonable compensation as provided in the Section 4958 excess benefit transactions.

SLIDE 2: Overview §4941

Section 4941 imposes an excise tax on certain transactions, what we call acts of self-dealing, between a private foundation and disqualified persons. The Internal Revenue Code imposes an initial excise tax of 10 percent of the amount involved for an act of self-dealing on the disqualified person, other than a foundation manager acting only as a manager, for each year or part of a year in the taxable period.

An excise tax of 5 percent of the amount involved is imposed on a foundation manager who knowingly participates in an act of self-dealing, unless participation is not willful and due to reasonable cause, for each year or part of a year in the taxable period.

An excise tax of 200 percent of the amount involved is imposed on the disqualified person, other than a foundation manager acting only as a manager, who participated in the act of self-dealing, if the act of self-dealing is not corrected within the taxable period.

If more than one person is liable for the initial and additional taxes imposed for any act of self-dealing, all parties are jointly and severally liable for those taxes.

SLIDE 3: General self-dealing rules under §4941(d)

These transactions are generally considered acts of self-dealing between a private foundation and a disqualified person:

- Sale, exchange, or leasing of property,
- Leases
- Lending money or other extensions of credit,
- Providing goods, services, or facilities,
- Paying compensation or reimbursing expenses to a disqualified person,
- Transferring foundation income or assets to, or for the use or benefit of, a disqualified person, and
- Certain agreements to make payments of money or property to government officials.

In addition, the law prohibits indirect self-dealing. The purpose of the indirect self-dealing rules is to prevent transactions from taking place indirectly that could not be accomplished directly between the private foundation and a disqualified person. Indirect self-dealing involves transactions between a disqualified person and an organization controlled by a private foundation.

SLIDE 4: Exception to self-dealing: Personal services

So that was just a very broad overview of self-dealing under Section 4941. We learned that a private foundation's paying compensation to or reimbursing expenses to a disqualified person is generally an act of self-dealing. The general rule does not apply, however, if the payments are for personal services that are reasonable and necessary to carry out the foundation's exempt purposes and not excessive. We call this the personal service exception.

A private foundation's payment of compensation or reimbursement for expenses to a disqualified person for performing personal services reasonable and necessary to carrying out the foundation's exempt purposes is not an act of self-dealing if that compensation is not excessive.

For example: it is not an act of self-dealing for a private foundation to pay reasonable compensation to a foundation manager, who is an investment advisor, for managing the private foundation's investment portfolio.

Another example in Rev. Rul. 73-613 shows that a private foundation's payment of court awarded legal fees to the counsel's director-manager, a disqualified person who had filed suit against the remaining directors to require them to carry on the foundation's charitable program, is not an act of self-dealing.

SLIDE 5: What Services Constitute Personal Services

So, we just talked about compensation to disqualified persons for personal services which is an exception to the self-dealing rules of Section 4941. Now we need to break it down a bit further and talk about:

- what constitutes a personal service
- what is compensation, and
- what is reasonable compensation.

First, what is a personal service? The regulations provide that the term personal services include:

- the services of a broker serving as an agent for the private foundation,
- but not the services of a dealer who buys from the private foundation as principal and resells to third parties.

There is a tax court case that talks about this issue, *Madden, Jr. v. Commissioner* 74 TCM 440 (1997). One of the questions before the Tax Court was whether general maintenance, janitorial and custodial services provided by a disqualified person to a private foundation museum were of the same character as those services discussed in the examples in the regulations and could therefore be deemed to be personal services. The examples in the regulations include legal services, investment management services and general banking services. After citing the legislative history of Section 4941, the Court noted that it was the intent of Congress that any exceptions to the self-dealing transaction rules should be construed narrowly. The Court concluded that general maintenance, janitorial and custodial services were different in nature from the professional and managerial services found in the examples in the regulations and, therefore, would not meet the definition of personal services.

SLIDE 6: What is Compensation?

Generally, compensation is what we typically think of in terms of salary, wages and bonuses. But it also includes reimbursement of expenses. Also, when payments are made by a private foundation for insurance policy premiums for a disqualified person's liability insurance, such payments may be self-dealing. We have several revenue rulings that talk about this situation.

For instance, Rev. Rul. 74-405 discusses a situation in which the private foundation paid insurance premiums. In that ruling, a private foundation's payment of premiums for insurance indemnifying a disqualified person against liability for claims from the person's foundation responsibilities is not an act of self-dealing so long as the total compensation of the disqualified person was not excessive.

Another revenue ruling that we issued also talks about payment of premiums. In Rev. Rul. 82-223 a private foundation's payment of premium for liability insurance for its foundation manager for all liabilities under state mismanagement laws was not an act of self-dealing as long as the total compensation was not excessive.

We also issued a revenue ruling that dealt not with insurance premium payments but payment of a pension. In Rev. Rul. 74-591 we ruled that payment of a pension for past services to one of the directors of a private foundation was not an act of self-dealing because the total compensation paid to the director, including the pension, was not excessive.

Slide 7: What is Reasonable?

So, we just discussed that compensation can include not only your typical kinds of compensations such as salary but also other economic benefits. Next, we need to look at what is reasonable compensation. There is no guidance in Chapter 42 to determine what is reasonable compensation. However, we can look to other areas to help us define it including the compensation as a business expense. Reasonable compensation is defined by Section 1.162-7(b)(3) as the amount like organizations would ordinarily pay for like services in like circumstances, and this standard is also adopted in the excess benefit transactions regulations under 4958. Under the excess benefit transactions provisions, if an organization meets three requirements, payments it makes to a disqualified person under a compensation arrangement are presumed to be reasonable. We call that the "rebuttable presumption" of reasonableness of compensation. Failure to meet the three requirements, however, does not automatically mean the compensation is not reasonable. The three requirements are one, advanced approval by an authorized body of the organization, second is that the authorized body looked at comparable data for making the particular compensation, and third is that the process is adequately documented.

We have a tax court case that talks about what is reasonable compensation for purposes of Section 4941 and that is *Kermit Fischer Foundation v. Commissioner*. In that case, a foundation's sole trustee received compensation from the foundation irregularly, and the amounts appeared to be related more to his need for funds than to his duties and responsibilities. The Service offered uncontradicted expert testimony as to the normal compensation paid for trusts of the foundation's size. The expert

suggested that a normal salary for a comparable trust would have been \$1,450 to \$2,000 per year rather than the approximately \$40,000 per year the trustee received during the years at issue. The court held that the disqualified person, the trustee of the foundation, was liable for tax under Section 4941(a) for receipt of excessive compensation. The annual compensation the manager received was disproportionately large compared to the foundation's total assets.

SLIDE 8: Excess Benefit Transaction Compared

Now we mentioned just a few moments ago the excess benefit transaction regulations as a guide to determine what is reasonable compensation under 4941 for self-dealing purposes. Overall, an excess benefit transaction is a transaction in which a tax-exempt organization provides an economic benefit, directly or indirectly, to or for any disqualified person's use and the value of the economic benefit exceeds the value of the consideration that the disqualified person received. Excess benefit transaction rules do not directly apply to private foundations but the reasonable compensation rebuttable presumption is helpful when looking at this issue. It is worth noting again, that, if an organization meets the three requirements, payments it makes to a disqualified person under a compensation arrangement are presumed to be reasonable. Failure to meet the three requirements does not, however, automatically mean the transaction is an excess benefit transaction.

SLIDE 9: Summary

Section 4941(d)(2)(E) states that the payment of compensation or the reimbursement of expenses by a private foundation to a disqualified person constitutes self-dealing. However, there's an exception to this rule when a foundation pays compensation to or reimburses the expenses of a disqualified person's expenses party for their personal services that are reasonable and necessary to carrying out the foundation's exempt purposes, if the payment is not excessive.

We also discussed that even the regulations under Section 4941 don't define what constitutes reasonable compensation we can look at other areas for guidance, including the 1.162 regulations and the rebuttable presumption criteria as noted in the excess benefit transactions.