

## Self Dealing Concerns with Gifts of Partnership Interests to a Private Foundation

### UBIT Concerns for the Private Foundation

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1. There is a substantial tax on a private foundation that conducts an act of self-dealing with a disqualified person. IRC §4941(a)(1). The term *self-dealing* includes a sale or exchange of property between a private foundation and a disqualified person, IRC §4941(d)(1)(A), and includes the sale of assets by a disqualified person to a private foundation in a bargain sale. Treas. Reg. §53.4941(d)-2(a).
2. A *disqualified person* includes (i) a *substantial contributor* to the foundation (the creator of the foundation formed as a charitable trust, and any contributor to the foundation whose contributions are in the aggregate more than \$5,000 and more than 2 percent of the foundation's total contributions), IRC §§4946(a)(1)(A) and 507(d)(2); (ii) *certain owners of entities* that are substantial contributors, IRC §4946(a)(1)(C); (iii) a *foundation manager* (an officer, director, or trustee of the foundation or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation, and with respect to any act (or failure to act), the employees of the foundation having authority or responsibility with respect to such act (or failure to act)), IRC §§4946(a)(1)(B) and (b); (iv) *certain family members* of substantial contributors, owners of substantial contributors, and foundation managers, IRC §§4946(a)(1)(D) and (d); and (v) *certain entities* that are owned by substantial contributors, owners of substantial contributors, foundation managers, and such family members, IRC §§4946(a)(1)(E), (F) and (G).
3. When a gift is made by a disqualified person to a private foundation of debt-encumbered property, or of a partnership interest in a partnership that owns debt-encumbered property, are the rules that govern whether there has been a "sale or exchange" for income tax purposes the same as the rules that govern whether there has been a "sale or exchange" for self-dealing purposes?

There is ample authority for the proposition that *for purposes of computing gain* from the disposition of property, the amount realized includes the amount of liabilities from which the transferor is discharged. Treas. Reg. §1.1001-2(a)(1). If the disposition is of property that secures a liability, the transferor is considered to be discharged from the liability even if the transferee takes the property subject to the liability and does not assume the liability. Treas. Reg. §1.1001-2(a)(4)(i). A disposition of property includes a gift of the property, Treas. Reg. §1.1001-2(a)(4)(iii), and the amount realized is the amount of the loan encumbering the property. Treas. Reg. §1.1001-2(c) *Example (6)*. Similarly, a gift of debt-encumbered property to a charity is a bargain sale, and the amount realized by the donor includes the liability even if the transferee does not agree to assume or pay it. Treas. Reg. §1.1011-2(a)(3). If the disposition is of a partnership interest, the liabilities from which the transferor

is considered to be discharged include the transferor's share of the partnership's liabilities. IRC §752(d); Treas. Reg. §1.1001-2(a)(4)(v). And so it is with a gift to charity of a partnership interest where the partnership owns the encumbered property-- the amount of liabilities from which the charitable donor is discharged equals the donor's share of the partnership's liabilities. Rev. Rul. 75-194. The discharge of the liability can presumably be negated where the donor assumes primary responsibility for the liability.

4. A special rule in IRC §4941(d)(2)(A) provides that *for purposes of defining self-dealing*, a sale or exchange includes the transfer of real or personal property by a disqualified person to a private foundation if the property is subject to a mortgage or similar lien *which the foundation assumes, or if the property is subject to a mortgage or similar lien which a disqualified person placed on the property within 10 years of the date of the transfer.*<sup>1</sup> This special rule describes alternative necessary conditions for self-dealing to result from a gift of debt-encumbered property by a disqualified person to a private foundation, and where neither of the alternative necessary conditions is present, a gift or bequest of debt-encumbered property by a disqualified person to a private foundation will not result in self-dealing. See PLR 9241064 (no self-dealing because the mortgage on the property was placed more than 10 years before the gift to a charitable lead annuity trust, and because the lead trust did not assume the mortgage).
5. The first alternative necessary condition is that self-dealing will arise if the foundation assumes the liability. Note, as cited in paragraph 3 above, that for income tax purposes a gain will result even if the transferee merely takes the property subject to the liability and does not assume the liability. But for purposes of self-dealing under the conditions described in this paragraph, there is no self-dealing if the transferee takes property subject to the liability without assuming it—since if mere acceptance of debt encumbered property caused self-dealing there would be no point to the second alternative condition which causes self-dealing (debt placed on the property by a disqualified person within ten years of the date of transfer). Rev. Rul. 78-395. Debt assumption by a donee foundation seems unlikely, especially where the gift is of a partnership interest and the debt is inside the partnership.
6. The second alternative necessary condition is that self-dealing will arise if the debt was placed on the property by a disqualified person within 10 years of the date of the transfer. If a partner or the partnership placed the debt on the property within 10 years but neither is a disqualified person, then the contribution of the partnership interest does not result in self-dealing. PLR 8932042.
7. Assuming that, within ten years of the charitable gift to the foundation, debt was placed on partnership property by either the partnership or a partner--we need to determine whether the partnership or the partner is a disqualified person with respect to the foundation. There appears to be no requirement that the partner or the partnership have been a disqualified person at the time that he, she or it placed the debt on the property—only that such partner or

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<sup>1</sup> The special rule also applies where the property transferred is a partnership interest and the debt is encumbering an asset inside the partnership. See PLR 8932042.

partnership is a disqualified person at the time that the property is contributed to the foundation. See *Gershman Family Foundation*, 83 TC 217 (1984), where the foundation was created after the lien was placed on the gifted property.

- a. If a partner is a substantial contributor to the foundation (or if certain family members or related entities are substantial contributors), or if a partner is a foundation manager, then the partner is a disqualified person. The partnership itself is a disqualified person if disqualified persons own more than 35% of the profits interest in the partnership. IRC §4946(a)(1)(F).
  - b. However, the “one bite rule” provides that self-dealing does not include a transaction between a private foundation and a disqualified person where the disqualified person status arises only as a result of the transaction. Treas. Reg. §53.4941(d)-1(a). So if the gift to a foundation by a donor (not otherwise a disqualified person) is of debt-encumbered property or of a partnership interest that owns debt-encumbered property (in either case where the debt was placed on the property by a disqualified person within ten years of the gift), no self-dealing occurs on account of such gift. Accordingly, one solution would be to use a “*fresh foundation*” each time a gift of such property is contemplated (note that the donor should not be a foundation manager prior to the gift). Consider giving multiple foundations different charitable purpose as a way of avoiding the IRS treating all such foundations as one foundation.
8. Interesting planning issues arise if partnership interests will pass to the private foundation at the partner’s death (where debt was placed on partnership property by a disqualified person within ten years of the bequest). Is the estate of the partner a disqualified person? Not necessarily:
- a. An estate has a separate identity from its deceased, so even if the deceased is a disqualified person with respect to the foundation, his estate is not automatically so. GCM 39445.
  - b. An estate is not a disqualified person merely because its executor is a disqualified person. *Id.*
  - c. An estate will become a disqualified person if it is a substantial contributor to the foundation, but the one bite rule will apply at the time of the estate’s initial funding of the foundation. Thereafter, the estate will be a disqualified person, but by then the estate may well terminate and will not have any further dealings with the foundation.
  - d. The estate will be a disqualified person if more than 35% of its beneficial interest is held by disqualified persons. IRC §4946(a)(1)(G). So if the decedent is a substantial contributor to the foundation during his lifetime, then he and certain family members are disqualified persons, and if more than 35% of the estate passes to such family, then the estate is also a disqualified person and thus there would be self-dealing when the estate

distributes the partnership interest to the foundation.

- (i) If the deceased partner leaves 35% or less of his estate to his family, then the estate will not be a disqualified person. The analysis of this issue should be done conservatively, without relying on delayed funding of the foundation until after family bequests are paid, and without relying on the existence of funded *intervivos* revocable trusts to shelter assets passing to family.
  - (ii) If the foundation benefiting from the estate is a “fresh foundation”, then the deceased will not be a substantial contributor to the foundation and he and his family will not be disqualified persons, and thus the family may have more than a 35% beneficial interest in the estate without the estate becoming a disqualified person.
  - (iii) However, even with a fresh foundation, if the family were foundation managers then they would be disqualified persons and could not have a 35% beneficial interest in the estate. So independent trustees of the foundation would be required prior to the funding of the bequest.
9. If a private foundation and a disqualified person each own interests in the same partnership, what other self-dealing issues are of concern?
- a. Is a redemption of the foundation’s interest a sale or exchange with the partnership or its partners?
  - b. If the partnership makes a capital call and either the foundation or the disqualified person fails to make the required capital contribution, resulting (in accordance with the terms of the partnership agreement) in a shift of beneficial interests from those partners who fail to make the contribution to those partners who make it--is this a sale or exchange that constitutes self-dealing?
  - c. Are the foundation’s and the disqualified person’s interests being pooled so that the disqualified person meets minimum investment requirements? Does any such pooling result in lower fees for the disqualified person? And does the disqualified person’s investment return vary on account of the foundation’s participation? Self-dealing occurs, even without a sale or exchange, if a disqualified person uses or benefits from the income or assets of a private foundation. IRC §4941(d)(1)(E). In PLR 9844031, the IRS ruled that there was no self-dealing where both a private foundation and an investment fund invested in the same private equity and real estate partnerships and where the investment fund both had investors who were disqualified persons and was managed by a disqualified person. Key factors in the IRS determination were (i) the fund did not rely on the foundation’s investment to meet minimum investment requirements; (ii) the fund did not use the foundation’s investment to qualify for lower investment fees; (iii) the disqualified person’s investment return (both as an investor in the fund and as a manager of the fund) did not vary on account of the foundation’s

participation; (iv) the foundation's participation as an investor in the partnership was not exploited by the fund in its marketing, including its private placement memoranda to its investors; and (v) the partnerships' management was independent of the fund and of any disqualified persons.

10. A tax-exempt organization, including a private foundation, pays tax on its unrelated business taxable income ("UBTI"). IRC §511. UBTI is income from activities that: (1) are regularly carried on, (2) rise to the level of a trade or business, and (3) are substantially unrelated to the organization's exempt purposes. IRC §§512, 513. UBTI does not include passive income such as dividends, interest, most rents from real property and gains from the sale of property (other than dealer property). IRC §512(b). If a tax-exempt organization is a partner in a partnership that regularly carries on a trade or business that is unrelated to the exempt purpose of the organization, such organization shall, in computing its UBTI, include its share of partnership gross income from the unrelated trade or business and its share of partnership deductions directly connected with such gross income, subject to the exceptions for passive income. IRC §512(c).
11. The exclusion of rent from UBTI does not apply if the determination of rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). §512(b)(3)(B)(ii). In other words, rent is not passive income if it represents a portion of the tenant's net income or profit. Some commercial leases (including many shopping center leases) provide for both a fixed minimum rent and an additional percentage of (i) gross receipts or sales from tenants minus (ii) agreed upon exclusions such as real estate taxes, property insurance, and common area maintenance paid by such tenants. To avoid UBTI for tax-exempt organizations owning rental property with such leases (or owning partnership interests where the partnership owns such rental property), care should be taken to craft a rental formula that avoids rent becoming an interest in the profits of the tenant. For example, if percentage rent contains exclusions from gross receipts, such exclusions should be tied to expenses of the property and not to other activities of the tenant's business.
12. The exclusion from UBTI for income from passive activities is limited when the property giving rise to the income is financed by "acquisition indebtedness," that is, indebtedness incurred to purchase or improve the property (or indebtedness incurred before or after a purchase or improvement that would not have occurred but for such purchase or improvement). IRC §§514(a), 514(c)(1). Where property is acquired (including by gift or bequest) subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien is considered acquisition indebtedness even though the organization does not assume or agree to pay such indebtedness. IRC §514(c)(2)(A).
13. When there is acquisition indebtedness, a portion of the gross income (including capital gain) generated by the property is UBTI. Such portion is the ratio of the average acquisition indebtedness over the average adjusted basis in the property during the year. However, the acquisition indebtedness rule does not apply to the extent that the use by the organization of the mortgaged property is substantially related to its exempt purposes. IRC §514(b)(1)(A).

14. Where mortgaged property (including a partnership interest in a partnership that owns mortgaged property) is acquired by the organization as a result of a bequest or devise from a deceased donor, the indebtedness is not treated as acquisition indebtedness during the 10-year period following the date of acquisition. Where mortgaged property (including a partnership interest in a partnership that owns mortgaged property) is acquired by the organization as a result of a gift from a living donor, the indebtedness is not treated as acquisition indebtedness during the 10-year period following the date of acquisition if: (i) the mortgage was placed on the property more than five years before the date of the gift and (ii) the donor owned the property for more than five years before the date of the gift. §514(c)(2)(B).

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