N. RECENT DEVELOPMENTS UNDER IRC 4941 AND 4945

1. Introduction

The purpose of this topic is to review important developments under IRC 4941 and 4945. Items noted in the 1980 EOATRI Textbook on IRC 4945 - Grants to Individuals - will not be repeated here.

2. Administrative Developments

Sections 1301 and 1309 of Pub. L. No. 94-455 (Tax Reform Act of 1976), 1976-3 C.B. (Vol. 1) 189,205, amended section 101(1)(2) of the Tax Reform Act of 1969. Section 101(1)(2) created a series of transitional rules that exempted certain transactions between private foundations and disqualified persons from the definition of self-dealing. (The 1979 EOATRI considered the transitional rules of section 101(1)(2) in detail.)

Section 101(1)(2)(B) of the 1969 Act permits a private foundation to sell certain excess business holdings to a disqualified person. This rule applies only to business investments and not to passive investments including leases. Section 101(1)(2)(C) of the 1969 Act permitted the continuation of certain existing leases between a foundation and a disqualified person until 1979. After 1979, the leasing arrangements must be terminated. The sale of leased property by a private foundation to a disqualified person was not covered by the above-noted transitional rules. Congress intended section 1301 of the 1976 Act to minimize the hardship of a forced sale of leased property by a foundation because the value of the property to a disqualified person is often greater than to any other person. (General Explanation of the Tax Reform Act of 1976, 1976-3 C.B. (Vol. 2) 390.) Section 1301 of the Act generally permits a foundation to sell, exchange, or otherwise dispose of certain property to a disqualified person where the property is being leased to the disqualified person pursuant to a binding contract in effect on October 9, 1969, if the foundation receives no less than fair market value for the property. This provision applies to dispositions made after October 4, 1976, and before January 1, 1978.

Secondly, section 101(1)(2)(B) of the 1969 Act permitted private foundations to sell, exchange, or otherwise dispose of certain "nonexcess" business holdings to disqualified persons before January 1, 1975. Section 1309 of the Tax Reform Act of 1976 extends the rule permitting dispositions of "nonexcess" business holdings to dispositions made after October 4, 1976, and before January 1, 1977.

Final regulations covering these new rules were published in 1980. See 1980-15 I.R.B. 14.

3. IRC 4941 Developments

This section will review Revenue Rulings and court decisions not currently discussed in Chapter 13(00) of the Private Foundations Handbook, IRM 7752, and certain new issues under consideration in the National Office.

a. Revenue Rulings

(1) Rev. Rul. 76-10, 1976-1 C.B. 355, holds that the use of a private foundation's library meeting room by a government official (a disqualified person) to meet with members of the public to discuss matters of mutual interest and concern; which room is made available at no charge to members of the community-at-large, does not constitute an act of self-dealing. The activity falls within the IRC 4941(d)(2)(D) exception since the room is made available to the government official on the same basis that it is made available to other community and civic groups, and the use of the room by the government official is functionally related to the foundation's exempt purpose of making the room available for civic and community purposes.

(2) Rev. Rul. 76-18, 1976-1 C.B. 355, holds that the sale of a private foundation's art objects to a disqualified person at a public auction conducted by an auction gallery to which the items were consigned for sale constitutes an act of self-dealing under IRC 4941(d)(1)(A).

(3) Rev. Rul. 76-158, 1976-1 C.B. 354, holds that a private foundation, owning 35 percent of the voting stock of a corporation and having a foundation manager personally owning the remaining 65 percent, but not holding a position of authority in the corporation by virtue of being foundation manager, does not control the corporation for purposes of the IRC 4941 self-dealing provisions.

(4) Rev. Rul. 76-159, 1976-1 C.B. 356, holds that the payment or reimbursement by a private foundation of expenses incurred by a trustee, a government official of the Commonwealth of Puerto Rico, for roundtrip travel

from Puerto Rico to the U.S. to attend the foundation's trustee meetings, does <u>not</u> constitute an exception to self-dealing under IRC 4941(d)(2)(G)(vii).

(5) <u>Rev. Rul. 76-448</u>, 1976-2 C.B. 368, holds that the exchange of securities between a private foundation and a corporation that was previously a disqualified person by reason of the ownership of more than 35 percent of its total combined voting power by a former foundation manager, who resigned five years prior to the exchange, and who did not participate in planning the exchange while serving as a foundation manager, does <u>not</u> constitute an act of self-dealing. The Rev. Rul. states that this result follows from the fact that the corporation is not a disqualified person at the time of the transaction. Comment: The Rev. Rul. states that the corporation offered to purchase all of its outstanding nonvoting stock in exchange for cash and the corporation's debentures. It is interesting to note that even if the corporation had been determined to be a disqualified person the proposed exchange would probably fall within the IRC 4941(d)(2)(F) exception to self-dealing. However, the foundation would receive debentures, creating an extension of credit between the foundation and a disqualified person. Under Reg. 53.4941(e)-1(e)(1)(i) an act of self-dealing occurs on the first day of each taxable year or portion of a taxable year that an extension of credit from a foundation to a disqualified person goes uncorrected. Thus, if the foundation held the debentures at the end of the disqualified person's taxable year, the extension of credit would then constitute an act of self-dealing. See Reg. 53.4941(d)-(2) <u>Example</u> (2).

(6) <u>Rev. Rul. 76-459</u>, 1976-2 C.B. 369, holds that the use of a private foundation museum's private road for access to the adjacent headquarters and manufacturing plant of a corporation (a disqualified person) during the same hours the road is used by the general public as a thoroughfare connecting two public streets is not an act of self-dealing. The activity falls within the IRC 4941(d)(2)(D) exception.

(7) <u>Rev. Rul. 77-6</u>, 1977-1 C.B. 350, holds that the purchase of a portion of a hospital bond issue by a person disqualified with respect to the private foundation which guaranteed the bonds (but not those sold to the disqualified person) is not an act of self-dealing. Because the guarantee does not apply to bonds purchased by the disqualified person, there is no use of the foundation's assets for the economical benefit of the disqualified person.

(8) <u>Rev. Rul. 77-160</u>, 1977-1 C.B. 351, holds that the payment by a private foundation of a disqualified person's church membership dues in order to

maintain that person's church membership is an act of self-dealing under IRC 4941(d)(1)(E).

(9) Rev. Rul. 77-251, 1977-2 C.B. 389, holds that a per diem allowance for travel inside the U.S. paid to a government official by a private foundation in connection with its educational and charitable purposes is excepted from the tax on self-dealing under IRC 4941(d)(2)(G)(vii) of the Code only if the allowance does not exceed 125 percent of the maximum authorized rate of $35 provided by section 5702(a) of title 5, U.S.C., notwithstanding the provision in section 5702(c) allowing higher rates in designated geographical areas.

(10) Rev. Rul. 77-259, 1977-2 C.B. 387, holds that the purchase by a private foundation of a mortgage from a bank, a disqualified person that in the normal course of its business acquires and sells mortgages, is not within the exception for general banking services and is an act of self-dealing under IRC 4941(d)(1)(A).

(11) Rev. Rul. 77-288, 1977-2 C.B. 388, holds that the purchase by a private foundation from a bank, a disqualified person, of certificates of deposit with a maturity date of one year from the date of issue and providing for a reduced rate of interest if they are not held to the maturity date is not within the exception for general banking services and is an act of self-dealing under IRC 4941(d)(1)(B).

(12) Rev. Rul. 77-331, 1977-2 C.B. 388, holds that the guarantee of loans made to disqualified persons under a student loan guarantee program established by a private foundation for the children of its employees constitutes an act of self-dealing within the meaning of IRC 4941(d)(1)(E).

(13) Rev. Rul. 77-379, 1977-2 C.B. 387, holds that a private foundation's transfer of stock in repayment of an interest-free loan, made by a disqualified person and used exclusively for exempt purposes, is tantamount to a sale or exchange of property between the private foundation and the disqualified person and is an act of self-dealing under IRC under IRC 4941(d)(1)(A).

(14) Rev. Rul. 78-76, 1978-1 C.B. 377, holds that the trustee of a trust that is a private foundation who, while representing both himself and the trust, willfully and without reasonable cause sells property he owns to the trust knowing the sale is an act of self-dealing under IRC 4941(d)(1)(A) is liable for both the tax imposed on an act of self-dealing by IRC 4941(a)(1) and the tax imposed on the participation of foundation managers by IRC 4941(a)(2).

(15) Rev. Rul. 78-77, 1978-1 C.B. 378, holds that a transaction in which a private foundation purchased property from a testamentary trust that is not a disqualified person with respect to the foundation, both of which had the same banking institution as trustee, is not an act of self-dealing under IRC 4941(d)(1)(A). Comment: One might question whether this activity is self-dealing under IRC 4941(d)(1)(E). However, any benefit to the bank, a disqualified person, appears to be incidental and tenuous.

(16) Rev. Rul. 78-395, 1978-2 C.B. 270, holds that a disqualified person's transfer to a private foundation of real property that is subject to a lien placed on the property by the disqualified person within the 10-year period ending on the transfer date is an act of self-dealing under IRC 4941(d)(1)(A) even though the lien was created merely as part of a multiphase financing plan begun more than ten years earlier. The exception in IRC 4941(d)(2)(A) does not apply.

(17) Rev. Rul. 79-374, 1979-2 C.B. 387, considers an exempt private foundation that conducts agricultural economics research and experimentation in part of an office building it owns, and rents the remaining spaces to disqualified persons who are engaged in agricultural business activities. The foundation does not utilize these businesses in its research. The rental of the office space is not functionally related to the foundation's exempt purpose and constitutes an act of self-dealing under IRC 4941(d)(1)(C).

(18) Rev. Rul. 80-132, 1980-1 C.B. 255, holds that the donation of a life insurance policy to a private foundation by a disqualified person, where the policy was subject to an outstanding loan made within the 10-year period ending on the date of the donation that was not insignificant in relation to the value of the policy, constitutes an act of self-dealing under IRC 4941(d)(1)(A).

(19) Rev. Rul. 80-271, 1980-41 I.R.B. 14, holds that a settlor's transfer of money to a charitable trust, a private foundation, does not qualify for a gift tax charitable deduction under IRC 2522(a), where the trust instrument provides that the settlor's child may borrow money from the trust. Such borrowing would constitute self-dealing under IRC 4941(d)(1)(B). Thus the trust fails to satisfy IRC 508(e) and the deduction is disallowed under IRC 508(d).

(20) Rev. Rul. 80-310, 80-46 I.R.B. 9, holds that a grant made by a private foundation to a university for the purpose of funding a program of study useful to a corporation a disqualified person, does not constitute an act of self-

dealing under IRC 4941(d)(1)(E) because the benefit to the disqualified person is merely incidental and tenuous.

b. Judicial Decisions

(1) Adams v. Commissioner, 70 TC 373 (1978).

Corporation X, a disqualified person with respect to private foundation P, engaged in self-dealing by selling one parcel of property to Corporation Y, a corporation controlled by P, a private foundation of which taxpayer A was trustee. However, the sale of a second parcel by Corp. X to Corp. Y wasn't self-dealing since Y was formed to acquire that piece of property and X acquired the property as nominee for Y. Thus, conveyance of title from X to Y was not a sale. Both X and A also engaged in self-dealing by failure to satisfy mortgage liabilities on properties conveyed. Initial 5 percent excise tax liability applied to two acts of self-dealing: the sale of one piece of property and the failure to satisfy mortgage liabilities.

(2) Adams v. Commissioner, 72 TC 81 (1979).

In a follow-up to the case noted above, the court held that the second level IRC 4941(b) taxes could not be imposed. The second-level tax cannot be imposed until the correction period has expired. However, the correction period does not end until the court makes a final decision with respect to such tax. This decision effectively negates the second-level tax. The Tax Court subsequently applied this interpretation to second tier taxes under IRC 4942 in H. Fort Flowers Foundation, Inc. v. Commissioner, 72 T.C. 399 (1979), and under IRC 4945 in Larchmont Foundation, Inc. v. Commissioner, 72 T.C. 131 (1979). A notice of appeal has been filed in the Larchmont case; an appeal filed in the Flowers case was dismissed on alternate grounds; and a notice of appeal is being considered in Adams. In addition, Congress is currently considering a revision of the second-level tax mechanism of IRC 4941, along with other similar two level taxing mechanisms, to make them viable under the Adams decision. H.R. 5391, 96th Cong., 2d Sess. (1980) and S.2485, 96th Cong., 2d Sess. (1980). In the meantime, agents should continue to impose second-level taxes under existing procedures.

(3) George M. Underwood, Jr. and the Underwood Foundation v. U.S., 461 F. Supp. 1382 (N.D. Tex. 1978).

The court held there was no act of self-dealing where the foundation manager donated a large sum of money to the foundation on the condition and to the extent that the donation would be tax deductible, and later received a refund of the donation to the extent the Service disallowed the charitable deduction. The manager was not liable for self-dealing tax. Nor was there an IRC 4945 taxable expenditure.

Also, where the foundation manager sent the foundation a letter stating his intention to sell land (subject to a mortgage) and donate the net proceeds to the foundation, there was no self-dealing because he did not convey legal title to the property, but only equitable title to the net proceeds.

Although the issues present in this case were not appealed, they represent areas of ongoing concern.

(4) Penalty v. Tax

In a series of decisions, the courts have held that the IRC 4941 "tax" on self-dealing constitutes a penalty rather than a tax.

Two cases involved bankruptcy hearings: In the Matter of Unified Control Systems, Inc., Bankrupt, 586 F. 2d 1036 (5th Cir. 1978) and In the Matter of Joel Kline, Bankrupt, 403 F. Supp. 974 (D.Md. 1975), aff'd per curiam 547 F. 2d 823 (4th Cir. 1977). The result of these cases is that the IRC 4941 tax, and probably the IRC 4942, 4943, 4944 and 4945 taxes, are not enforceable against a bankrupt.

The third case is Hanford F. Farrell et al. v U.S., 484 F. Supp. 1098 (W.D. Ark. 1980). This case holds that the IRC 4941 "tax" is a penalty for purposes of imposing interest under IRC 6601(e)(3). Thus, no interest can be assessed if the IRC 4941 "tax" is paid within 10 days from the date of notice and demand therefor. If not paid within 10 days, interest can be imposed only for the period from the date of the notice and demand to the date of payment rather than from the date the original returns were filed.

(5) "Sham" Transaction

Dupont v. Commissioner, 74 T.C. No. 35 (June 3, 1980). The Service determined that a sale of a 50-acre of land by petitioner to a private foundation in 1971 was an act of self-dealing and would have to be reversed to avoid imposition of the second-tier excise tax imposed by section 4941(a) of the Code. In July of

1973 the foundation transferred the property back to petitioner who immediately retransferred the property to the foundation through a straw man who was not a "disqualified person." In December of 1975 the Service determined that the 1973 transaction was a second act of self-dealing and imposed the first-tier tax. Petitioner filed a motion for judgment on the pleadings on the ground that the 1973 series of transactions were shams and that the statute of limitations barred collection of any tax resulting from the 1971 transaction. The Tax Court denied petitioner's motion, holding that the 1973 transactions cannot be ignored and thus it could not find on the undisputed facts that petitioner is not liable for the tax as a matter of law.

c. New Issues Considered

(1) Statute of Limitations

Proposed Regs. 301.6501(e)-1 and 301.6501(n)-1, published 8-25-80, provide that if a private foundation discloses an item in its 990-PF in a manner sufficient to apprise the district director or service center of the existence and nature of such item, the three year limitation on assessment and collection of IRC 6501(a) shall apply to the Chapter 42 taxes (other than IRC 4940) arising from any transaction disclosed by such item. Also, the 990-PF is considered the return of all persons required to file a return with respect to any such tax arising from such act, notwithstanding that all such persons have not signed the return. Also, the 990-PF constitutes the filing of a return with respect to any act giving rise to Chapter 42 taxes (other than IRC 4940), even though the foundation incorrectly answers questions on the return with respect to such taxes.

For example, in 1973 D, an individual taxpayer who was a disqualified person under the provisions of IRC 4946(a)(1), participated in an act of self-dealing with a private foundation and incurred a tax under IRC 4941(a)(1). On May 15, 1974 the private foundation files a Form 990-PF and answers all the questions thereon with regard to any acts of self-dealing (as defined in IRC 4941(d)) in which it may have engaged in 1973. Assuming that the foundation's return was not a false or fraudulent return nor made with the willful attempt to defeat tax, the period of limitations on assessment and collection under IRC 6501(a) shall start with respect to any tax under IRC 4941 imposed on D arising out of that transaction with such foundation. See proposed Reg. 301.6501(n)-1(c).

Also, consider the following hypothetical assessment situation in which the issue presented is whether separate periods of limitation apply to each separate act of self-dealing arising out of an initial transaction under Reg. 53.4941(e)-1(e)(1). The taxable event involves a loan by a private foundation to a disqualified person under circumstances not covered by any exception or transitional rule to IRC 4941. For the taxable periods involved, the foundation timely filed all required returns and indicated "no" or "not applicable" to all questions concerning Chapter 42 transactions. The disqualified person did not file Form 4720. The only indication of the self-dealing event was the listing of the note involved among the assets of the organization on Forms 990-PF and 990-AR, without any description of the relationship or identity of the maker of the note. Both the foundation and the self-dealer are calendar-year taxpayers.

IRC 4941(a)(1) imposes a tax on each act of self-dealing between a disqualified person and a private foundation. The hypothetical case concerns a loan by a private foundation to a disqualified person, which constitute an act of self-dealing under IRC 4941 (d)(1)(B). Reg. 53.4941(e)-1(e)(i) provides that, in general, there is one act of self-dealing that involves a single discrete transaction. In situations involving a transaction of a continuing nature (e.g., a lease of property, the lending of money, an extension of credit), the regulation provides that an act of self-dealing occurs on the day the transaction first occurs and an additional act of self-dealing occurs on the first day of each subsequent taxable year. Example (2) under Reg. 53.4941(e)-1(e)(1)(ii) specifically indicates that the subsequent prohibited acts arising from the initial transaction are to be treated as separate acts of self-dealing occuring in separate taxable periods.

IRC 6501(a) provides that, as a general rule, the amount of any tax shall be assessed within 3 years after the tax return is filed. However, with respect to excise taxes imposed by subtitle D (including those imposed by Chapter 42), IRC 6501(e)(3) provides that if the return omits an amount of tax exceeding 25 percent, assessment may take place within 6 years after the return is filed.

IRC 6501(e)(3) provides that in determining the amount of tax omitted on a return, there shall not betaken into account any amount of tax imposed by Chapter 41, 42, 43, or 44 which is omitted from the return if the transaction giving rise to such tax is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the existence and nature of such item.

IRC 6501(n) provides, in part, that for purposes of any tax imposed by Chapter 42 (other than IRC 4940), or by IRC 4975, the return referred to in this section shall be the return filed by the private foundation, plan or trust (as the case may be) for the year in which the act (or failure to act), giving rise to the liability for such tax occurred.

It appears that IRC 6501(e)(3) and 6501(n) provide that separate assessment periods shall apply to the initial prohibited transaction and to the separate acts of self-dealing occurring on the first day of each subsequent taxable year. Reg.53.4941(e)-1(e)(1)(i) describes a single prohibited transaction of a continuing naturepotentially giving rise to many separate taxable acts of self-dealing. In determining the assessment period, IRC 6501(e)(3) provides that either a 3 or 6 year period will apply depending upon whether "the transaction giving rise to such tax is disclosed on the return." In determining which return <u>commences</u> the assessment period, IRC6501(n) makes clear that it is <u>commences</u> the assessment period, IRC 6501(n) makes clear that it is the foundation's return "for the year in which the act(or failure to act)giving rise to the liability" occurred.

Thus, by virtue of Reg. 53.4941(e)-1(e)(1)(i), the "act" giving rise to the liability takes place on the day of the prohibited transaction and on the first day of each subsequent taxable year. Therefore, although the "transaction" required to be disclosed on the foundation's return for each year would be the initial transaction giving rise to the tax, the assessment period itself would run independently as to each separate <u>act</u> of self-dealing.

(2) <u>Fair Market Value of the Use of Money</u>.

Consider the following situation: Private foundation X loans $ 100X to a disqualified person. The loan clearly constitutes an act of self-dealing under IRC 4941(d)(1)(B). However, in calculating the tax imposed by IRC 4941, it is necessary to compute the "amount involved" with respect to the act of self-dealing.

Under IRC 4941(e)(2), the term "amount involved" means the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received. Reg. 53.4941(e)-1(b)(2) further provides that where the use of money or other property is involved, the amount involved shall be the greater of the amount paid for such use or the fair market value of such use for the period for which the money or other property is used.

The question is how the fair market value of the use of money should be determined. Arguably, the fair market value of the use of money could be based on the imputed arms-length interest rate under Reg. 1.482-2(e)(2)(iii)(B). On the other hand, it could be based on the minimum investment return under IRC 4942(e) and Reg. 53.4942(a)-2(c)(5). However, we have tentatively concluded that the fair market value of the use of money should not be determined by reference to either of these standards. Instead, we believe that the fair market value of the use of money should be determined by reference to a standard based on market rates of interest.

The regulations under IRC 2031 provide general rules for the valuation of property. Reg. 20.2031-1(b) provides that, in general, fair market value is the price at which property will change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. In addition, all relevant facts and elements of value are to be considered in every case. Under these regulations, fair market value is usually determined by reference to the amount that the property could be sold for in the market in which the property is most commonly sold to the public. Thus, the regulation provides that the fair market value of an automobile is the price for which an automobile of the same description, make, model, age, condition, etc., could be purchased by a member of the general public in the retail market. Similarly, under Reg. 20.2031-2(a), the fair market value of stocks and bonds is determined by reference to their selling price on the market in which they are traded. These principles provide general guidance with respect to the determination of the fair market value of the use of money.

In light of the principles stated in the regulations under IRC 2031, the fair market value of the use of money is the amount that would be paid by a willing borrower to a willing lender for the use of money if neither was under any compulsion to borrow or lend and both had reasonable knowledge of relevant facts. This value can be determined by reference to the amount that would be charged for the use of money in the market in which the use of money is most commonly offered to the public; i.e., through commercial lending institutions. It appears that the rates of interest charged by such institutions should be used to determine the fair market value of the use of money.

(3) <u>How Many Acts</u>?

Consider the following hypothetical: A private foundation sells its excess business holdings to a disqualified person for $ 80X. The holdings were held by the foundation on May 26, 1969, so that the sale would be excepted from IRC 4941 by 101(1)(2)(B), but only if $ 80X equals or exceeds the fair market value of the stock. Under section 101(1)(2)(B) of the Tax Reform Act of 1969, the sale of property (which a foundation is required to dispose of under IRC 4943) by a foundation to a disqualified person does not constitute an act of self-dealing if the foundation receives an amount equal to or in excess of the fair market value of the business holdings. Conversely, if a foundation receives less than the fair market value of the property, the transaction will constitute an act of self-dealing.

In this case, assume that the Service determines that the fair market value of the stock is $ 110X. Thus, the sale constitutes an act of self-dealing under IRC 4941(d)(1)(A), which defines self-dealing to include a sale or exchange of property between a private foundation and a disqualified person.

The question arises, however, whether the sale might also constitute an act of self-dealing under IRC 4941(d)(1)(E). IRC 4941(d)(1)(E) defines self-dealing to include the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

To insure the effectiveness of the self-dealing sanctions, the term "self-dealing" was comprehensively defined to include a wide range of both direct and indirect transactions between a private foundation and a disqualified person. See IRC 4941(d)(1)(A)-(F). In its discussion of IRC 4941(d)(1)(E), Congress noted that:

> A self-dealing transaction may occur even though there has been no transfer of money or property between the foundation and any disqualified person. For example, a "use by, or for the benefit of, a disqualified person of the income or assets of a private foundation" may consist of securities purchases or sales by the foundation in order to manipulate prices of the securities to the advantage of a disqualified person. S. Rep No. 91-552 at 29; 1969-3 C.B. 443.

The range of transactions described under IRC 4941(d)(1)(E) may also include transactions described under IRC 4941(d)(1)(A), (B), (C), (D), or (F). For example, a sale of property by a private foundation to a disqualified person would be literally described as a "sale" under IRC 4941(d)(1)(A) and as a "transfer" under IRC 4941(d)(1)(E). We have tentatively concluded that IRC 4941(d)(1)(E) was designed to encompass certain transactions such as those where there had been no actual transfer of money or property between a foundation and a disqualified person. Section 4941(d)(1)(E) serves as a "catch-all," a general definition of self-dealing meant to encompass those transactions not specifically described by the other self-dealing provisions.

Thus, it does not appear to be appropriate to characterize a single transaction as "self-dealing" under IRC 4941(d)(1)(E) if that transaction is more specifically described by one of the other definitions of self-dealing.

In the above example, the sale would be specifically described in IRC 4941(d)(1)(A), and thus should not be construed as a second act of self-dealing under IRC 4941(d)(1)(E).

(4) Liability of an Estate.

Consider the following hypothetical situation: X, a disqualified person, borrows $ 50x from a private foundation at a fair market rate of interest. X dies one year later, before the loan is paid off. X's estate, not a disqualified person, pays off the loan two years later with interest. The loan is an act of self-dealing under IRC 4941(d)(1)(B).

A number of questions arise in this situation. First, does the passing of the loan obligation to the estate constitute correction, since there no longer exists a debtor-creditor relationship between a DP and a PF? Second, is the estate liable for the self-dealing tax imposed on X? Thirdly, do new acts of self-dealing occur for the years in which the estate is the obligor on the loan?

First, Reg. 53.4941(e)-1(c)(1) provides that a correction shall be accomplished by undoing the transaction which constituted the act of self-dealing to the extent possible, but in no case shall the resulting financial position of the private foundation be worse than that which it would be if the disqualified person were dealing under the highest fiduciary standards. Reg. 53.4941(e)-1(c)(4) deals specifically with correction in the case of the use of a foundation's property, including money, by a disqualified person. Undoing the transaction includes, but is not limited to, terminating the use of such property. In addition, the disqualified person must pay the foundation

(a) The excess (if any) of the fair market value of the use of the property over the amount paid by the disqualified person for such use until such termination, and

(b) The excess (if any) of the amount which would have been paid by the disqualified person for the use of the property on or after the date of such termination, for the period such disqualified person would have used the property (without regard to any further extensions or renewals of such period) if such termination had not occurred, over the fair market value of such period. In applying (a), the fair market value of the use of property shall be the higher of the rate (that is, fair market value per period in the case of use of property other than money or fair interest rate in the case of use of money) at the time of the act of self-dealing or such rate at the time of correction of such act of self-dealing. In applying (b), the fair market value of the use of property shall be the rate at the time of correction.

Under this section of the regulations, correction must begin, in the case of a loan transaction, with repayment of the loan. Thus, as to the first issue, there appears to be no basis for saying that the passing of the obligation to the estate of the disqualified person may be substituted for repayment. A transfer of the obligation to the estate is not within the literal language of the regulations and would not necessarily result in the foundation's being made whole.

Secondly, as the legal representative of a decedent, here X, an estate is responsible for the decedent's acts and obligations. Thus, it appears that the estate is responsible for paying any taxes under IRC 4941 arising from acts of self-dealing occurring before the decedent's death, even though taxes with respect to such acts may not have been assessed before the decedent's death, and for correcting such acts of self-dealing on the decedent's behalf.

Thirdly, the estate does not become a disqualified person merely by being the estate of a disqualified person. It must be classified as a disqualified person under IRC 4946(a)(1)(G). In this case it is not so classified. Thus, the holding of the loan over a period of years by the estate should not constitute additional acts of self-dealing.

5. <u>Prepayment of Pledge</u>.

Consider the following situation: A donor, a disqualified person, executes a pledge to a private foundation due at the end of the year. The pledge is payable in cash and is enforceable under state law. The donor now wishes to satisfy the pledge before its due date, at an amount equal to present value, discounted at market rates of interest to reflect the loss of earnings on the prepaid amount between the date of payment and the stated due date of the pledge.

It appears that such an arrangement would not constitute self-dealing under IRC 4941(d)(1)(A), (B), or (E). The satisfaction of a debt is generally not classified as a sale or exchange of property, so IRC 4941(d)(1)(A) does not apply. Secondly, there is no transfer of property from the foundation to the debtor. The payment merely extinguishes the indebtedness so that IRC 4941(d)(1)(E) does not apply. Finally, Reg. 53.4941(d)-2(c)(3) provides that the making of a pledge to a private foundation by a disqualified person will not be considered an extension of credit under IRC 4941(d)(1)(B) before the date of maturity. Since the pledge was paid before the due date, Reg. 53.4941(d)-2(c)(3) applies and IRC 4941(d)(1)(B) is not applicable.

On the other hand, a variance of these facts could result in self-dealing. For example, cancellation of an enforceable pledge by a private foundation without consideration, or prepayment of a pledge at less than present value discounted at market rates of interest, or forbearance of enforcement of a pledge after it has matured may constitute acts of self-dealing under IRC 4941(d)(1).

6. Correction?

Consider the following situation: A private foundation loaned money to a disqualified person with respect to the foundation. When both parties realized that the loan was an act of self-dealing under IRC 4941(d)(1)(B), the disqualified person proposed to correct the act of self-dealing by transferring to the private foundation a parcel of real estate with a fair market value purportedly equal to the amount of the debt.

Reg. 53.4941(e)-1(c) illustrates the minimum standards of correction in the case of certain specific acts of self-dealing and provides that similar principles shall be applied with respect to other acts of self-dealing. In the case of the use of a foundation's property by a disqualified person, Reg. 53.4941(e)-1(c)(4) states that undoing the transaction includes, but is not limited to, terminating the use of the property. Reg. 53.4941(e)-1(c)(1) also states that any correction pursuant to the Reg. and IRC 4941 shall not be an act of self-dealing.

It appears that the proposed transfer or real property would not be proper correction of the act of self-dealing because the minimal standards of Reg. 53.4941(e)-1(c)(4) would not be met. Even if the property is equal in value to the amount of the loan, it will be generally less advantageous to the foundation to receive the property than to have the loan repaid since it may be both difficult and costly for the foundation to convert the property to cash and thus restore its position.

Also, if the property were transferred in return for cancellation of the self-dealer's indebtedness to the foundation the transfer would be considered a sale of property by the disqualified person to the private foundation and would itself be an act of self-dealing under IRC 4941(d)(1)(A). The rule of Reg. 53.4941(e)-1(c) that any correction pursuant to that Reg. and IRC 4941 shall not be an act of self-dealing is not applicable as the proposed transfer of real property would not constitute proper correction of the original act of self-dealing.

Under certain circumstances, a transfer of property could be acceptable correction of a loan transaction that is an act of self-dealing. For example, if a disqualified person purchased property with money borrowed from a private foundation and the property increased substantially in value, transfer of the property to the foundation would be an acceptable substitute for repayment of the loan if it could be shown that the property could be converted readily into an amount of money in excess of the amount borrowed. The transfer would not only meet the minimum standards of Reg. 53.4941(e)-1(c)(4), but would be required by the rule of Reg. 53.4941(e)-1(c)(1) that the foundation must be restored to a position no worse that if it the disqualified person were dealing under the highest fiduciary standards.

(7) Protection of Foundation Managers.

Consider the following situations:

Situation 1. A private foundation suffered a loss of assets in a transaction involving its foundation manager, who is a disqualified person under IRC 4946(a)(1)(B). State officials brought suit against the manager under state laws relating to the mismanagement of funds of charitable organizations. During the trial, the state and the foundation manager entered into a settlement agreement which required the manager to reimburse the foundation for the value of assets lost. The foundation now proposes to indemnify the manager for attorney's fees, court costs, and the amount paid in settlement of the suit. State statutes relating to non-profit organizations allow such an indemnification. The foundation would indemnify the manager directly from its own assets and not pursuant to any policy of insurance.

Situation 2. A private foundation proposes to authorize the payment of premiums for an insurance policy providing liability insurance to its foundation manager for all liabilities, including settlement amounts, arising from a judicial or administrative proceeding involving state laws relating to the mismanagement of funds of charitable organizations. The premiums paid by the foundation would be treated as part of the compensation paid to the manager.

Reg. 53.4941(d)-2(f)(1) provides that the payment by a private foundation of the premiums for an insurance policy providing liability insurance to a foundation manager for taxes imposed under Chapter 42 shall be an act of self-dealing unless such premiums are treated as part of the compensation paid to the manager.

Reg. 53.4941(d)-2(f)(3) provides that IRC 4941(d)(1) shall not apply to the indemnification by a private foundation of a foundation manager, with respect to his defense in a judicial or administrative proceeding involving either Chapter 42 or state laws relating to mismanagement of funds of charitable organizations, against all expenses (other than taxes, penalties, or expenses of correction) including attorneys fees, if (i) such expenses are reasonably incurred by him in connection with such proceedings, and (ii) he has not acted willfully and without reasonable cause with respect to the act or failure to act which led to liability for tax under Chapter 42.

Rev. Rul. 74-405, 1974-2 C.B. 384, holds that the payment of premiums by a private foundation for an insurance policy providing indemnification of a disqualified person for claims arising under the securities laws would not be an act of self-dealing under IRC 4941(d)(1)(E) as long as the premiums paid would not cause the total compensation of the disqualified person to be excessive.

In Situation 1, the issue presented is whether the foundation manager's attorney's fees, court costs, and the amount paid to settle the state mismanagement proceeding are "expenses" within the meaning of Reg. 4941(d)-2(f)(3). As used in that section, the term "expenses" refers to costs incurred with respect to a foundation manager's defense of a state mismanagement proceeding. The attorney's fees and court costs incurred by the manager are costs incurred with respect to the manager's defense of the state proceeding and, therefore, appear to be "expenses" for purposes of section 53.4941(d)-2(f)(3). It does not appear, however, that the amount paid in settlement of the state proceeding is a cost associated with the manager's defense. Rather, it is a personal liability assumed by the foundation as part of the settlement agreement. Consequently, the settlement amount is not an "expense" for purposes of Reg. 53.4941(d)-2(f)(3), and the payment of such amount would constitute an act of self-dealing.

In Situation 2, the issue presented is whether the foundation's payment of the premiums for an insurance policy providing liability insurance to a foundation manager for liabilities, including settlement amounts, arising from a state mismanagement proceeding would constitute an act of self-dealing under IRC 4941(d)(1)(E).

The provision of indemnification for liabilities through the purchase of insurance is a common practice which enables an organization to attract and retain qualified management personnel. The indemnification of a foundation manager by a foundation for liabilities arising under state laws relating to the mismanagement of funds of charitable organizations is similar to the indemnification for Chapter 42 tax liabilities addressed in Reg. 53.4941(d)-2(f)(1) and the indemnification for liabilities arising under the securities laws addressed in Rev. Rul. 74-405. Thus, it appears that the foundation's payment of the premiums for such an insurance policy would not be an act of self-dealing under IRC 4941(d)(1)(E) as long as the premiums paid to procure the insurance do not cause the total compensation paid to the foundation manager to be excessive.

4. IRC 4945 Developments

This section will generally review Revenue Rulings and Procedures, and Court Decisions, not currently discussed in Chapter 17(00) of the Private Foundations Handbook, IRM 7752, and certain new issues under consideration in the National Office.

However, the area of grants to individuals will not be discussed except to the extent not covered in the 1980 EOATRI topic; IRC 4945-Grants to Individuals.

a. Revenue Rulings and Revenue Procedures.

(1) Rev. Rul. 77-161, 1977-1 C.B. 358, holds that a loan by a private foundation to a disqualified person that constitutes an act of self-dealing, but otherwise is a permissible expenditure, is not a taxable expenditure within the

meaning of IRC 4945(d)(5). The loan was made at a reasonable rate of interest, adequately secured, and otherwise met prudent investment standards.

(2) Rev. Rul. 77-213, 1977-1 C.B. 357, holds that a private foundation that failed to list on its original annual information return a grant to an organization not described in IRC 509(a)(1), (2), or (3) has failed to exercise expenditure responsibility under IRC 4945(h) with respect to the grant, and the grant is a taxable expenditure.

Subsequent filing of an amended return with the proper information, after the due date of the 990-PF, does not nullify the taxable expenditure, though such filing may constitute correction.

(3) Rev. Rul. 80-97, 1980-1 C.B. 257, holds that an unrestricted contribution made by a private foundation to an exempt cemetery company that is not described in section 170(c)(2)(B) of the Code is not a qualifying distribution within the meaning of section 4942(g) and is a taxable expenditures within the meaning of section 4945(d)(5). Although a cemetery company exempt under section 501(c)(13) is also described in section 170(c)(5), it is not also described in section 170(c)(2)(B) as required by section 4945(d)(5).

(4) Rev. Proc. 80-39, 1980-39 I.R.B. 22, provides guidelines for determining whether educational loans made by a private foundation under an employer-related loan program are taxable expenditures under IRC 4945(g). The guidelines are similar to those for grant programs in Rev. Proc. 76-47, 1976-2 C.B. 670.

b. Judicial Decisions

(1) Larchmont foundation, Inc. v. Commissioner, 72 TC 131 (1979). The Court held that a foundation was liable for the excise tax under IRC 4945(a)(1). The foundation did not adequately substantiate the nature and purpose of certain expenditures listed on its 990-PF, and failed to produce its books and records during an audit. The Court held that the foundation had the burden of proving that certain expenditures it made were not taxable expenditures within the meaning of IRC 4945(d). However, the Service failed to establish that the foundation's liability for the excise tax under IRC 4945(a)(1) was due to willful and flagrant conduct within the meaning of IRC 6684(2). Relying on the decision that the second-level tax cannot be imposed until the correction period expires

(Adams v. Commissioner, above) the court determined that no deficiencies existed under IRC 4945(b)(1) and (2). This case has been appealed.

c. New Issues Considered

(1) Grants to instrumentality. Consider the following situation: A private foundation has made a grant, for exclusively charitable purposes as described in IRC 170(c)(2)(B), to X, a wholly-owned instrumentality of a political subdivision of the State of Y. X has not been recognized as exempt from federal income tax under IRC 501(c)(3), and is not itself a political subdivision described in IRC 170(c)(1). The grant was not earmarked for use by a secondary grantee in the manner described in Reg. 53.4945-5(a)(6). Does the foundation have to exercise expenditure responsibility with respect to the grant in accordance with IRC 4945(h)?

Generally, pursuant to IRC 4945(d)(4), a private foundation must exercise expenditure responsibility in connection with any grant to an organization, unless the grantee organization is described in IRC 509(a)(1), (2), or (3). Failure to comply with this requirement will cause the grant to be a taxable expenditure within the meaning of IRC 4945(d)(4).

Reg. 53.4945-5(a)(4) provides that, for purposes of IRC 4945(d)(4), an organization will be treated as a IRC 509(a)(1) organization if it is an organization described in IRC 170(c)(1), even if it is not described in IRC 501(c)(3), or if it is a foreign government or any agency or instrumentality thereof, even if it is not described in IRC 501(c)(3). However, any grant to such organizations must be made exclusively for charitable purposes as described in IRC 170(c)(2)(B).

Because a grant to an instrumentality of a foreign government is treated as a grant to an IRC 509(a)(1) organization, for purposes of IRC 4945(d)(4), it appears that a grant made to an instrumentality of a domestic political subdivision, such as X, should also be treated as a grant made to an IRC 509(a)(1) organization. Thus, the foundation would not be required to exercise expenditure responsibility over the grant made to X.

(2) Fraternal Expenditure.

Consider this fact situation: A private foundation is formed primarily to grant scholarships to members of a national college fraternity. The foundation proposes to inaugurate a program whereby alumni of a local fraternity chapter can make gifts to it for the purpose of creating a fund which can then be loaned to a non-profit housing corporation for the purchase of a new fraternity house or for the renovation of an existing fraternity house. These loans will be secured by a first, second or third mortgage on the real estate and improvements, or on the improvements in those instances where the real estate is owned by the college or university.

The loan will bear interest at a rate less than the market rate for comparable loans.

The interest income will be used to provide additional scholarships. Gifts will be made with the understanding that an amount equal to the sum of the several gifts (less expenses) will be loaned to the non-profit housing corporation. Gifts will be irrevocable.

IRC 4945(d)(5) includes in the term "taxable expenditures", amounts paid or incurred by a private foundation for any purpose other than one described in IRC 170(c)(2)(B).

IRC 170(c)(2)(B) purposes include religious, charitable, literary, or educational purposes, or the prevention of cruelty to children or animals.

Rev. Rul. 64-118, 1964-1 C.B. 182, holds that an organization does not qualify for exemption under 501(c)(3) as an educational organization, where its primary activity is the operation and maintenance of a chapter house for the use and benefit of the members of a local fraternity. The ruling further holds that assisting such an organization to acquire and maintain a chapter house is likewise not an educational purpose.

Thus, the making of loans to a non-profit fraternity housing corporation for the purpose of acquiring, improving or maintaining a fraternity chapter house is not an educational activity within the meaning of IRC 170(c)(2)(B) and would constitute a taxable expenditure under IRC 4945. In addition, such an activity may jeopardize the foundation's status as an organization described under IRC 501(c)(3). See PLR 7913122.