

Patterson Belknap Webb & Tyler LLP

Self-Dealing (Family Foundations and Family Offices)

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What Is a Private Foundation?

- Overview of Private Foundations Under U.S. Law and Practice
 - Public Charities vs. Private Foundations
 - Non-Operating vs. Operating Foundations
 - IRC Sections 4940-4946: A Suite of Tools for Regulating Private Foundations
 - Family vs. Corporate vs. Institutional Foundations
 - Wholly Charitable Trusts vs. Not-for-Profit Corporations
- Evolution of the Section 501(c)(3) Universe Since 1969
 - “Excess Benefit Transactions”
 - Regulation of Donor-Advised Funds and Type 3 Supporting Organizations
 - State Law Regulation (NY Nonprofit Revitalization Act of 2013)
- Charitable Remainder Trusts and Charitable Lead Trusts as Quasi-Private Foundations

Legislated Manifestations of the Duty of Loyalty

- The federal “self-dealing” rules and New York’s “related party transaction” rules are part of a continuum of rules that should guide the conduct of foundation insiders.
- These two relatively recent pieces of legislation are merely a subset of the ancient and expansive “fiduciary duty of loyalty” that exists at common law.
- Mere compliance with technical rules is not the end of the analysis of whether a legal issue exists. Conflict of interest policies should encompass **but not be limited to** the handling of “acts of self-dealing” and “related party transactions.”
- In an age of transparency, e-filing of returns, and populist sentiment from the left and the right, it is reasonable to expect more legislation, more disclosure and more scrutiny.
- Charitable trusts may be subject to state law duty-of-loyalty limitations stricter than those imposed on not-for-profit corporations.

Definition of an “Act of Self-Dealing”

- The definition of an “act of self-dealing” under IRC Section 4941 is very broad.
- Acts of self-dealing include the following types of transactions or arrangements (whether direct or indirect):
 - Sales and exchanges of property (in either direction and even if on terms that favor the foundation),
 - Loans or other extensions of credit (except certain no-interest loans ***from*** a disqualified person),
 - Leases of property (except where the private foundation leases property ***from*** a disqualified person at no cost),
 - Furnishing goods, services or facilities (with limited exceptions),
 - Compensation or reimbursement of a disqualified person, unless reasonable and necessary,
 - Transfer to (or use by or for the benefit of) a disqualified person of the income or assets of the private foundation, and
 - Certain payments to certain government officials.

What Persons Are “Disqualified Persons”?

- Board members, officers and individuals with similar responsibilities (collectively known as “foundation managers”) (subject to “first bite of the apple” for new hires)
- “Substantial contributors” (subject to “first bite of the apple”)
- An owner of more than 20% of the voting power of a corporation that is a substantial contributor (with similar principles applying to partnerships and trusts)
- Certain family members of the above (spouses, ancestors, children, grandchildren, great grandchildren, and spouses of children, grandchildren and great grandchildren) **but not** siblings and their spouses, descendants, and descendants’ spouses
- Corporations or partnerships of which the disqualified persons above own more than 35%
- Trusts of which more than 35% of the beneficial interests are held by the disqualified persons above (possibly including CRTs and CLTs of which the foundation is also a beneficiary)
- Certain government officials

Who Is Excluded from the Definition of “Disqualified Person”?

- For IRC Section 4941 purposes, the class of disqualified persons does not include:
 - Section 501(c)(3) organizations (other than those organized and operated exclusively for testing for public safety) and
 - Wholly-owned subsidiaries of public charities.
- But self-dealing might still exist if the arrangement is, in substance, a use of private foundation assets by a disqualified person.

Excise Tax on “Acts of Self-Dealing”

- For the act of self-dealing itself, regardless of intent or whether the private foundation benefits, the initial tax is:
 - 10% of amount involved (imposed on disqualified person) (annually until correction and without proration for partial years) **and**
 - 5% of amount on foundation managers who knowingly and without reasonable cause participated in the transaction (capped at \$20,000) (joint and several).
- If the private foundation does not correct (“undo”) the transaction, a second tier tax is applied:
 - 200% of amount involved on disqualified person **and**
 - 50% on foundation managers who refuse to agree to the correction (capped at \$20,000) (joint and several).
- Revocation of tax-exempt status on grounds of private inurement may also be a remedy.

Allowance for “Incidental Benefit” and Certain Compensation

- A disqualified person may receive incidental and tenuous benefits on account of the foundation’s activities, e.g.
 - Enhanced reputation or prestige or
 - Participation in wholly incidental degree in fruits of some charitable program that benefits the community.
- A private foundation may pay compensation to and reimburse the expenses of a disqualified person if:
 - The services are “personal services” (i.e., professional services) by the disqualified person that are reasonable and necessary to carrying out the activities of the private foundation and
 - The compensation is “reasonable” and “not excessive.”

What Is “Indirect Self-Dealing”?

- Certain transactions between a disqualified person and an entity controlled by a private foundation (together with its disqualified persons insofar as they have voting rights in their foundation capacity).
 - The possibility of indirect self-dealing exists even if the foundation is a minority owner of the entity, depending on the control structure.
- Certain transactions and arrangements involving property in which a private foundation, as beneficiary of a trust or an estate, has an interest or expectancy. Cases to consider:
 - Auctions or other sales of estate assets to disqualified persons
 - Compensation of executors
 - Loans to disqualified persons
- If a foundation or a trust or estate for its benefit owns a share of the family office entity, the arrangement should be reviewed for indirect self-dealing issues.

Interplay with Excess Business Holdings Rules

- Broadly speaking, a private foundation is subject to the excise tax on “excess business holdings” (EBH) if the foundation, together with certain of its disqualified persons, owns more than 20% of the equity of an operating business.
- It is possible for a foundation to have EBH but avoid the excise tax **if an exception is available** (if the holdings were acquired by gift or bequest and have not been held for more than the permissible period **or** if the foundation owns 2% or less by vote and value **or** if the business is “functionally related”), and it is possible for the EBH ownership threshold to be raised from 20% to 35% (if the foundation can show that the business is controlled by persons other than the foundation and its disqualified persons).
- A transaction between the private foundation and a company that constitutes permitted EBH may be an act of self-dealing if the company is itself a disqualified person due to ownership of shares by disqualified persons. This is true even if the foundation is the majority or controlling shareholder.
- It is possible for co-investing with disqualified persons to result in EBH for which the time-based (i.e., gift/bequest) exception would not be available.

How Is “Self Dealing” Disclosed?

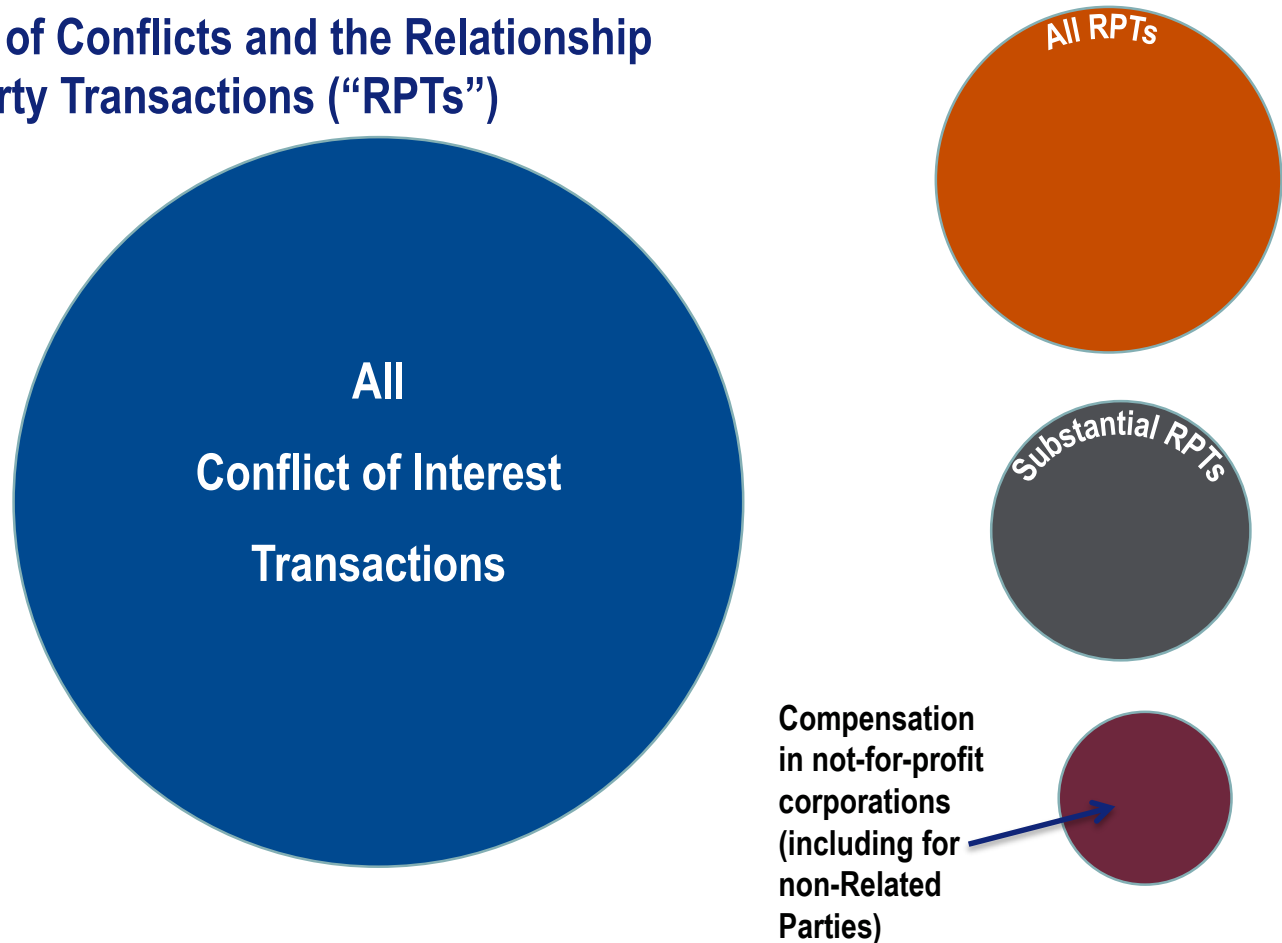
- Three Yes/No Questions on IRS Form 990PF (Part VII-B, Lines 1a, 1b and 1c)
- IRS Form 4720

Mandatory Conflict of Interest Policy Under New York Law

- Section 715-a of the New York Not-for-Profit Corporation Law (NPCL)
- Purpose: To ensure that directors, trustees, officers and key persons act in the organization's best interests and comply with applicable laws
- Requirements
 - Definition of circumstances constituting a conflict
 - Prohibition of improper attempts to influence the process
 - Recusal (no presence or participation in deliberation or voting except by request of the board or committee prior to commencement of deliberations and voting)
 - Documentation
 - Audit Committee or Board disclosure procedures
 - Annual and pre-appointment written conflicts disclosure by directors and trustees
 - Related Party Transaction procedures

Mandatory Conflict of Interest Policy Under New York Law

The Universe of Conflicts and the Relationship to Related Party Transactions (“RPTs”)



Related Party Transaction Requirements Under New York Law



Related Party Transaction:

Any transaction, agreement or other arrangement in which a **related party** has a financial interest and in which the organization or an **affiliate** is a participant

Related Parties:

Directors, officers and **key persons** of the organization and its **affiliates**

Any **relative** of the above

35% entities (corporations and trusts)

5% entities (partnerships and professional corporations)

NPCL Sections 102(a)(19), (22)-(25)

Related Party Transaction Requirements Under New York Law



Affiliates:

An entity controlled by or in control of the organization

Key Persons:

Any person in a position to exercise substantial influence over the organization's affairs

Defined by reference to IRC Section 4958(f)(1)(A) and the regulations thereunder (to the extent applicable)

Relatives:

Spouse or domestic partner, child, grandchild, great-grandchild, sibling, or half-sibling, ancestor, or the spouse or domestic partner of a child, grandchild, great-grandchild, sibling or half-sibling

Related Party Transaction Requirements Under New York Law



Basic Requirements:

Good faith disclosure of material facts to Board or an authorized Board committee

Non-participation in deliberations or voting (except if requested to present information) (though still counted for quorum purposes)

Board determination that the transaction is fair, reasonable and in the organization's best interests

NPCL Sections 715(a), (h)

New Related Party Transaction Requirements



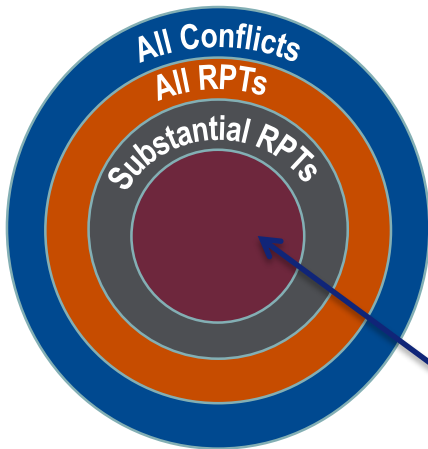
Additional Requirements:

If a **related party** has a substantial financial interest in a **related party transaction**, additional requirements apply:

- Advance consideration of alternative transactions, to the extent available
- Approval by not less than majority vote
- Contemporaneous documentation

NPCL Section 715(b)

Decisions about Compensation



**Compensation
in not-for-profit
corporations
(including for
non-Related
Parties)**

No person who may benefit from compensation paid by a not-for-profit corporation may be present at or otherwise participate in any Board or committee deliberation or vote concerning such person's compensation.

NPCL Section 515(b)

New York Attorney General Enforcement Powers

- NYAG has power **to commence proceedings** to:
 - Enjoin, void or rescind any actual or proposed Related Party Transaction, including a compensation arrangement, if it
 - violates any law or
 - is otherwise not reasonable or in the best interests of the organization,
 - Obtain damages, restitution, removal and/or an accounting, and
 - Obtain double damages if there was willful and intentional conduct.

How “Self-Dealing” & “Related Party Transactions” Differ

- New York vs. Federal (NYAG vs. IRS)
- Discovery/Whistleblower Rule vs. Self-Declaration/Audit Rule
- Removal, Rescission & Double Damages vs. Excise Tax
- “Related Party” ≠ “Disqualified Person”
- Procedure & Reasonableness vs. Effective Prohibition in Most Cases

Selected “Self-Dealing” Issues in Private Foundations

1. Bifurcation of Payments for Quid Pro Quo Grants (e.g., gala events)
2. Personal or Business Use of Benefits of a Quid Pro Quo Grant
3. Family Travel to Meetings & Retreats
4. Satisfaction of an Enforceable Charitable Pledge
5. Personal Use of Credit Card
6. Use of Office Space or Equipment, Sharing of Employees, and Group Insurance
7. Exhibition of Foundation Artwork in the Family Office (and the “Shopping Mall Rule”)
8. Loans, Leases and Exchanges that Are Meant to Benefit the Foundation
9. Loans and Employment (the “First Bite Indigestion Rule”)
10. Use of Premises (the “Sleep Over Rule” and the “Public Use Rule”)
11. Legal, Accounting, and Investment Services vs. Security, Cleaning and Private Jets
12. Establishment of “Reasonable Compensation” in Light of the “Related Party Transaction” Rules
13. Co-Investing
 - Excess Business Holdings Implications

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