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Estate Administration – The Not-So-Hidden Exception to Self-Dealing Prohibitions

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Private foundations are a favored vehicle for many charitably inclined clients — particularly those who seek to take a hands-on approach to their charitable mission while establishing a lasting legacy for their families.

The rules governing private foundations are extensive, but the thorniest restrictions are arguably those surrounding self-dealing. Private foundations are prohibited from engaging in nearly all direct or indirect transactions with disqualified persons (as defined below).[1]

Clients who wish to leave a portion of their estate to their private foundations must carefully consider the self-dealing rules, particularly when a donor carries a great portion of their wealth in illiquid assets, such as family business interests or tangible personal property.

Wise advisors will encourage clients to plan for the disposition of these assets during life. Too often, this does not occur, and private foundations receive assets upon the donor's death that present challenges. Fortunately, the Internal Revenue Service (IRS) has given us a rare gift — the estate administration exception under Section 4941 of the Code.

Consider the Following Scenario

You represent various members of an influential family known as the Freeman Family. The Freeman Family's wealth is held primarily in a textile business that has remained wholly in the family for over 50 years and a collection of preeminent contemporary art.

The senior generation established the Freeman Family Foundation to support economic advancement in underrepresented communities and to provide arts and other cultural education and programming to young people around the country. A member of the Freeman Family has expressed her desire to leave the majority of her assets to the Freeman Family Foundation. She requests your advice on how to proceed.

Self-Dealing Defined and Its Consequences

Pursuant to Section 4941(d)(1) of the Internal Revenue Code (IRC), self-dealing is any direct or indirect transaction between a private foundation and a disqualified person.

The IRC provides six technical definitions of direct self-dealing, including, but not limited to: (a) any sale, exchange, or leasing of property between a private foundation and a disqualified person; (b) the furnishing of goods, services, or facilities between a private foundation and a disqualified person; and (c) transfer or use of the income or assets of a private foundation by a disqualified person. In contrast, indirect self-dealing is explained only by way of example.[2]

Though a disqualified person is commonly assumed to be the donor and the donor's family, Section 4941 of the Code also includes "a more-than-20% owner of a business that is a substantial contributor... as well as a corporation or trust in which disqualified persons own or hold a greater-than-35% interest."

Clients that are deeply involved with their private foundations might find compliance with the self-dealing rules difficult, but it is critical. Violation of the rules against self-dealing results in a steep excise tax on the disqualified person. This is a two-tiered tax. First, an initial 10% tax is applied to the amount involved in the self-dealing transaction for each year in the tax period.[3] A 5% tax is also imposed on any foundation manager who knowingly participates in an act of self-dealing, unless such participation was not willful or due to reasonable cause.

If the self-dealing transaction is not unwound during the tax period, a 200% tax may be applied to the disqualified person (other than a foundation manager only acting as manager) for each full or partial year in the taxable period. An additional 50% excise tax may also be imposed on a foundation manager who refuses to cooperate with undoing the prohibited transaction.

Application of the Rules to the Freeman Family

Textile Business. Interests in the Freeman Family textile business could open the door to self-dealing issues for the Freeman Family Foundation. If a member of the Freeman Family contributed her closely held family business interest to the Freeman Family Foundation, the donor's family members, or, say, a trust for the benefit of those individuals, would own the remaining interests. First and foremost, this would make disposing of the asset complicated, as described below. Separately, this ownership structure could trigger the excess business holdings rules, as a private foundation may generally not own an interest of 20% or more in a single business entity, reduced by the amount of voting stock actually or constructively owned by disqualified persons.

The IRC imposes a tax equal to 10% of the value of such holdings when that occurs. If a third party has effective control over the family enterprise, the private foundation and the disqualified persons may, however, own up to 35% of the voting stock of the family business. Fortunately, when the excess business holdings are obtained by gift (or inheritance), the IRS gives the foundation five years to dispose of the assets.[4]

More than likely, the Freeman Family Foundation would want to sell this interest and invest in marketable securities, bonds, or other assets more in line with its investment objectives. Unfortunately, a family business does not typically welcome outside shareholders. Even if it would, the Freeman Family Foundation would struggle to find a buyer for a partial interest in a family business. The only natural buyer for this asset would be a family member and, therefore, a disqualified person.

Contemporary Art Collection. As a general rule, a member of the Freeman Family may leave her art collection (and any other tangible personal property) to the Freeman Family Foundation without triggering self-dealing rules. However, given the value of the client's collection, advisors should review the provenance of the art to confirm that the client is indeed the sole owner of the works. If owned by more than one family member, there would then be practical concerns regarding where the artwork was stored and/or displayed. If the artwork continued to hang in the home of such family member, that family member would be using foundation property for his or her own enjoyment — an obvious concern. As the foundation could not lease the artwork to the family, the co-owner would instead be forced to lease the artwork, free of charge, to the foundation.

In both scenarios, the client should be advised to dispose of troublesome assets during life or at least plan for disposition to non-charitable recipients. But, as all advisors know, many clients put off action until it is too late. So, when a member of the Freeman Family dies, how can the self-dealing penalties be avoided?

Estate Administration Exception to Self-Dealing

Fortunately, the IRC provides some exceptions to the self-dealing rules. The most relevant exception, and the focus of this article, is the estate administration exception.

Section 4941 of the IRC states that indirect self-dealing does *not* include a transaction involving a private foundation's interest in estate property, regardless of when title to the property vests under local law, if the following requirements are satisfied:

1. *Power of Sale* – Executor has the power to sell the property, power to reallocate the property, *or is required to sell the property pursuant to an option*.

2. *Court Approval* – The transaction must be approved by the probate court. This will likely also involve the state Attorney General and public disclosure of the transaction.

3. *Timeliness* – The transaction must occur before the estate is considered terminated for federal income tax purposes. In the case of a revocable trust, the transaction must occur before the trust is subject to Section 4947.

4. *Fair Market Value* – The estate or trust must receive at least the fair market value for the foundation's interest in the property. As relevant case law demonstrates, the valuation rules must be strictly followed to avoid a potential bargain sale situation.

5. *Nature of Consideration* – Consideration must be at least as liquid as the assets being given up. The transaction must result in the foundation receiving an asset related to its charitable purpose, *or it must be required under the terms of a pre-existing option*.[5]

For many clients, the implicit difficulties in adhering to these rules is enough motivation to plan ahead for disposition. However, this is not always practical, or even possible. The estate administration exception is a powerful tool when reallocation of assets does not occur during a client's life.

Complexities of the Estate Administration Exception

The most complex requirements of the estate administration exception rules are that the transaction be done at fair market value and that the private foundation receive an interest or expectancy at least as liquid as the one it previously had. As relevant case law demonstrates, the IRS' rules of valuation surrounding these sales must be strictly followed.[6]

An often-overlooked component of the estate administration exception is the sale under the option agreement. For this unique exception to apply, the donor can provide heirs with an option agreement that would allow them to purchase the property from the foundation at fair market value. Upon the donor's death and exercise of the option, the executor (or trustee, as the case may be) is then obligated to sell the assets to the heirs. Of course, fair market value must be determined by a third-party appraisal and court approval in order to avoid the self-dealing rules.

Importantly, the option must be considered when determining the fair market value of the asset. However, if the valuation provided by the option and the fair market value vary too greatly, the client risks being subject to a valuation mismatch — when the value for inclusion and deduction purposes are separated. In that unfortunate instance, additional estate tax could be due.[7] To avoid this result, advisors should consult case law (or his or her client's legal advisor) before recommending such an agreement.[8]

Let's apply this to the Freeman Family textile business. As a closely held family business, the shareholders (all disqualified persons) would enter into an agreement, for nominal consideration, giving the other shareholders an option to purchase interests in the textile company. If a family member exercises the option, an appraisal shall be obtained, and court permission timely sought. Following the sale, the foundation could then safely be funded with cash or cash-equivalents, rather than the family business, and avoid any self-dealing (or excess business holding) issues.

Ultimately, the estate administration exception to self-dealing prohibitions is a helpful and powerful tool for charitably inclined clients with complex assets. Advisors should continue to encourage clients to plan around these assets during life, but clients and advisors alike should take comfort in the backstop provided by Section 4941 of the IRC.

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[1] Treas. Reg. § 53.4941(d)-1(b)(3)

[2] For illustration, the Code provides the following example: Private foundation P owns the controlling interest of the voting stock of corporation X, and as a result of such interest, elects a majority of the board of directors of X. Two of the foundation managers, A and B, who are also directors of corporation X, form corporation Y for the purpose of building and managing a country club. A and B receive a total of 40 percent of Y's stock, making Y a disqualified person with respect to P under section 4946(a)(1)(E). In order to finance the construction and operation of the country club, Y requested and received a loan in the amount of $4 million from X. The making of the loan by X to Y shall constitute an indirect act of self-dealing between P and Y. *See* 26 CFR § 53.4941(d)-1(b)(8).

[3] The tax period begins on the date the act occurs and ends on the earliest to occur of (1) the date a notice of deficiency for the initial tax is mailed, (2) the date the initial tax is assessed, or (3) the date correction of the act of self-dealing is completed. *See* IRS, *Taxable Period: Private Foundation Self-Dealing*,.

[4] Treas. Reg. § 53.4943(c)(6); Treas. Reg. § 53.4943-6(a)(1).

[5] Treas. Reg. § 53.4941(d)-1(b)(3); *see also* Brad Bedingfield, *"Deserve's Got Nothing to Do with It" – Deconstructing the Self-Dealing Rules for Private Foundations*, 56th Annual Heckerling Institute on Estate Planning (2022).

[6] *See Estate of Dieringer*, 146 T.C. No. 8 (2016) (holding that estate was not entitled to the full amount of its claimed charitable contribution deduction because events occurring post-death changed the nature and reduced the value of the property); IRS Letter Ruling 200635016 (ruling that neither the exercise of an option and related sale and purchase between one or more disqualified persons and the taxpayer's company, nor the retention by that company of a note following the taxpayer's death, constitute indirect acts of self-dealing); IRS Letter Ruling 201446024 (ruling that a private foundation's ownership of non-voting units in an LLC did not constitute a violation of the prohibition against ownership of excess business holdings).

[7] Nancy Schmidt Roush, et. al, *Shareholders Agreements For Closely-Held Corporations Outline*, The American College of Trust and Estate Counsel (2011).

[8] *Schwan v. Commissioner*, T.C. Memo 2001-174 (holding that while interests in a corporation (subject to a redemption agreement) left to a private foundation may be aggregated for inclusion purposes, for deduction purposes, the interests may be valued separately. Consequently, there may be a mismatch between valuation for inclusion and deduction purposes and additional tax may be due).

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