

Evaluating the Self-Dealing Rules Applicable to Private Foundations*

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An organization exempt under section 501(c)(3) must serve a “public rather than a private interest.”¹ That is, section 501(c)(3) organizations are required to provide public benefit through fulfilling their exempt purpose. Defining public purpose and ensuring that these organizations act to promote that purpose, however, can be difficult. The law in this area will often focus instead on trying to ensure that such organizations do not provide benefit to insiders. Such a focus seems to assume that lack of such benefit assures public benefit. The regulation quoted above, for example, continues, “it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.”²

The rules in this regard are particularly strict for private foundations, those section 501(c)(3) organizations that, in general, receive their support from a single individual or corporate source or family group and make grants to other charitable organizations.³ The applicable rules under section 4941 apply two-tier excise taxes that in practice prohibit any transactions between the private foundation and certain specified insiders, even when the transaction would benefit the organization. In characterizing the private foundation excise taxes, the leading textbook on exempt organizations has referred to these self-dealing rules as “perhaps the best example of legislative overkill” of the private foundation excise tax regime⁴ because, in order to prevent untoward benefit by insiders, the rules prohibit transactions that in no way involve untoward benefit. At the same time, however,

¹ Treas. Reg. § 1.501(c)(3)-1(c)(3)(d)(ii). All citations are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

² *Id.*

³ See § 509(a).

⁴ FISHMAN & SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS (3RD ED. 2010) 788. The fourth edition dropped this sentence. See FISHMAN & SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS (4TH ED. 2010) 729.

by defining self-dealing transactions broadly and taxing the entire amount of any such transaction, the rules avoid difficult questions of valuation as well as provide clarity and certainty to those who run or advise private foundations. Moreover, the rules permit private foundations that have engaged in self-dealing to continue as exempt section 501(c)(3) organizations rather than lose exempt status and thus loosen, rather than tighten, prior law.

The private foundation excise tax rules are not the only approach to policing transactions between insiders and their organizations. Public charities are now subject to the strictures, such as they are, of section 4958, which require that all such transactions be reasonable, but also offer exempt organizations procedural protections. Trust law and state corporate nonprofit law offer yet more approaches. Trust law generally forbids transactions between trustees and a trust unless approved in advance by beneficiaries or a court or ratified by beneficiaries. State nonprofit statutes generally establish procedural safeguards that are easy to meet. Yet another set of rules for self-dealing are the prohibited transaction rules applicable to pension plans under ERISA. Congress modeled these rules explicitly on the private foundation excise taxes, but, unlike the rules of section 4941, also provided a mechanism for pension plans to obtain exceptions, whether individual or group, from their strictures. Thus, no other regime is as absolute as the private foundations self-dealing rules. The private foundation self-dealing rules are even stricter than other private foundations excise tax rules, because the first-tier tax for other such excise taxes, but not for self-dealing, can be abated under section 4962.

The purpose of this paper is to evaluate the private foundations self-dealing rules by asking how well they achieve the goal of protecting the organization and ensuring that it serves its public ends. To do so, it reviews these rules and their history, compares other regimes, considers actual experience under the private foundation rules and applies various penalty theories to them. It demonstrates that Congress has displayed ambivalence and inconsistency about the purpose of the excise taxes on self-dealing. It shows how, under various penalty theories, some kind of exemption from the rigors of section 4941 is appropriate. The article concludes that a system such as that established under ERISA,

which permits the Department of Labor to grant group and individual exemptions to self-dealing rules similar to section 4941, offers an attractive alternative model but that, in practice, both the costs of such a model and the fact that private foundations have adjusted to the rules first established in 1969 may argue against major change. Smaller changes, however, are feasible, such as extending section 4962 relief, in whole or in part, to self-dealers.

Part I reviews current law. Part II presents the history of the provision. Part III describes other self-dealing regimes. Part IV discusses section 4941 as a penalty. Part V concludes.

I. Current Law

This section will give an overview of the definitions of self-dealing and disqualified person, describe the applicable excise taxes, and consider when violation of these rules can lead to involuntary termination of private foundation status. Most of those attending the conference know these rules and can skip this section.

A. *Definition of Self-Dealing*

Section 4941 of the Internal Revenue Code forbids all self-dealing, direct or indirect,⁵ between a disqualified person and a private foundation. It does not matter whether the transaction results in a “benefit or a detriment to the private foundation.”⁶ The code lists five such categories and one special category for government officials. It also includes a number of exemptions.

Any sale or exchange of property between a foundation and a disqualified person falls into the first category,⁷ even if it is at fair market or if the foundation receives a bargain price. Transfers of encumbered real property or personal property to the

⁵ Despite the attempt in section 4941 to lay out clear rules by defining self-dealing broadly and forbidding it completely, private practitioners tell me that there is confusion about indirect self-dealing, that the regulations regarding indirect self-dealing add to the confusion, and that one area of particular uncertainty is joint investment by disqualified persons and private foundations in various investment vehicles.

⁶ Treas. Reg. § 53.4941(d)-1.

⁷ § 4941(d)(1)(A).

foundation by a disqualified person are deemed to be sales or exchanges if the foundation expressly assumes the debt or takes subject to a mortgage or lien placed on the property within the 10-year period preceding the transfer.⁸ This category also embraces a lease of property between a private foundation and a disqualified person. Under the regulations, rent-free leases by a disqualified person to a foundation are not acts of self-dealing if payments made for janitorial services, utilities and other maintenance costs are not made to the disqualified person.⁹

The second category is the “lending of money or other extension of credit” between a private foundation and a disqualified person.¹⁰ The statute provides an exception, however, for interest free loans by a disqualified person to a private foundation if the loan proceeds are used exclusively by the foundation in pursuit of its exempt purpose.¹¹

Furnishing of good, series or facilities between a private foundation and a disqualified person forms the third category.¹² Again, there is an exception when goods, services or facilities are furnished by the disqualified person without charge and used by the foundation in pursuit of its exempt purposes.¹³ There is another exception if goods, services or facilities are furnished by the private foundation to the disqualified person on terms not more favorable than those made available to the general public¹⁴

Under the fourth category, payment of compensation or reimbursement of expenses by a foundation to a disqualified person is self-dealing,¹⁵ unless the payment is not excessive and is “for personal services which are reasonable and necessary to carrying

⁸ § 4941(d)(2)(A). There is an exception for corporate transactions such as liquidations, mergers, redemptions, recapitalizations, etc. between a private foundation in its capacity as a shareholder of a corporation that is a disqualified person if all securities of the same class as those held by the foundation are subject to the same terms and those terms are not less than fair market value. § 4941(d)(2)(F).

⁹ Treas. Reg. § 53.4941(d)-2(b)(2).

¹⁰ § 4941(d)(1)(B).

¹¹ § 4941(d)(2)(B).

¹² § 4941(d)(1)(C).

¹³ § 4941(d)(2)(C).

¹⁴ § 4941(d)(2)(D).

¹⁵ § 4941(d)(1)(D).

out the exempt purpose” of the private foundation.¹⁶ Subject to a number of exceptions, no compensation or reimbursement payments may be made to a government official, however.¹⁷

The fifth category, a catch-all, is any transfer by a private foundation of its income or assets to or the use or benefit of a disqualified person.¹⁸ As an example of such an act of self-dealing, the regulations give the indemnification (of a lender) or guarantee (of repayment) by a private foundation with respect to a loan to a disqualified person.¹⁹

Thus, while these rules are very strict, they do allow reasonable compensation for personal services. Such an exception seems a practical necessity. Yet, because compensation of disqualified persons is so important a category, the exception is an important limitation on liability under the statutory scheme.

B. Definition of Disqualified Person

Of course, to apply any of these rules, we must know the meaning of “disqualified person.” For purposes of the self-dealing rules of section 4941, the term includes a “substantial contributor;” a “foundation manager” a more than 20 percent owner of a business entity that is a substantial contributor; a member of the family, as defined, of any of these; corporations, partnerships, trust or estates in which any of the foregoing (as a group) have a greater than 35 percent ownership interest; and a government official.²⁰

Perhaps the key category is that of substantial contributors. A substantial contributor is any person (whether a natural person or an entity such as a corporation, partnership or trust) that has contributed or bequeathed an aggregate amount of more

¹⁶ § 4941(d)(2)(E).

¹⁷ Indeed, payments to government officials are a special category. § 4941(d)(1)(F). Exceptions include travel reimbursement and prizes or awards that qualify under section 74. § 4941(d)(2)(G). The regulation permits a foundation to agree to employ or make a grant to a government official for any period of government service if the agreement is made no more than 90 days before that service terminates. § 4941(d)(1)(F); Treas. Reg. § 53.4941(d)-3(e)(8).

¹⁸ § 4941(d)(1)(E).

¹⁹ Treas. Reg. § 53.4941(d)-2(f)(1).

²⁰ § 4946(a).

than \$5,000 to the foundation, if that amount is more than 2 percent of the total contributions and bequests received by the foundation from its inception through the end of the taxable year in which the contribution or bequest is received.²¹ The creator of a trust is always a substantial contributor.²² The determination is made annually on the last day of a foundation's taxable year, but a donor is deemed a substantial contributor as of the first date the donor has made sufficient contributions to satisfy the \$5,000/more than 2% requirement.²³

“Foundation managers” are also disqualified persons. Foundation managers include officers, directors, trustees as well as individuals having similar powers or responsibility.²⁴ Moreover, employees of the foundation having authority or responsibility with respect to a particular or failure to act can be a foundation manager for that purpose, although not for other purposes.²⁵

Persons owning more than 20% of entities that are substantial contributors are themselves substantial contributors. The 20% threshold is of voting stock of a corporation, profits interests of a partnership, and beneficial interest of other entities.²⁶ Additional provisions provide rules for attribution rule for stock ownerships and constructive ownership of interests in partnerships, trusts, and other entities.²⁷

Importantly, family members of a substantial contributor, a foundation manager, or a more than 20 percent owner of a substantial contributor are also disqualified persons.²⁸

²¹ § 507(d)(2).

²² *Id.*

²³ *Id.*; Treas. Reg. § 1.507-6(b)(1). Gifts received on or after October 9, 1969 are taken into account at their fair market value on the date the foundation receives the gift. § 507(d)(2)(B)(i). Once a substantial contributor, always a substantial contributor (even after death), unless during the ten-year period ending at the close of the foundation's taxable year, neither the contributor or any related person makes any contribution to the foundation or serves as its foundation manager and the IRS determines that the aggregate contribution made by the contributor and related persons are “insignificant” when compared with the aggregate amount of contributions made by one other person. § 507(d)(2)(C)(i)(III).

²⁴ § 4946(a)(1)(B).

²⁵ *Id.*; Treas. Reg. § 53.4946-1(f)(4).

²⁶ § 4946(a)(1)(C).

²⁷ § 4946(a)(3) and (a)(4).

²⁸ § 4946(a)(1)(D).

“Family” includes a person’s spouse, ancestors, children, grandchildren, great-grandchildren and the spouses of children, grandchildren and great grandchildren.²⁹

The term “disqualified person” also includes any corporation, partnership, trust or estate if more than 35% of the corporation’s voting stock, the partnership’s profits interests, or the trust or estates beneficial ownership interest is owned by substantial contributors, foundations managers, more than 20 percent owners of substantial contributors and any family member of the foregoing.³⁰

For purposes of section 4941, disqualified persons also include government officials,³¹ with an elaborate listing of who is included in the category. To give some idea of the range, the category includes anyone holding an elective or appointive public office in the executive or legislative branch of the United States government as well as an elective or appointive public office in any branch of a State or political subdivision receiving gross compensation of \$20,000 or more.

The definition of disqualified person thus reaches very broadly, especially because family members of a substantial contributor are among those to which the strictures of section 4941 apply.

C. *Applicable Excise Taxes*

Like other of the excise taxes applicable to private foundations, those applicable to self-dealing employ a two-tier structure. An initial tax is imposed on the self-dealer and on foundation manager who knowingly participates in the transaction. If the act of self-dealing is not corrected, a second set of taxes applies. No tax, however, is imposed on the foundation itself.

²⁹ § 4946(d).

³⁰ § 4946(a)(1)(E), (F), and (G). Section 267 attribution rules, with slight modification, apply.

³¹ § 4966(a)(1)(I); (c).

The initial tax on the self-dealer is 10 percent of the “amount involved” with respect to the act of self-dealing for each year or part of a year in the taxable period.³² The initial tax on a foundation manager who knowingly engages in the act for each year (or part thereof) is 5 percent of the amount involved up to a maximum of \$20,000.³³ The “amount involved” is 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, valued as of the date of the act of self-dealing.³⁴ The taxable period begins with the act of self-dealing and ends on the earliest of (1) the date of mailing of an IRS deficiency notice, (2) the date on which the first-level tax is assessed, or (3) the date on which the act of self-dealing is fully corrected.³⁵

The self-dealing transaction must be corrected for the self-dealer to avoid the second tier taxes of 200 percent of the amount involved and a foundation manager who refuses to agree to all or part of the correction 50 percent on the amount involved on up to a maximum of \$20,000.³⁶ “Amount involved” means the greater of the amount of money paid or the highest fair market value during the taxable period.³⁷ The statute defines correction as “undoing the transaction to the extent possible, but in any case placing the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.”³⁸ The regulations “provide amplification, essentially imposing a restitution plus (profits) if any requirement.”³⁹

Unlike other of the private foundation excise taxes, the Secretary cannot abate the first tier self-dealing tax under section 4962.⁴⁰ In addition, under section 6684 if anyone is

³² § 4941(a)(1).

³³ § 4941(a)(2); (c)(2).

³⁴ § 4941(e)(2).

³⁵ § 4941(e)(1).

³⁶ § 4941(b), (c)(2).

³⁷ § 4941(e)(2).

³⁸ § 4941(3)(3).

³⁹ FISHMAN & SCHWARZ (4TH ED. 2010) 772, citing Treas. Reg. § 53.4941(e)-1(c).

⁴⁰ See § 4962(b). Abatement of other first tier taxes requires establishing that the taxable event was due to reasonable cause and not willful neglect and that the event was corrected within the correction period. See § 4962(a).

liable for a private foundation excise tax which is not due to reasonable cause⁴¹ and the taxpayer has either been liable for such a tax before or such an act (or failure to act) is willful and flagrant, the person is liable for a penalty equal to the amount of the excise tax.⁴² Note that the excise taxes are not labeled in the Internal Revenue Code as penalties; only the additional amount due, which is equal to the tax, is deemed a penalty by the Internal Revenue Code. Several cases, however, have characterized private foundation excise taxes as penalties rather than as taxes for various purposes.⁴³

Revocation of Private Foundation Status

A private foundation can involuntarily lose its private foundation status if “there have been either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act)” giving rise to liability under the excise taxes applicable to private foundations.⁴⁴ The regulations explain that “willful repeated act” (or failure to act) means “at least two acts or failures to act both of which are voluntary, conscious, and intention.”⁴⁵ A willful and flagrant act (or failure to act) is one “which is voluntarily, consciously, and knowingly committed in violation of the private foundation excise tax rules” and which appears to a reasonable man to be a gross violation of any such provision.⁴⁶ Moreover, an act or failure to act may be treated as an act or failure to act by the foundation even if the tax is imposed upon one or more foundation managers, rather than the foundation itself,⁴⁷ an important proviso in the context of the self-dealing rules.

⁴¹ The regulations explain that reasonable cause must “be made in the form of a written statement containing a declaration by such person that it is made under the penalties of perjury, setting forth all the facts alleged as reasonable cause.” Treas. Reg. § 301.6684-1(b). The evaluation of reasonable cause is made by the district director or director of the Internal Revenue Center.

⁴² § 6684.

⁴³ *Farrell v. U.S.*, 484 F. Supp. 1097 (E.D. Ark. 1980) (§ 4941 a penalty for purposes of calculating interest); *Rockefeller v. U.S.*, 718 F.2d 290 (8th Cir. 1983), *cert. denied* 466 U.S. 1984 (§ 4941 a penalty for purposes of calculating interest); *In re United Control Systems, Inc.* 586 F.2d 1036 (5th Cir. 1978) (§ 4941 a penalty for purposes of Bankruptcy Act). In contrast, *Latterman v. U.S.*, 872 F.2d 564 (3rd Cir. 1989), found that § 4975, an excise tax on self-dealing transactions under ERISA, was indeed a tax and not a penalty for purposes of calculating interest.

⁴⁴ § 507(a)(2).

⁴⁵ Treas. Reg. § 1.507-(1)(c)(1).

⁴⁶ Treas. Reg. § 1.507-1(c)(2).

⁴⁷ Treas. Reg. § 1.507-1(c)(3).

Failure to correct act or failure to correct failure to act by the close of the application correct period “may be a willful and flagrant act.”⁴⁸

If private foundation status is involuntarily revoked, the foundation owes a termination tax equal to the lower of (a) aggregate historical tax benefits of exemption to the foundation and its substantial contributors (dating back to its organization or February 28, 1913, whichever is later), plus interest, or (b) the value of the net assets of the foundation.⁴⁹ The IRS has authority to abate any portion of the termination tax if the private foundation distributes all of its net assets to one or more public charities that have existed for at least 60 months, or upon assurance that appropriate action has been initiated under state law.⁵⁰

One author has observed, “As a practical matter, the IRS does not use the extreme sanction provided by § 507(a)(2) with great frequency, in light of the numerous other, less severe measures at its disposal to discipline private foundations.”⁵¹ Similarly, in TAM 923001 (March 12, 1992), the IRS observed, “We realize that revocation of tax exempt status under section 501(c)(3) and involuntary termination under section 507(a)(2) are severe sanctions.” Nonetheless, the IRS has at times terminated private foundation status.⁵²

⁴⁸ Treas. Reg. § 1.507-1(c)(4).

⁴⁹ § 507(c), (d).

⁵⁰ § 507(g).

⁵¹ Laura Watson Cesare, BNA 877-2nd T.M. Private Foundations X-C.

⁵² In TAM 923001 (March 12, 1992) because the private foundation engaged in repeated acts of self-dealing and of taxable expenditures by its only trustee, a former IRS lawyer, the IRS recommended such termination. At the same time that the ruling recommended imposition of the § 507 tax, the ruling suggested that if the foundation requested that the IRS consider abatement and wished again to operate as an exempt private foundation, it terminate its relationship with the self-dealer. Similarly, in TAM 935001 (April 27, 1993), the IRS found that the personal use of the foundation’s real estate by a substantial contributor alone could be a willful and flagrant act for purposes of imposing involuntary termination. The TAM recommended, however, that the organization correct the Chapter 42 violations, pay appropriate taxes and penalties and then distribute its assets to public charities. It explicitly noted that payment of excise taxes does not negate responsibility for the involuntary termination tax. In PLR 9627001 (November 30, 1995), the IRS concluded that collateralizing the personal security trading accounts of disqualified persons who were members of a family constituted acts of self-dealing and jeopardizing investments under section 4944. The IRS also concluded that the collateralizing arrangements were a “willful and flagrant act, calling for consideration of section 507(a)(2) involuntary termination.” It urged the foundation to accept instead the administrative disposition of the case by distributing net assets to public charities after paying Chapter 42

II. History of Section 4941

The structure of the private foundation two-tier excise taxes, including section 4941, took shape in the Tax Reform Act of 1969. From 1969 forward, private foundations could engage in no self-dealings with disqualified persons, other than compensation that is not excessive for personal services and the other limited exceptions discussed in the previous section, without imposition of these taxes. There is much controversy as to whether the rules were adopted on the basis of animus, anecdote, or evidence. In any case, this set of rules followed attempts to take another approach, an approach similar in an important way to that we have adopted for public charities today. Understanding how these self-dealing rules came about and how their stated purpose has changed over the years is important in deciding how to evaluate them.

A long history of Congressional examination of private foundations preceded the Tax Reform Act of 1969. The Revenue Act of 1950⁵³ introduced a category of “prohibited transactions” between organizations that today we would call private foundation and their creators and substantial contributors, members of their families and corporations controlled by them.⁵⁴ The restrictions were limited to what we now know as private foundations, although not referred to as such, because churches, schools, hospitals, and charities supported by contributions from the public were not subject to them.⁵⁵ Under the 1950 provisions, a private foundation engaged in a prohibited transaction if it

- 1) Lent any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest . . .
- 2) Paid any compensation, in excess of a reasonable allowance for personal services actually rendered . . .
- 3) Made any part of its services available on a preferential basis . . .

taxes and penalties and existing liabilities. It further suggested that, if the foundation were to request that the IRS consider abatement of the § 507 tax under § 507(g) and that it be permitted to operate again as an exempt private foundation, it should have a governing board that did not include the family that committed the self-dealing transactions.

⁵³ See Rev. Act of 1950, tit 3. 64 Stat. 947.

⁵⁴ IRC of 1954 §§ 503-504.

⁵⁵ IRC of 1954, § 503(b).

- 4) Made any substantial purchases of securities or any other property, for more than adequate consideration in money or money's worth.
- 5) Sold any substantial part of its securities or any other property for less than adequate consideration in money or money's worth.
- 6) Engaged in any other transaction which results in a substantial diversion of its income or corpus.⁵⁶

As Marion Fremont-Smith has described, the House version of this legislation would have gone further and “denied deduction for a gift of stock where the foundation receiving it and the corporation issuing it were controlled by the donor or his family, and would also have prohibited all loans, purchases, and sales with such a person or officers of the corporation.”⁵⁷ The Senate disagreed with so harsh a regime and the resulting compromise permitted transactions so long as they were at arms'-length.⁵⁸ Organizations that engaged in transactions that violated these rules risked loss of exemption.

In 1952 the House of Representatives created a Select Committee to Investigate and Study Educational and Philanthropic Foundations and Other Comparable Organization Which Are Exempt From Federal Taxation under the chairmanship of E.E. Cox (“Cox Committee”) not only “to conduct a full and complete investigation and study,” but also “to determine which such foundations and organizations are using their resources for purposes other than the purposes for which they were established and especially to determine which such foundations and organizations are using their resources for un-American and subversive activities or for purposes not in the interest or tradition of

⁵⁶ IRC of 1954, § 503(c). Note that the substantive 1950 private foundation rules closely resemble the current rules under section 4958 for public charities. Self-dealing transactions are not forbidden, but they must not harm the organization. These possible sanctions, of course, differ, as discussed *infra*.

⁵⁷ MARION FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 180 (1965), citing § 333(a) of H.R. 8920, 81st Cong, 2d Session, 1950, pp. 43-44, 131; and U.S. Congress House of Representatives Committee on Ways and Means, *Revenue Act of 1950: Report To Accompany H.R. 8920*, pp. 380, 412-13.

⁵⁸ FREMONT-SMITH, *supra* note 57 citing U.S. Congress, Senate, Finance Committee, *Revenue Act of 1950: Report To Accompany H.R. 8920* 483, 510. She also explains that these provisions followed a 1948 investigation by the Senate Committee on Interstate and Foreign Commerce of the activities of a textile industrialist, Royale Little, who used his foundations to finance business ventures. FREMONT-SMITH, *supra* note 57, at 357.

the United States.”⁵⁹ The Cox Committee undertook a large-scale study, sending questionnaires to more than 1,500 organizations, interviewing 200 persons, communicating by letter with approximately 200 more and holding 18 days of hearings as well as sending a special questionnaire of 120 inquiries to the larger foundations. Ultimately, the Committee endorsed the role of private foundations and concluded that on balance the record of foundations regarding infiltration by subversives was good, although some innocent mistakes had been made. It noted problems of donor control, but found those issues to be matters for the Committee on Ways and Means.

In 1953, however, the House of Representatives passed a resolution to establish the Select Committee to Investigate Tax-Exempt Foundations and Comparable Organizations. Congressman B. Carroll Reece of Tennessee, who had been a member of the Cox Committee, became its chair. The Reece Committee conducted 16 sessions of public hearings filled with accusations of socialism on the part of private foundations. The findings were similarly controversial. For example, it warned about foundation activities in the social sciences because they were empirical rather than theoretical and “thereby threatened the basic moral, religious and governmental principles of the country.” It further stated that foundations had displayed a distinct tendency to favor political opinions to the left and had directly supported “subversion.”⁶⁰ The Committee’s actual recommendations were not nearly so fiery, however. In the case of prohibited transactions, it simply recommended further study.

The next round of investigations of private foundations began in 1961 when Wright Patman as a member of the Select Committee on Small Business of the House of

⁵⁹ FREMONT-SMITH, *supra* note 57, at 358, *citing* U.S. Congress, House of Representatives, Select (Cox) Committee To Investigate and Study Educational and Philanthropic Foundations and Other Comparable Organizations Which Are Exempt from Federal Income Taxation, *Final Report*, 82nd Congress, 2d Sess., House Report 2514, 1953 at 2. E. E. Cox of Georgia was chairman of the Committee until his death in December of 1952, when Brooks Hays of Arkansas became chairman. *Id.*

⁶⁰ U.S. Congress, House of Representatives, Special (Reece) Committee to Investigate Tax-Exempt Foundations and Comparable Organizations, *Report*, 83rd Cong. 2d Sess. House Report 2681, 1954, *cited by* FREMONT-SMITH, *supra* note 57, at 358. The Reece Committee has been called “the most totally mismanaged Congressional investigation of the McCarthy period.” Waldemar A. Neilsen, “How Solid Are the Foundations,” *New York Times Magazine*, Oct. 21, 1962, *cited by* FREMONT-SMITH, *supra* note 57, at 264.

Representatives conducted a preliminary survey of more than 500 private foundations. A resolution authorizing the committee, with Patman as its chair, to study the impact of tax-exempt foundations on the American economy passed in 1962. His data have been disputed, his general antagonism to private foundations criticized, and his unwillingness to afford foundations any public opportunity to testify about the charges made against them faulted.⁶¹

Patman issued eight reports over ten years⁶² and made a number of recommendations. Recommendations relevant to self-dealing included a ban on use of foundations funds to assist employees of controlled corporations and a requirement of an arm's length relationship for all foundation dealings. He attacked Treasury for its inadequate statistics and charged that its "indefensible apathy and its archaic procedures" had encouraged abuse by donors and foundations.⁶³

At the beginning of 1964, the Senate Finance Committee and the House Ways and Means Committee asked the Treasury Department to study and report on possible tax abuses by private foundations. In preparing its report, Treasury conducted a special canvass of approximately 1300 foundations.⁶⁴ By and large, the Treasury Report praised foundations and their role in American society: "Available even to those of relatively restricted means, [private foundations] enable individuals or small groups to establish new charitable endeavors and to express their own bents, concerns, and experience. In doing so, they enrich the pluralism of our social order. Equally important, because their funds are frequently free of commitment to specific operating programs, they can shift the focus

⁶¹ FREMONT-SMITH, *supra* note 57, at 372-73.

⁶² The seventh installment was released during Congressional consideration of the Tax Reform Act of 1969 and consisted of his testimony before the House Ways and Means Committee. *Congressional Research Service, Development of the Law and Continuing Legal Issues in the Tax Treatment of Private Foundations* 12 (1983).

⁶³ WIDEMAR A. NIELSON, *THE BIG FOUNDATIONS* (The Twentieth Century Fund, 1972), *quoted in* FISHMAN & SCHWARZ (3RD ED. 2006) 763.

⁶⁴ Foundations were chosen from information from the Internal Revenue Service and the Foundation Library Center as well as other sources. The study used a stratified sampling designed to produce the 1,300 samples of Form 990-A for 1962. It included, however, 100% of foundations of over \$10,000,000. Smaller percentages were obtained of smaller foundations. U.S. Congress, Senate Committee on Finance, *Treasury Department Report on Private Foundations* (hereinafter Treasury Report) 77.

of their interest and their financial support from one charitable area to another. They can, hence, constitute a powerful instrument for evolution, growth, and improvement in the shape and direction of charity.”⁶⁵

Nonetheless, the Treasury Report described six areas of concern. Self-dealing was discussed first.⁶⁶ The Treasury Report found the 1950 self-dealing rules, which relied on such inherently ambiguous terms as “substantial,” “adequate,” and “reasonable,” were unsatisfying and unworkable, leaving too much discretion to donors as to what is reasonable and requiring too much expensive effort by the IRS to administer such a vague standard.⁶⁷

The Treasury Report listed a number of examples of self-dealing transactions which the IRS had examined. The report explained that a donor “may borrow the foundation’s funds or have the foundation lend its funds to a business which he controls. He may have the foundation use its liquid assets to purchase either his property or property owned by others which he wishes to keep from being acquired by competitors or other unfriendly parties. He may have his foundation rent its property to him. He may purchase the foundation’s assets.” The Treasury Report recommended that an absolute ban on self-dealing be instituted.⁶⁸

The Treasury Report failed to note that a number of its sets of recommendations overlapped. That is, it did not acknowledge or point out that if Congress adopted one set

⁶⁵ Treasury Report 5.

⁶⁶ The other areas were foundation involvement in business, and family use of foundations to control corporate and other property, delay in benefit to charity, financial transactions unrelated to charitable functions, and broadening of foundation management. As discussed further *infra*, self-dealing and other categories overlap.

⁶⁷ Treasury Report 18.

⁶⁸ As others have noted, the Treasury Report “provides a fuller and more accurate statement of the purposes and intent” of the 1969 private foundation excise tax rules than do the official committee reports, which “are little more than executive summaries of the more detailed consideration of the germane topics provided four years earlier by Treasury.” Richard Schmalbeck, *Reconsidering Private Foundation Investment Limitations*, 58 TAX. L. REV. 59, 68 (2004). Moreover, “Congress seems to have treated the Treasury Report as something of an information legislative history in itself, sometimes referring to the Treasury Report explicitly and almost always tracking closely the arguments made in the report.” *Id.* at 70-71, footnotes omitted.

of its recommendations, another might not be necessary.⁶⁹ Several instances of self-dealing in the Treasury Report involved loans by foundations to corporations controlled by the donor. A number of other examples listed under self-dealing involved transactions with family-controlled businesses.⁷⁰ Another set of proposals, under the category “Family Use of Foundation to Control Corporate and Other Property” would have deferred deductions based for gifts to private foundations of stock in companies controlled by donors and their families.⁷¹ If the concern troubling Treasury was self-dealing in the context of controlled corporations, provisions preventing control should suffice; there would be no need for a broad and absolute prohibition on self-dealing.

Moreover, as Fremont-Smith has discussed, the Report did not propose any sanctions for violations.⁷² The Treasury Report simply observed in a footnote that the sanction of current law – denial of exemption – would have to be scrutinized carefully to determine adequacy to securing adherence to the new rules.⁷³ Writing in 1966, Thomas Troyer, who helped to draft the Treasury Report, rejected, on the basis of this footnote, those who subjected the Treasury Report to a “good deal of criticism” on “the supposition that violation of its rules would occasion loss of exemption.”⁷⁴ In a 2000 article, he remembered, “Treasury worked extensively with the Joint Committee staff between 1965

⁶⁹ As Prof. Richard Schmalbeck writes, “the remedies proposed were quite comprehensive, almost to the point of conscious redundancy,” noting that “because [the authors] had no way of knowing which parts, if any, of the proposal would be enacted, each set of remedies to some degree needed to be independent of the others, so as to be a reasonably self-sufficient solution to the perceived problems in each area, even if the other proposals were not enacted.” Schmalbeck, *supra* note 68, at 59.

⁷⁰ Of 12 examples, 8 involved transactions between a foundation and a corporation or corporations controlled by the donor. Treasury Report 19-20.

⁷¹ Treasury Report 37-45. Ultimately, Congress did not adopt this recommendation but did adopt the excess business holding rules of section 4943, although, unlike the Treasury Report, it aggregated the ownership of the foundation and disqualified persons to determine excess business holdings. See Schmalbeck, *supra* note 68.

⁷² She also notes that the year studied, 1962, might not be typical and that the Treasury Report never gives the extent of abuse by citing the amount of assets subject to the abuse under examination. FREMONT-SMITH, *supra* note 57, at 378.

⁷³ Treasury Report 3 n. 9

⁷⁴ Thomas A. Troyer, *The Treasury Department Report on Private Foundations: A Response to Some Criticisms*, 13 UCLA L. REV. 965, 973 (1966).

and 1969 to devise appropriate sanction, and by the spring of 1969 the present enforcement regime for the Chapter 42 rules had been developed.”⁷⁵

In 1969, the new Nixon administration, at the request of the tax-writing committees, recommended that Congress act on the Treasury Report. The Committee on Ways and Means held four days of hearing. Wright Patman led off the hearings. The limitations on business holdings garnered particular interest. Many foundation leaders testified that the proposed limitation would be a hardship, but other issues also garnered attention. For example, after McGeorge Bundy testified, the Committee members questioned him closely about Ford Foundation grants for voter registration drives in Cleveland and grants to eight former aides of Senator Robert Kennedy after his death in 1968.⁷⁶

The House hearings ended on April 25, 1969, and the Tax Reform Act of 1969 was introduced on August 1, 1969. Along with establishing the private foundation excise taxes, it formally defined private foundations, differentiated treatment of public charities and private foundations, and gave the IRS additional tools regarding information from private foundations and public charities. The House bill defined section 4941 in terms we know it today, although with an initial tax of 5 percent per year on a self-dealer until correction and a 2-1/2 percent on a knowing foundation manager, limited to \$10,000. A 1989 Joint Committee Report stated that the excise tax regime of the 1969 Act was “substituted for the principal penalties imposed under prior law for foundation misuse, i.e., loss of the foundation’s exempt status and its eligibility to receive the deductible contribution, because [i]n the case of relatively minor abuses, the prior-law penalties seemed unduly harsh” and “resulted in extensive litigation.”⁷⁷

⁷⁵ Thomas A. Troyer, *The 1969 Private Foundation Law: Historical Perspectives on Its Origin and Underpinnings*, 27 EXEMPT ORG. TAX REV. 52, 58 (2000).

⁷⁶ One commentator has written, “according to private statements made later by five members who were present, Bundy conveyed a strong impression of arrogance and condescension.” NIELSON quoted in FISHMAN, SCHWARZ, *supra* note 63, at 765.

⁷⁷ Joint Committee on Taxation, Description of Income Tax Provisions Relating to Private Foundations, Scheduled for Hearings before the Subcommittee on Oversight of the Committee on Ways and Means, June 27, 28 and 30 (1983) (JCS-31-32 1983).

In the 1969 Senate Finance Committee hearings, representatives of private foundations, including Ford, Carnegie, and Rockefeller, testified as the Foundations Coordinated Testimony Group and expressed their concern with the House Bill. The last witness, Peter G. Peterson, President of Bell & Howell, appeared as chairman of a commission on private foundations funded by John D. Rockefeller III and several major foundations. His testimony conceded only infrequent instances of abuse, but nonetheless endorsed the self-dealing prohibition, among other reforms.⁷⁸ The Peterson commission's report explained, that "strict self-dealing prohibitions are essential both in order to restore public confidence in foundations and to assure that funds which have been dedicated to philanthropy will not be diverted into non-philanthropic purposes."⁷⁹ The commission's "studies of the prevalence of self-dealing practices" suggested that there was "sufficient justification for the enactment of the strict self-dealing prohibitions contained in the House bill."⁸⁰

The Petersons commission report also addressed the proposed sanctions. It took the position that that the objective of any sanction should be to make the charity whole and not to collect taxes.⁸¹ Thus, they should be imposed not against the assets of the corporation, but against the individuals responsible. Penalties should be fines and not taxes and not necessarily measured by the amount involved.⁸² The seriousness of the violation and whether violations were willful or inadvertent should be important considerations.

The Senate Finance Committee added a provision limiting the life of any foundation to forty years, but the provision was removed during debate on the floor of the

⁷⁸ Other recommendations included a payout rate of 6-8% and 100% audit of foundations over 3 years. 13 Tax Reform 1969 A Legislative History of the Tax Act of 1969, Public Law 91-172 with Related Amendments, Hearings before Senate Finance Committee 6174-91.

⁷⁹ *Id.* at 6176.

⁸⁰ *Id.*

⁸¹ *Id.* at 6177.

⁸² *Id.*

Senate.⁸³ Ultimately, the Senate added an additional self-dealing transaction⁸⁴ and made some changes to the definition of disqualified persons.

The conference committee working on the Tax Reform Act of 1969 completed their work on December 23, 1969. The Joint Committee explained the basis for the self-dealing rules as follows:⁸⁵

To minimize the need to apply subjective arm's length standards, to avoid the temptation to misuse private foundations for noncharitable purposes, to provide a more rational relationship between sanctions and improper acts, and to make it more practical to properly enforce the law, the Act generally prohibits self-dealing transactions and provides a variety and graduation of sanctions. . . . This is based on the belief by Congress that the highest fiduciary standards require complete elimination of all self-dealing rather than arm's length standards.

Thus, the Tax Reform Act of 1969 established a two-tier excise tax on self-dealing transactions between disqualified persons and private foundations in the six categories we have today. The taxes were imposed at the rates found in the House Bill - a first level tax on self-dealers of 5-percent of the amount in the self-dealing from the date of the transaction for each year or part of a taxable year for the taxable period and a second tier tax of 200% if the transaction was not corrected within 90 days of the mailing of a deficiency tax. For knowing managers, the first level tax was 2-1/2 percent with a maximum of \$10,000 and the second-tier tax 50% up to \$10,000 if the manager refused to correct the transaction.⁸⁶ For self-dealers, the tax was to be imposed regardless of fault.

⁸³ MARION FREMONT-JONES, GOVERNING NONPROFIT ORGANIZATIONS (2004) 79.

⁸⁴ It involved paying any taxes of a disqualified person imposed by these new rules. It was dropped in conference on the basis that it would be included in the prohibition on transfers for the benefit of a disqualified person. Joint Committee on Taxation, *supra* note 77, at 81

⁸⁵ General Explanation of the Tax Reform Act of 1969, prepared by the Staff of the Joint Committee on Internal Revenue Taxation (December 3, 1970) (Joint Committee Explanation,) JCS-16-70. The Senate Report contains the same language. S. Rept. 91-552 29 (1969), 1969-3 C.B. 443, H. Rept. 911-413 (Part 1) 21 (1969). The Senate Report notes, "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 the prices of the securities to the advantage of the disqualified person." S. Rep. at 196-3 C.B., 443-44. *Cf.* Treasury Report at 20 (examples 10 and 11, involving sales of publicly traded stock to benefit donor).

⁸⁶ Joint Committee on Taxation, *supra* note 85, at 33-34

Importantly, the strict liability of the self-dealing rules and the initial two-tier excise tax levels were enacted in the context of high levels of audit. These rules were adopted against a background of criticism of Treasury for its lackadaisical oversight of private foundations. The Treasury Report stated that audits of section 501(c)(3) organizations had increased from approximately 2,000 in the 1950's to over 10,000 in fiscal year 1964. Moreover, “[a]fter the Tax Reform Act of 1969, the IRS established a program of auditing all private foundations at least once every five years, with the largest and most complex being audited once every two years.”⁸⁷

The Tax Reform Act of 1969 also introduced other provisions applicable to all private foundation excise taxes, including section 4941. A penalty equal to the amount of the tax could now be imposed under section 6684 for willful and flagrant acts and involuntary termination of private foundation status under section 507 for willful repeated acts or a willful and flagrant act, with the tax on the lower of aggregate tax benefits of the foundation and substantial contributors or the value of the net assets of the foundation.

Few changes have been made to the self-dealing rules since then. For example, Congress held hearings in 1973 and 1974 on general tax reform that included two days devoted to private foundations and charitable contributions in order to review the 1969 law. Foundations expressed enormous concern about the audit fee of section 4940 and payout requirement of section 4942, but not the self-dealing rules.⁸⁸

In 1984, Congress enacted section 4962, which permitted abatement of first-level excise taxes “if the taxable event was due to reasonable cause and not to willful neglect” and “corrective action is accomplished within the appropriate correction period.”⁸⁹ As the Joint Committee on Taxation explained, “Because of the complexity of some of the private foundation rules and because smaller foundations may not have sophisticated legal

⁸⁷ Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PENN. LAW REV. 497, 602 n. 335 (1981), 335, citing *Private Foundations: Hearings on the Role of Private Foundations in Today's Society and a Review of the Impact of Charitable Provisions of the Tax Reform Act of 1969 on the Support and Operation of Private Foundations Before the Subcomm. on Foundations of the Senate Comm. on Finance*, 93rd Cong., 2d Sess. 1113 (1974) (background paper submitted by Donald C. Alexander, Comm'r of the IRS).

⁸⁸ See FREMONT-SMITH, *supra* note 83, at 84-85.

⁸⁹ § 4962(a).

counsel, inadvertent violations of these rules may occur.”⁹⁰ What is important for our purposes is that Congress did not extend this relief to acts of self-dealing where the penalty tax is payable by the self-dealer and not the foundation. Congress either could not conceive of an innocent self-dealer or did not wish to spare such an individual.

Finally, as part of the Pension Protection Act of 2006, the rate for exempt organization excise taxes was doubled. In the case of section 4951, the initial tax went from 5% to 10% for self-dealers and from 2-1/2% to 5% for managers. The maximum for managers was increased from \$10,000 to \$20,000.⁹¹ The Senate Finance Committee explained these changes as follows:⁹²

The Tax Reform Act of 1969 introduced the present-law regime of excise taxes that is applicable to certain actions of private foundations (self-dealing, failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures). The amount of such taxes has not been changed since. The excise taxes were established to provide strong deterrents to foundations, and in some cases foundation managers, from engaging in abusive or disapproved transactions. In the years following passage of the 1969 Act, the IRS closely monitored the conduct of private foundations, and in 1990 the Treasury Department concluded that foundations were largely a compliant sector. In subsequent years, however, audits of foundations and other section 501(c)(3) organizations generally have fallen significantly. With a decreased enforcement presence, there is an increased likelihood that private foundations are not as compliant as reported by the Treasury Department in 1990 and that the current excise tax rates, which have not increased in 35 years, are not providing a sufficient deterrent. Thus, the Committee believes that it is appropriate to double the initial taxes and the dollar amount limitations on foundation manager liability.

This explanation is to some extent revisionist history. While compliance with the tax laws is always important, the legislative history of the 1969 Tax Reform Act had emphasized proportionality and administrability rather than deterrence

⁹⁰ Joint Committee on Taxation, *supra* note 77, at 52-53.

⁹¹ Pension Protection Act of 2006, P.L.109-280, § 1212(a)(1)(A)-(B), (a)(2).

⁹² Senate Finance Committee, Report on Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006 (footnotes omitted), 2006 TNT 180-67 (Sept. 18, 2006). The increases in the first level of excise taxes for self-dealing become part of the Pension Protection Act of 2006, P.L. 109-208, § 1212(a)(1)(A)-(B).

In sum, the private foundation excise tax regime is a burdensome one. So severe are the excise taxes, particularly the confiscatory second tier taxes, that they operate largely as a prohibition.⁹³ The self-dealing rules impose these taxes even on transactions that benefit the organization. The rules regarding self-dealing have become only more burdensome over time. Unlike the other private foundation excise taxes, no abatement of the first tier tax is possible. The rate of tax on self-dealing, like the rate on other excise taxes on section 501(c)(3) organizations, has recently been doubled. Moreover, as discussed below, this treatment of self-dealing is stricter than other regimes designed to address self-dealing in the nonprofit world.

III. Other Self-Dealing Regimes

Not only are the section 4941 rules the strictest of the private foundation excise taxes, they are also the strictest of the rules applicable generally to nonprofit or tax-exempt entities for acts of self-dealing. All other applicable regimes – whether trusts under common or statutory law, nonprofit corporations under state law,⁹⁴ or public charities and pensions under federal tax law – permit self-dealing in some cases.

The Treasury Report relied on trust law for the prohibition of self-dealing. A ban on self-dealing, it assured, “would introduce into the tax law the concept which is fundamental to the law of private trusts: it is better to forbid self-dealing and to strike down all such transactions rather than to attempt to separate those which are harmful from those which are not.”⁹⁵ It is true that under what has long been known as the “no further inquiry rule,” a trustee is per se liable so long as a beneficiary shows that the

⁹³ Arguments that these excise taxes are unconstitutional because they are intended to regulate private foundations rather than raise revenue have failed. See *Rockefeller v. U.S.*, 572 F. Supp., 1982 U.S. Dist. LEXIS 10246 1982 (E.D. Ark), *aff'd* 718 F.2d 290 (8th Cir. 1983) (§. 4941); *Stanley Miller Charitable Fund v. CIR*, 89 T.C. 1112 (1987) (§ 4942).

⁹⁴ Private foundations are required by the IRS to include the private foundation rules in their articles. See § 508(e) Treas. Reg. § 1.508-3(d). Many states have incorporated required provisions into their statutes. See Rev. Rul. 75-38, 1975-1 C.B. 161.

⁹⁵ Treasury Report 23. The Treasury Report states, “Anglo-American trust law has long recognized the impossibility of insuring that a trustee who is permitted to deal with himself will act fairly to the trust. As a result, the courts have refused to inquire as to the fairness of dealings between a trustee and a trust and have generally barred such actions.” *Id.* at 18.

trustee had a personal interest in the transaction; harm to the trust is irrelevant. Restatement (Third) of Trusts § 78(2) states that a trustee is ordinarily subject to a “strict prohibition against engaging in transaction that involve self-dealing or that otherwise involve or create a conflict between the trustee’s fiduciary duties and personal interests.” The Restatement (Third) § 78 comt. b (2007) explains that “it is immaterial that the trustee may be able to show that the action in question was taken in good faith, that the terms of the transaction were fair, and that no profit resulted to the trustee.” There is no need for the beneficiaries to prove damages for the trustee to be guilty of a breach of loyalty and to disgorge any profit. The Treasury Report, however, overstates the law of trusts; beneficiaries can ratify such transactions.⁹⁶ Moreover, trust law permits transactions between a trust and a trustee if the trustee, after full disclosure, obtains advance approval of the trust beneficiaries or a court.⁹⁷

In the case of state nonprofit corporate law, the standards in general are looser. Transactions between a nonprofit public benefit corporation and its directors are neither void nor voidable so long as the conflict of interest is disclosed and the transaction is disclosed and approved by disinterested directors of the organization’s members, or the transaction is fair to the corporation.⁹⁸ Marion Fremont-Smith has criticized the corporate

⁹⁶ FREMONT-SMITH, *supra* note 57, at 136. See also FREMONT-SMITH, *supra* note 83, at 196 (describing the change in modern trust law away from an absolute prohibition on self-dealing).

⁹⁷ Melanie Leslie, *Helping Nonprofits Police Themselves: What Trust Law Can Teach Us about Conflicts of Interest*, 85 CHICAGO-KENT L. REV. 551, 556 (2010). As support, she quotes Restatement (Second) of Trusts § 170 comt. f (1959):

Purchase by trustee with approval of court. The trustee can properly purchase trust property for himself with the approval of the court. The court will permit a trustee to purchase trust property only if in its opinion such purchase is for the best interest of the beneficiary. Ordinarily the court will not permit a trustee to purchase trust property if there are other available purchaser swilling to pay the same price that the trustee is willing to pay.”

She continues, “This clear rule compensates for beneficiaries’ poor monitoring abilities and for the lack of market pressures that align trustees’ and beneficiaries’ interests. The rule, phrased as a prohibition with a procedural safe harbor, also bolsters social norms against self-dealing.” *Id.*

⁹⁸ The Revised Model Nonprofit Corp. Act § 8.31 permits approval of a transaction in which a director has an interest if approval is obtained in advance by vote of the board and either the material facts of the transaction and the director’s interest are disclosed or known to the board or committee of the board or the directors approving the transaction in good faith reasonably believe that the transaction is fair to the corporation. Under the Proposed Model Nonprofit Corporation Act (Third Edition 2008) a self-dealing transaction is not voidable if the material facts are disclosed or known, if a majority of disinterested directors or of members vote affirmatively or “the contract or transaction is fair as to the corporation as of the time it

standard for permitting self-dealing transactions to be ratified after the fact without a showing of fairness and for using the business judgment rule in all but extreme cases of gross negligence.⁹⁹ She urges adoption of provision that permit directors to void an approved self-dealing transaction that is later found to be unfair to the corporation.¹⁰⁰ This recommendation, while stricter than current law, would nonetheless continue to allow some self-dealing transactions.

Melanie Leslie and Henry Hansmann would go further and reinstate the trust law standard for nonprofit public benefit corporations. Leslie, however, emphasizes the ability to obtain advance approval,¹⁰¹ while Hansmann focuses on the clarity and certainty of such a rule, although he, too, is willing to consider allowing such transactions with prior consent from a court of equity “showing that prohibition of that transaction would result in substantial disbenefit to the organization’s patrons as a whole.”¹⁰²

is approved.” § 8.60. That is, fairness of the transaction is not required, but is an alternative basis for protecting the transaction.

⁹⁹ FREMONT-SMITH, *supra* note 83, at 435. Goldschmid explains that, basically, the business judgment rule “requires that decisions be made: (i) in good faith and without a conflict of interest; (ii) on a reasonable informed basis; and (iii) with a rational belief (connoting broad discretion and wide latitude) that the business judgment is in the best interests of the corporation.” Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Proposed Reforms*, 23 J. CORP. L. 631, 644 (1988). His suggested reform is that, rather than the highly deferential business judgment rule, a fairness test should provide the applicable standard of review in the case of nonprofit corporations. *Id.* at 650-51.

¹⁰⁰ *Id.* at 436. Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131 (1993), takes a similar position. She rejects the more general prohibition of the private foundations rules as hurting small nonprofits in particular because some self-dealing is “truly benevolent” and finds advanced administrative approval of all self-dealing transactions cumbersome, particularly since the review does not itself establish the standard to be applied. *Id.* at 144.

¹⁰¹ Leslie, *supra* note 97. She would require “board members to approve transactions with board members in advance. And because there is no one with an adverse financial interest in a position to approve the transaction (in contrast to the trust context), the board should be required to substantiate that the transaction is a better deal than what could be obtained on the market.” *Id.* at 255. She suggests 20% below market value.

¹⁰² Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PENN. LAW REV. 497, 572 (1981). Hansmann looks to the private foundation self-dealing rules as a model. He describes them as “detailed, clear, and workable.” *Id.* at 569. He acknowledges that trust law permits consent by beneficiaries but “because a charitable trust has no beneficiaries able to ratify an otherwise voidable transaction necessarily makes this prohibition against self-dealing absolute.” *Id.* at n. 216.

These scholars argue that, like trustees of private trusts, directors of public benefit corporations lack adequate monitoring.¹⁰³ Other arguments in favor of a strict prohibition are predictability, ease of application, deterrent effect, and reducing the burden on courts and attorney generals.¹⁰⁴ As Fishman and Schwarz nicely summarize, arguments against the prohibition include the benefit that nonprofit organizations, especially smaller ones, gain from interested transactions with board members and the difficulties of detecting violations.¹⁰⁵ These considerations, of course, apply to section 4941 as well.

The Principles of the Law of Nonprofit Organizations currently being drafted by the American Law Institute, take a middle ground. They would permit a governing board to approve a self-dealing transaction, but only if “if in good faith the board reasonably determines that the transaction with the charity is both fair to and in the best interest of the charity, or that the approval or waiver of the charity’s interest in any other conduct is in the best interests of the charity.”¹⁰⁶ If the transaction is challenged, the defendant has the burden of proving that the challenged transaction was “both fair and in the best interests of the charity”¹⁰⁷ unless before the transaction the conflicted fiduciary disclosed all relevant facts and refrained from seeking to influence the decision making process, only disinterested persons sit on the board or the board committee making the decision, and the decision making body “in good faith determined, and so evidenced by contemporaneous documentation, that the transaction between the charity and the fiduciary was both fair to and in the best interests of the charity, or that waiver of the charity’s interest in any other transaction or conduct is in the best interests of the charity.”¹⁰⁸ These Principles do not

¹⁰³ See Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 616 (1999); Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Form*, 40 NYL SCH. L. REV. 457, 465 (1996).

¹⁰⁴ See generally FISHMAN & SCHWARZ, *supra* note 39, 213-214.

¹⁰⁵ *Id.*

¹⁰⁶ American Law Institute, *Principles of the Law of Nonprofit Organizations*, Chapter 3, Governance (Tentative Draft No. 1 2007) § 330.

¹⁰⁷ *Id.* at §375(b).

¹⁰⁸ *Id.* at §330.

provide for voiding a transaction after the fact. They, like current nonprofit statutes, allow self-dealing transactions, although under the Principles only after careful scrutiny.¹⁰⁹

The intermediate sanction rules Congress adopted in 1996 for public charities and social welfare organizations also permit self-dealing transactions if certain substantive or procedural requirements are met.¹¹⁰ The rules of section 4958 offer important comparisons to the self-dealing rules of section 4941. The extreme nature of the sanction for inurement – revocation of exemption – and the uncertainty as to the term’s meaning caused enforcement difficulties for the IRS in connection with public charities as it had with private foundations before the Tax Reform Act of 1969.¹¹¹ That is, the desire to craft a proportional penalty in large measure prompted the provisions of section 4958; Congress sought a more modest penalty that could be applied in lieu of revocation. Congress looked to the private foundation rules and adopted an approach that in many ways resemble them. Like the private foundation taxes, intermediate sanctions involve a two tier excise tax.¹¹² Like the private foundations taxes, they define the disqualified

¹⁰⁹ The American Law Institute Principles resemble to some extent the current California rules. Under California law, in order to avoid a suit by the Attorney General for an interested party transaction in situations where the Attorney General or a court has not approved the transaction before or after it was consummated, it must be shown, among other requirements, not only that the transaction was approved in good faith with a vote of a majority of the directors without counting the vote of any interested director and with knowledge of material facts and of the director’s interest, but also that the transaction was “fair and reasonable as to the corporation at the time the corporation entered into the transaction” and that “[p]rior to authorizing or approving the transaction the board “considered and in good faith determined after reasonable investigation under the circumstances that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances.” CA Corp. Code § 5233. Thus, to avoid possible suit by the Attorney General, directors of California nonprofit organizations must engage in a careful procedural and substantive review even more rigorous than that recommended by the American Law Institute Principles.

¹¹⁰ Taxpayer Bill of Rights 2, Pub. L. No. 104-118, § 1311(a) (1996) (codified as section 4958).

¹¹¹ Margaret Richardson, then Commissioner of the Internal Revenue Service, testified when intermediate sanctions were being considered:

The lack of a sanction short of revocation of exemption in cases in which an organization violates the inurement standard or one of the other standards for exemption causes the Service significant enforcement difficulties. Revocation of an exemption is a severe sanction that may be greatly disproportional to the violation in issue.

Federal Tax Laws Applicable to the Activities of Tax-Exempt Charitable Organizations: Hearing before the Subcomm. on Oversight of the House of Representatives Comm. On Ways and Means, 103d Cong., 14 (1993) (prepared statement of Hon. Margaret Milner Richardson, Commissioner of Internal Revenue).

¹¹² Under section 4958, the initial penalty on disqualified person is 25 percent of the excess benefit. § 4958(a)(2). If not corrected, the second tier tax is 200 percent of the excess benefit § 4958(b). Knowing

persons and managers to which these taxes apply. Like the private foundation taxes, there is no direct burden on the organization itself for violation, unless violations become so severe that revocation is called. Both sets of rules permit reasonable compensation for personal services.

But these two sets of rules differ in important ways as well. There is no absolute prohibition on self-dealing for public charities; the only requirement is that the value of the benefit not exceed the consideration received by the organization receiving the benefit. Moreover, only the excess benefit above what is reasonable is subject to tax. Thus, to a large extent, Congress in the intermediate sanction rules went back to the ambiguity of the pre-1969 standards for self-dealing transactions that the Treasury Report so criticized.

Establishing what is an excess benefit above the fair market price under an arm's length standard for section 4958 purposes presents difficulties that taxing the entire amount involved for any self-dealing transaction under section 4941 avoids. The *Caracci* case demonstrates well the difficulty in establishing the appropriate price in a sale between a disqualified person and public charity under section 4958. The Fifth Circuit reversed, without remanding, the Tax Court's finding of an excess benefit transaction giving rise to a collective liability of \$69,702,390 in excise taxes in the conversion of three home health care agencies from exempt to nonexempt status. It wrote that "the Tax Court erred as a matter of law in affirming the Commissioner's decision to impose excise taxes after the Commissioner failed to meet his burden of proving that the taxes were correctly assessed; erred as a matter of law in selecting the method to value the assets and liabilities transferred; and made clearly erroneous fact findings in applying that valuation method."¹¹³ In the case, the IRS unsuccessfully had attempted to hire for the case the expert in valuing home-healthcare agencies who testified for the taxpayers. Valuation, as tax lawyers know well, is often a difficult and delicate task. By subjecting the entire

and willing managers are subject to a 10 percent first tier tax up to a maximum of \$20,000. § 4958(a)(2), (d)(2).

¹¹³ *Caracci v. CIR*, 456 F.3d 444, 447 (5th Cir. 2006).

amount of a self-dealing transaction to the excise tax, section 4941 avoids this difficult problem.

In addition to the difficulty the IRS has in enforcing section 4958 because of the difficulty in establishing what is an excess benefit, the rebuttable presumption of reasonableness complicates enforcement. If a public charity (1) approves the terms of a transaction in advance by a board (or board committee) composed of person who have no conflict of interest regarding the transaction; (2) prior to making a determination, these disinterested person obtain and rely upon appropriate comparability data,¹¹⁴ and (3) the board adequate documents the basis for its determination, the transaction will be presumed not to be an excess benefit transaction and the IRS will have the burden of proving otherwise.¹¹⁵ Thus, public charities have a clear process for essentially negating charges of self-dealing not available to private foundations.¹¹⁶

A number of commentators and observers have expressed dissatisfaction with section 4958. During consideration of the health care legislation, Senator Grassley offered an amendment that would have eliminated the rebuttable presumption. The Senate Finance Committee's description of the amendment noted that the IRS surveys of exempt hospital and other public charities had found high salaries, but difficulty in challenging the high amounts because of compliance with the rebuttable presumption.¹¹⁷ A discussion draft of proposed reform for tax-exempt organizations prepared by Senate Finance

¹¹⁴ Comparable data can include data from for-profit organizations. *See* Treas. Reg. § 53.4958-4(b)(1)(ii).

¹¹⁵ *See* Treas. Reg. § 53.4958-6. If the burden shifts, the IRS will be required to present "sufficient contrary evidence to rebut the probative value of the evidence put forth by the parties to the transaction." *Id.*

¹¹⁶ Jill S. Manny has observed that, as a result of the rebuttal presumption, "Ultimately the intermediate sanctions provisions are all about process, not substance." Jill S. Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?*, 76 *FORD. L. REV.* 735, 736 (2007). Given the extent to which the intermediate sanction rules favor tax exempt organizations, it is not surprising that the regime "was propelled largely by efforts of the nonprofit sector on which it was to be imposed." *Id.* at 750. Such, of course, was not the case for the private foundation self-dealing rules. In 2002, however, the ABA Tax Section called for a similar rebuttable presumption of reasonableness for payment for services by private foundations. It explained, "It is generally believed by practitioners that compliance with the three steps required to give rise to the presumption of reasonableness under section 4958 is the best way to ensure that compensation for services rendered by a disqualified person is reasonable, and thus exempt from self-dealing sanctions." *ABA Responds to Request for Comments on Excise Taxes Imposed on Foundation and Organization Managers*, 2002 *TNT* 200-41 (October 16, 2002).

¹¹⁷ *Grassley Proposal Would End Reasonable Compensation Safe Harbor for Exempt Organizations*, 2009 *TNT* 181-6 (Sept. 22, 2009).

Committee Staff urged application of the private foundation self-dealing rules to public charities.¹¹⁸ To date, however, the rules regarding self-dealing by public charities remain unchanged.

Like the rules for public charities, the rules regarding self-dealing in connection with pension plans evidence significant parallels to the private foundation rules. In 1974, only 5 years after adoption of the private foundation excise tax regime, Congress imposed a two-tier excise tax on any disqualified person who participates in a prohibited transaction between a qualified pension plan¹¹⁹ and a disqualified person when it enacted ERISA. The prohibited transactions of section 4975 are essentially identical to those of section 4941.¹²⁰ The legislative history of the prohibited transaction rules made this connection explicit, describing the tax law provisions under ERISA as “similar to the approach taken under the present rules against self-dealing that apply to private foundations.”¹²¹ The initial tax on the disqualified person who participates in a prohibited transaction is 15%. As with the private foundation taxes, benefit to the plan is irrelevant. If the transaction is not corrected within the taxable period, the second tier tax is 100%.¹²²

However inspired Congress may have been by the private foundation rules in enacting the prohibited transaction under ERISA rules, it also made a number of changes when it adopted the general approach of the private foundation rules. The statutory provisions of ERISA include many more exemptions. Many of these exemptions address the very purpose of plans to invest for the benefit of participants – such as permitting

¹¹⁸ *Senate Finance Issues Discussion Draft on Reforms for EOs*, 2004 TNT 12-18 (June 22, 2004). See also Marion R. Fremont-Smith, *Is It Time to Treat Private Foundations and Public Charities Alike?* 52 EXEMPT ORG. TAX REV. 257 (2006).

¹¹⁹ These rules also apply to IRAs, Archer MSAs, and Coverdell education savings accounts.

¹²⁰ For purposes of § 4975, a disqualified person generally includes a fiduciary, a person providing services to the plan, an employer any of whose employees are covered by the plan, an employee organization any of whose members are covered by the plan, a 50% or more owner of entities that is an employer or an employee organization, a member of the family of any of the foregoing, an officer or director, an officer, director or 10% or more shareholder or a highly compensated employee of certain of the proceeding categories, 10% partners or joint venturers of certain of the other categories. A fiduciary exercises discretionary authority, renders investment advice or has discretionary responsibility regarding the plan. § 4975(e)(2), (3).

¹²¹ ERISA Conf. Rept. at 195, 1974-3 C.B. 456.

¹²² § 4975(a), (b).

loans to participants or ancillary services by a bank that is a fiduciary of a plan. Of particular interest to those more familiar with the private foundations rules, arrangements for office space as well as legal, accounting, or other services are permitted if reasonable compensation is paid.¹²³

Even more noteworthy is that neither the tax nor the labor rules of ERISA are absolute. They permit an exemption “if the exemption is found to be administratively feasible, in the interests of the plan and its participants and beneficiaries and protective of the rights of participants and beneficiaries of the plan.”¹²⁴ Only two commentators on self-dealing by nonprofits have noted that ERISA includes prohibited transaction rules and they do so only in passing.¹²⁵ Neither examined the ERISA procedures for exemptions. Indeed, one of these commentators, Professor DeMott, concluded that advanced administrative approval of all self-dealing transactions would be too cumbersome, but did not examine the procedures the DOL had already put into place.¹²⁶

Exemptions from the ERISA prohibited transaction rules involve two categories, class exemptions and individual exemptions. Some of the most important categories of class exemptions involve areas where “otherwise ordinary and customary transactions” would be prohibited under ERISA, such as securities transactions, mutual fund transactions, and professional asset managers.¹²⁷ Of even more significance in comparison to the section 4941 regime is the ability under the ERISA prohibited transaction rules to obtain individual exemptions. The applicant for an individual exemption has the burden of demonstrating that the transaction is desirable and the lack of harm to the plan.¹²⁸ Only the parties to an individual exemption may rely on it. In addition, before granting an

¹²³ § 4975(d)(2)

¹²⁴ § 4974(c)(2). Almost all exemption applications are now handled by the Department of Labor. See § 102 of Reorganization Plan No. 4 of 1978 (43 Fed Reg. 44713, Oct 17, 1978, 5 U.S.C. App. 1). The DOL, however, presents to the Treasury any proposed exemption involving possible tax avoidance. William P. Wade and Richard I. Loeble, *Individual Prohibited Transaction Exemptions*, in ERISA FIDUCIARY LAW 2D ED (SUSAN P. SEROTA AND FREDERICK A. BRODIE, ED.) at 635 n. 21

¹²⁵ Hansmann, *supra* note 87, at 569 n. 216; DeMott, *supra* note 100, at 135 n. 19.

¹²⁶ DeMott, *supra* note 100, at 144.

¹²⁷ Donald J. Myers and Michael B. Richman, *Class Exemptions from Prohibited Transactions*, in SEROTA & BRODIE, *supra* note 124, at 356.

¹²⁸ ERISA § 408.

exemption the Secretary must publish notice in the Federal Register of the pendency of the exemption, must require that adequate notice be given to interested persons, and must afford interested persons the opportunity to present their views. The Secretary must also make a determination on the record regarding the administrative feasibility, the interests of the plan and of its participants and beneficiaries and the protection of the rights of the participants and beneficiaries.¹²⁹

According to one legislative history of ERISA,¹³⁰

One of the major points of contention between the Senate and House conferees was the degree to which party-in-interest transactions by plan fiduciaries should be barred. The House bill would have barred such transactions only if they were not for adequate consideration. The Senate bill - with certain limited statutory exemptions - barred such transactions outright unless the plan received a variation from the Secretaries of Labor and Treasury permitting such a transaction in the interests of plan participants and beneficiaries. . . .The Senate position prevailed and the bill is now universally regarded as having closed what otherwise would have been a major loophole in the Federal effort to protect the integrity of employee pension and welfare funds against "raiding" by insiders.

The Washington Service Bureau has reported more than 4000 individual exemptions and denials in the ERISA Update through 1990.¹³¹ Many exemptions involve sales of property to plans. Such exemptions were often subject to the condition that the property must represent no more than 25% of the value of plan assets and that the plan pay no more than fair market value, frequently through use of an appraisal by a qualified independent party. Exemptions were often also conditioned on a requirement that the plan pay no commission, fees, or other transaction costs.¹³² Hundreds of other exemptions have related to sales of property to disqualified persons. These exemptions often required independent appraisal, no payment of fees by the plan, and payment of the

¹²⁹ ERISA § 408(a) 4975(c)(2). Some believe this procedure "needlessly aggrandizes the power of the DoL." LANGBEIN ET AL, PENSION AND EMPLOYEE BENEFIT LAW (4TH ED) 626.

¹³⁰ Arnold & Porter, *Legislative History: Employee Retirement Income Security Act of 1974*, available on Westlaw, Federal Statutes and Legislative History Database.

¹³¹ Wade and Loebke, *supra* note 124, at 644. Of course, there are many more pension plans than private foundations. SOI data give 883,064 as the number of employee plan returns filed in Fiscal Year 2001. <http://www.irs.gov/taxstats/article/0,,id=97165,00.html>. For the same year, SOI gave 72,644 as the number of private foundations. <http://www.irs.gov/taxstats/article/0,,id=97165,00.html>.

¹³² Wade and Loebke, *supra* note 124, at 648.

sales price in cash.¹³³ Another large class of individual exemptions involves leases and loans to plans not covered by the statutory exemptions as well as loans by plans.

Not all of these exemptions involve large amounts of money or large plans. Prohibited Transaction Exemption 82-169 permitted a \$100,000 plan loan, representing 23 percent of the plan's assets and Prohibited Transaction Exception 82-167 permitted a plan to loan \$200,000, representing 11 percent of the plan.¹³⁴ In granting exemptions in the category of loans by plans, the Department of Labor ("DOL") has generally required an independent appraisal, favorable interest rates for the plan, and security. In many cases, it has also required review and monitoring by an independent party.¹³⁵

The DOL has established a fairly quick procedure for granting individual exemptions, known as the EXPRO Exemption.¹³⁶ Under this procedure, exemptions can be granted in as few as 78 days.¹³⁷ The applicant submits an application to the DOL, and it is deemed "tentatively authorized" within 45 days unless the DOL indicates otherwise. If there is no indication from the DOL, the applicant provides notice of the proposed transaction to interested parties as determined by the applicant and approved by the DOL. A 25-day comment period follows. The transaction is authorized 5 days after the close of the comment period unless the DOL takes action. In order to be eligible for the EXPRO Exemption, the applicant must cite two "substantially similar" individual exemptions granted within the preceding 60 months or one individual exemption granted within the preceding 120 months and one exemption granted under EXPRO within the preceding 60 months. The applicant must also explain how any differences between the cited exemptions and the applicant's request are not material.

Not all plans, especially smaller ones, can avail themselves of individual exemptions, even if they have a transaction for which an individual exemption may make

¹³³ *Id.* at 648.

¹³⁴ *Id.* at 169.

¹³⁵ *Id.* at 658

¹³⁶ *Id.* at 639-43.

¹³⁷ The period can be shortened further through early tentative authorization if there is a business necessity. *Id.* at 640.

sense because obtaining an individual exemption, like obtaining a private letter ruling, is expensive.¹³⁸ They also require a large investment of resources by the DOL. But if the current self-dealing rules of section 4941 are deemed unsatisfactory because they lack flexibility, the exemptions offered under ERISA and the expedited procedures adopted by the DOL offer a model for consideration.¹³⁹

In sum, the failure of the private foundation rules to allow an exception, even for transactions beneficial to the entity, is unusual. So unusual an approach as that taken by the private foundation self-dealing rules would seem to call for the rules, rather than opposition to them, to be justified.

IV. Section 4941 as a Penalty

Many believe the private foundation excise tax rules, including those on self-dealing, have worked. As one scholar of the private excise taxes, Professor Richard Schmalbeck, has written, “In the view of many in the field, . . . the 1969 private foundations rules, taken as a whole, should be counted among the more successful tax reform efforts of the latter half of the 20th century. Private foundations still have their critics, but the tenor of the criticism has change markedly since the passage of the 1969 Act. Prior to that time, most of the focus was on case studies of foundations that had paid inflated prices for assets purchased from foundation insiders, or foundations. . . . The Act seems to have been effective in removing most of those abusive practices from the private foundation landscape.”¹⁴⁰ Similarly, James Joseph, then of the Council on Foundations, testified before the House Committee on Ways and Means that “the rules are working well, and have proven to be beneficial. Although they were initially greeted with great

¹³⁸ Attorney’s fees in particular can be costly. Author’s conversation with Susan Serota, head of the executive compensation and benefits practice at Pillsbury Winthrop, June 7, 2011.

¹³⁹ In 2002, the ABA Tax Section, without discussing the parallels between section 4941 and 4975, similarly suggested the option of giving the Internal Revenue Service the ability to authorize a waiver, “either in advance in a ruling or retrospectively on audit and/or upon request by a private foundation, to authorize a waiver for a particular transaction that can be shown to be or to have been favorable to the foundation.” *ABA Seeks Input on Draft Report Examining Private Foundation Rules*, 36 EXEMPT ORG. TAX REV. 262 (2002).

¹⁴⁰ Schmalbeck, *supra* note 68, at 62. He also observes, “Perhaps the most compelling evidence of the 1969 Act reforms is simply that they have endured.” *Id.* at 101.

dismay, we have learned not only to live with them, but to view their benefits as helpful in keeping the field free from those whose motives may not be primarily charitable.”¹⁴¹

To evaluate a policy, however, we need to go beyond general impressions to data when possible. According to the 1965 Treasury Report, .9 percent of foundations reported on their Form 990-A borrowing from what today would be disqualified persons, 1.4 percent receipt for personal services, .2 percent availability of assets or services, and 1.4 percent the purchasing of securities or other property.¹⁴² Today, these all would be self-dealing transactions, but at the time, many may have been permissible as arm’s-length transactions. The Treasury Report recognized, however, that these transactions may have gone unreported because of fear of IRS enforcement action.

SOI data permits a comparison of those numbers to the situation today. In 2008,¹⁴³ 178 Forms 4720 were filed reporting tax on self-dealing with taxes of \$1,146,999, or an average of \$6,444 per form. For the same year, SOI puts the total number of 990-PFs filed at 90,850.¹⁴⁴ Assuming that there is only one form per foundation,¹⁴⁵ .2 percent of foundations engage in prohibited self-dealing transactions.¹⁴⁶ Thus, the section 4941 excise tax has seemingly reduced instances of reported self-dealing, although we continue to

¹⁴¹ *Task Force Releases Penalty Reform Proposals*, 89 TNT 45-36 (Feb. 27, 1989).

¹⁴² The Treasury Report breaks these numbers down further by size of foundation and percentage of donor influence. As discussed earlier, the percentage of foundations reporting these transactions does not tell us the amount or percentage of assets involved.

¹⁴³ SOI Tax Statistics, available at <http://www.irs.gov/taxstats/charitablestats/article/0,,id=96996,00.html>.

¹⁴⁴ *Id.* In 2009, 261 Forms 4720 reporting self-dealing were filed for a total amount of \$3,097,03, or an average of \$11,866 per form, and for 2010, 201 forms were filed for a total of \$1,005,447, or an average of \$5,002. SOI data as to the number of Forms 990-PF for 202 and 2010 are not available; if we assume the number of foundations is the same as that in 2008, 90,850, and only one form per transaction, the percentage of foundations involved in self-dealing transactions in 2009 is .3 percent and in 2010 .2 percent.

¹⁴⁵ This assumption may not be accurate; several disqualified persons and knowing managers may be involved in one transaction. The assumption used gives a larger percentage of foundations engaged in prohibited self-dealing transactions.

¹⁴⁶ A 2007 study conducted by the Urban Institute’s Center on Nonprofit and Philanthropy found that more than twenty percent of nonprofits surveyed acknowledged engaging in financial transactions with board members in the preceding two years, with many not below market. Moreover, the bigger the charity, the more likely were such self-dealing transactions. FRANCINE OSTROWER, NONPROFIT GOVERNANCE IN THE UNITED STATES: FINDINGS ON PERFORMANCE AND ACCOUNTABILITY FROM THE FIRST NATIONAL REPRESENTATIVE STUDY (2007) 8-9.

suspect considerable unreported self-dealing.¹⁴⁷ Moreover, if we were to assume that these are all first-tier taxes imposed only on self-dealers and not knowing managers and that the taxable period averages three years, then we get a very rough estimate for 2008 for the amounts involved in a single act of self-dealing of \$21,480.¹⁴⁸ Again we do not know to what extent these acts of self-dealing involve transactions that benefit the private foundation or how many unreported acts of self-dealing exist.

While these data suggest that section 4941 has succeeded in reducing self-dealing, it does not tell us whether the cost of forbidding even beneficial transactions is worth the benefit of certainty¹⁴⁹ nor whether the ability of private foundations to correct self-dealing transactions avoids involuntary terminations that would otherwise occur.

How we answer these questions depends in large part on how we view the purpose of section 4941 and its two-tier excise tax scheme. We need to ask whether or not it should be evaluated as a penalty. When the IRS Commissioner conducted an elaborate study of penalties in 1989, the study treated the private foundation taxes as penalties,¹⁵⁰ as discussed in more detail below. Yet, when the Joint Committee on Taxation studied penalties in 1999, it declined to study these excise taxes as penalties. It explained:¹⁵¹

First, such provisions were determined to be closely linked with the provisions conferring the tax benefit - i.e., they are in lieu of loss of tax-exempt status. Because the loss of tax-exempt status was not considered a penalty, it was

¹⁴⁷ I would guess that there are those in very small foundations who assume that self-dealing is prohibited only when it hurts the foundation, but I have no evidence for this assertion. According to NCCS data on large foundations (those with assets over \$10 million), only 15 of 4,534 report self-dealing transactions not covered by an exemption. I thank Joseph Cordes for calculating this number for me from the NCCS database.

¹⁴⁸ To obtain this number, I divided the average per form by 3 and then divided the result of the calculation by .1, since the initial tax on a self-dealer for a self-dealing transaction is now 10%.

¹⁴⁹ The ABA Section of Taxation suggested as one reform option an arm's-length standard for transactions that could clearly be shown to be beneficial to the private foundation and retention of the bright line prohibition for those that could not. *ABA Seeks Input, supra* note 139.

¹⁵⁰ *Task Force Releases Penalty Reform Proposals*, 89 TNT 45-36 (Feb. 27, 1989).

¹⁵¹ *Study of Present-Law Penalty and Interest Provisions As Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1988 (Including Provisions Relating to Corporate Shelters)* JCS-3-99 (July 22, 1999), Vol. 1, 15. The Treasury Penalty and Interest Study also mandated by the Internal Revenue Service Restructuring and Reform Act made no mention of private foundation excise taxes. *See Treasury Relates Penalty and Interest Study*, 1999 TNT 206-34 (Oct. 26, 1999). I plan to address characterization of private foundation excise taxes as a regulatory device, instead of a penalty, in a future paper.

considered inappropriate to treat generally lesser, alternative sanctions as a penalty. Second, including such provision could make it more difficult to draw a distinction between normal operation of the substantive rules of the Code and “penalty” provisions, and could result in the inappropriate expansion of the study to include almost any Code provision.

Treating these excise taxes as penalties, however, enables us to analyze and test them according to a number of approaches and criteria.

In increasing the first level private foundation excise taxes in 2006, the Senate Finance Committee described the purpose of two-tier excise taxes for private foundations as deterrence and stated that they needed to be raised because the audit rate for private foundations (and public charities) had fallen. In so describing the excise taxes, the Senate Finance Committee, unlike the Joint Committee, treated the private foundation excise taxes as penalties. Moreover, it adopted a particular theory regarding penalties, namely the economic theory of deterrence. This approach traces its roots back to Bentham and was formalized by Gary Becker in the context of criminal law.¹⁵²

Yet, under an economic model of deterrence, as Professor Logue has observed, if the taxpayer’s “position is certain to be scrutinized by the Service, because the probability of detection is one, then the optimal tax liability rule is strict liability and the optimal fine is simply the amount of additional taxes owed plus an appropriate interest charge for the time value of money.”¹⁵³ Such may seem to describe the case under section 4941 as first adopted. Section 4941 adopts a strict liability rule, rather than a penalty based on fault or negligence, and this strict liability rule was adopted when all private foundations were to

¹⁵² See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. OF POLIT. ECON. 169 (1968). Allingham and Sandmo first adapted the model to tax. See Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 3 J PUB. ECON. 201 (1974). Under their argument, a taxpayer will evade tax to the extent that the benefit of evasion, which is the amount of tax not paid because of evasion, exceeds the product of the total amount the taxpayer would have to pay if the evasion is detected (which is the tax plus any penalty) and the probability of detection. See also Andreoni et al., *Tax Compliance*, 36 J. OF ECON. LIT. 818 (1998).

¹⁵³ Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law Is Uncertain*, 27 VA. TAX REV. 241, 260 (2007).

be audited over a short cycle.¹⁵⁴ Yet, even under this model, the strict liability of section 4941 is questionable because it extends to transactions that benefit the foundation, transactions in which there is no harm.

Under the Bentham-Becker economic model of deterrence, when scrutiny is not certain, penalties need to be introduced a level severe enough that taxpayers expect the costs of noncompliance to exceed the costs of compliance. Under this theory, the lower the probability of detection, the higher a penalty must be in order to give taxpayer an incentive to obey the law. As Professor Logue has described this model, the appropriate penalty “is calculated by dividing the harm caused by the probability of detection.”¹⁵⁵ Such a penalty makes a risk-neutral taxpayer indifferent between paying and not paying the tax. Nonetheless, the Bentham-Becker model poses some difficult issues when applied to section 4941. As noted above, section 4941 imposes a burdensome excise tax even when there is no harm to the foundation.

Professor Michael Doran has described the Becker model as designed “to determine optimal punishments by setting a wrongdoer’s expected costs as a function of both the severity of the punishment potentially imposed and the probability of punishment. That implies that the level of punishment and the probability of punishment generally are substitutes. If all else is held constant, a less severe punishment with a higher probability of imposition can yield the same expected costs to the wrongdoer – and therefore, the same level of deterrence – as a more severe punishment with a lower probability of imposition.”¹⁵⁶ If we accept this characterization of the model, we might view not only the level of the excise tax, but also the broad reach of section 4941 to any self-dealing transaction, whether or not it is beneficial to the private foundation, as a means of increasing a potential penalty. In any case, under the Bentham-Becker approach, when

¹⁵⁴ See text at *supra* note 90. Strict liability based on a 100% audit rate assumes that acts of self-dealing would be detected on audit and upheld if challenged, neither of which assumptions is necessarily accurate. That is, it assumes 100% detection of any violations, not simply a 100% rate of audit.

¹⁵⁵ Logue, *supra* note 153, at 266.

¹⁵⁶ Michael Doran, *Tax Penalties and Tax Compliance*, 46 Harv. J. on Leg 111, 124 (footnotes omitted) 2009. See also Leandra Lederman, *The Interplay between Norms and Enforcement in Tax Compliance*, 64 OHIO STATE L.J. 1453 (2003); Eric M. Zolt, *Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343 (1989).

audit rates are low, the model calls for very high penalties, higher than is politically feasible in an era of low audit rates.¹⁵⁷ In 2006, of course, Congress did not explicitly adopt the economic deterrence theory. Nonetheless, in general terms, such an approach animated Congress in 2006 – private excise taxes were raised because audit rates had fallen.¹⁵⁸

The economic model of tax penalties, however, cannot explain the generally high level of compliance and self-reporting of taxes in the United States.¹⁵⁹ The key model that competes with the economic deterrence model of penalties, the norms model, tries to explain this high level of compliance. Under the norms model, taxpayers pay tax because they want to adhere to specific social or personal norms.¹⁶⁰ Professor Schmalbeck's and James Joseph's view of the success of the private foundation rules quoted above seem to reflect the view that the self-dealing rules may well have changed the norms when it comes to private foundation self-dealing. The high penalty (although not as high as the Bentham-Becker model would demand) signals the importance of complying. A norms model, moreover, allows consideration of equity. As Professor Logue has noted, "there is the view that the Bentham-Becker punitive penalty would create a kind of ex post unfairness because of the disparity between the size of the penalty and the magnitude of the offense."¹⁶¹ With the high penalties that the Bentham-Becker model demands, the government may fear a perceived lack of equity between the treatment of those who are detected and subject to the penalty and those who are not.¹⁶²

Several problems that usually plague application of the norms model of penalties to tax are absent in the context of the private foundation excise taxes. Although it may be difficult to think of institutions such as nonprofit corporations or trusts having social

¹⁵⁷ Under the Bentham-Becker approach, with very low audits rates, revocation could well be an appropriate penalty for violation of rules applicable to section 501(c)(3)'s. The Bentham-Becker approach does not concern itself with administrability; rather than investing resources in detection, it would increase penalties.

¹⁵⁸ The taxes are not named as "penalties;" only the additional tax paid under § 6682 is deemed a penalty. Nonetheless, the private foundation excise taxes are generally viewed as sanctions.

¹⁵⁹ See Doran, *supra* note 156, at 123.

¹⁶⁰ See Doran, *supra* note 156, Lederman *supra* note 156.

¹⁶¹ Logue, *supra* note 156, at 268.

¹⁶² Lederman, *supra* note 156.

norms, the high fiduciary duty that trustees and directors owe nonprofit institutions boards may provide the necessary standard. Another issue with the norms model of penalties when applied to tax is the fact that most tax returns are confidential. Such confidentiality prevents observable compliance or noncompliance and thus mutes possible social pressure on individuals who fail to comply with the law.¹⁶³ In the case of private foundations, however, the Form 990-PF, with its questions about the private foundations excise taxes, is available to the public. On the other hand, the public availability of the Form 990-PF might encourage private foundations not to report self-dealing transactions for fear of condemnation.¹⁶⁴

More generally, liability for self-dealing even for transactions that benefit a private foundation may strike many as inequitable and thus in conflict with generally applicable tax norms. Under the norms model of penalties, harsh penalties may undermine compliance. They may signal that many taxpayers shirk their duty to pay taxes or may crowd out the commitment to comply. At the same time, the norms theory of penalties posits that perceived fairness requires imposition of sanction on those who do not comply with the tax laws. The two-tier structure of the private foundation excise taxes can easily be seen as an attempt to satisfy both these somewhat contradictory needs. Nonetheless, the norms model may call for exemptions, as do the ERISA rules, or the possibility of abatement under section 4962, to satisfy a widely held norm that penalties should be related to fault.

The Commissioner's study on penalties tried to take all these various considerations into account by setting up four criteria for penalties.¹⁶⁵ The first criterion, fairness, required that similar situated taxpayers be treated similarly and that the penalty be proportional to the seriousness of departure from the standard of behavior. The criterion

¹⁶³ Some have suggested that tax norms are conveyed more informally. "One of the most consistent findings in survey research about taxpayers and behaviors is that those who report compliance believe their friends (and taxpayers in general) comply, whereas those who report cheating believe that others cheat". John S. Carroll, *How Taxpayers Think About Their Taxes: Frames and Values*, in *WHY PEOPLE PAY TAXES* 43 (Joel Slemrod, ed. 1992), *quoted in* Lederman *supra* note 156, at 1469 n 79.

¹⁶⁴ Cf. Joshua Blank, *In Defense of Individual Tax Privacy*, *forthcoming* 61 EMORY L. J. (2011).

¹⁶⁵ *Task Force Releases Penalty Study*, *supra* note 150.

of effectiveness asked whether the costs of the penalty were sufficiently severe to deter taxpayers from noncompliance. It included as well consideration of whether a penalty would encourage a noncompliant taxpayer to take corrective action. The Commissioner's study added two criteria not addressed under either the economic or the norms model of penalties, whether the penalty was comprehensible by taxpayers and whether it was administrable in giving sufficient guidance to administrators, but also leaving room for administrative discretion. As to the last consideration, administrability, it observed that a designer of a penalty "should resist the temptation to establish hard and fast rules requiring the assertion of a penalty in particular circumstances. The designer is poorly positioned to determine whether a specific situation runs afoul of the standard." The study also noted that "such sociological evidence as exists suggests that when the severity of the penalty exceeds that which is perceived as fair, such severe sanctions are difficult to impose."¹⁶⁶

In considering these criteria in connection with the private foundation excise taxes, the Commissioner's study was generally positive.¹⁶⁷ It found the two-tier excise taxes, with the second tier tax at very high levels, to effectively encourage remedial action. It acknowledged that two-tier excise taxes could pose issues as to comprehensibility, but assumed that private foundations generally would have tax advisors. As for administrability, the report stated, "In administering the excise tax provision, the Service can exercise a certain amount of discretion in imposing the tax. Section 4962 provides that, if the Service determines the event was due to reasonable cause and not willful neglect and such event was corrected within the applicable correction period, no first tier tax will be imposed."¹⁶⁸ This statement, however, fails to note that section 4962 does not apply to self-dealing transactions under section 4941. Thus, section 4941 does not meet

¹⁶⁶ *Id.*

¹⁶⁷ *Id.* It did suggest that similar taxes be applied to public charities, so that the same activities lead to similar results for both public charities and private foundations, rather than, as was the case at the time of the report, self-dealing leading to a tax for private foundations and revocation for public charities. That is, it found that the differing treatment of public charities and private foundations violated principles of equity. Since this study, of course, the intermediate sanctions of section 4958 for public charities have been enacted.

¹⁶⁸ *Id.*

the Task Force's own criteria for administrability, which calls not for strict liability, but for some administrative discretion.

At the same time, the penalty under section 6681 and termination of private foundation status under section 507, both of which apply to all private foundation excise taxes and not just section 4941, permit administrative discretion and, unlike section 4941, are fault-based. The section 6681 penalty, which is equal to the excise tax, applies if an IRS official determines whether liability for the tax is due to reasonable cause or whether the act is willful and flagrant. Termination under section 507 also requires willfulness. Such fault-based penalties stand in tension with the strict liability of section 4941.

Furthermore, in the years since the adoption of the 1969 Act, many have come to see the excise taxes of section 4941 themselves as disproportionate to the violations because they apply to transactions that benefit the organization without possibility of exception. That is, revocation of exemption is no longer the baseline from which we view regulation of private foundations. Although the Senate Finance Committee recently asserted a form of the economic theory of deterrence, the history of the private foundation excise taxes, as well as that of section 4958, in contrast, adopt a normative theory of proportionality. In addition, data seem to suggest that self-dealing is not widespread (of course, low levels of audit make that conclusion somewhat uncertain as well).¹⁶⁹ Nonetheless, the norms model, the 4-criteria model used by the Commissioner's study, and perhaps even the Bentham-Becker economic deterrence model call for introducing some possibility of exemption to the strictures of section 4941.

V. Conclusion

Self-dealing rules for private foundations are unusually strict in a number of ways. They apply not only to transactions that harm the entity, but also to those at fair market value or at a bargain. There is no possibility of waiver or exemption of the prohibition or of the first-level excise tax. Yet available data suggests that these rules have reduced self-

¹⁶⁹ See text at *supra* notes 142-148.

dealing transactions. At the same time, several penalty theories call for the possibility of some kind of exemption. Should revision of these rules be desired, the exemptions available under ERISA offer a model. The ERISA model avoids the need to define fair market value and arm's-length in general¹⁷⁰ while permitting a mechanism for those able to demonstrate a transaction benefits the foundation. If the cost of implanting such a mechanism would seem too great in the case of private foundations, however, we could consider extending section 4962 to permit a waiver of the first level excise tax case or at least, as the ABA Tax Section has suggested, calculate the excise tax not on the amount involved but on the basis of excess, if any, above fair market value in cases of inadvertent or harmless self-dealing.¹⁷¹

The private foundation community, however, has not clamored for changes to the self-dealing provisions of section 4941.¹⁷² As Professor Bittker observed many years ago, the flat prohibition on self-dealing for private foundations but not other section 501(c)(3) organizations seems unjustified. He concluded, however, “On the other hand, this discrimination (as I would regard it) is ordinarily unlikely to impinge seriously on the legitimate activities and social values of private foundations.”¹⁷³

¹⁷⁰ Others would suggest an arm's length standard under § 4941 to parallel § 4958. See *ABA Seeks Input*, *supra* note 139; FREMONT-SMITH, *supra* note 96. Because of the difficult valuation issues such a standard can raise and because § 4941 was enacted because the arm's length standard was seen as inadequate, I do not personally endorse such a change.

¹⁷¹ *ABA Seeks Input*, *supra* note 139.

¹⁷² See generally FREMONT-SMITH, *supra* note 96 at 84-86.

¹⁷³ Research Papers sponsored by The Commission on Private Philanthropy and Public Needs, Department of the Treasury, 1977, Volume IV, Taxes, 2116-2117 quoting Boris Bittker, *Should Foundations Be Third Class Charities?* in THE FUTURE OF FOUNDATIONS, HEIMANN, ED., 1973) 149-50. Prof. Bittker continues, “We may, in short, be witnessing a tempest in a teapot.” *Id.*