

Private foundations; self-dealing; taxable expenditure; indemnification of foundation manager. The treatment, under sections 4941(d)(1)(E) and 4945(d)(5) of the Code, of indemnification amounts and of insurance premiums paid by a private foundation to or on behalf of a foundation manager who is a defendant in a proceeding involving state laws relating to the mismanagement of funds of charitable organizations.

ISSUE

Does the indemnification of a foundation manager by a private foundation, in either situation described below, constitute an act of self-dealing under section 4941(d)(1)(E) of the Internal Revenue Code or a taxable expenditure under section 4945(d)(5)?

FACTS

The organization is exempt from federal income tax under section 501(c)(3) of the Code and is a private foundation under section 509(a).

Situation 1. The foundation suffered a loss of assets in a transaction involving its foundation manager, who is a disqualified person under section 4946(a)(1)(B) of the Code. The foundation manager's actions were not willful or without reasonable cause. State officials brought suit against the manager under state laws relating to the mismanagement of funds of charitable organizations. During the trial, the state and the foundation manager entered into a settlement agreement which required the manager to reimburse the foundation for the value of assets lost. Under an existing indemnification agreement, the foundation proposes to indemnify the manager for attorney fees, court costs, and the amount paid in settlement of the suit. State statutes relating to nonprofit organizations allow such an indemnification. The foundation would indemnify the manager directly from its own assets and not pursuant to any policy of insurance, and would treat any amounts that it paid as part of the compensation paid to the manager.

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

LAW AND ANALYSIS

Section 4941(a)(1) of the Code imposes a tax on each act of self-dealing between a disqualified person and a private

foundation.

Section 4941(d)(1)(E) of the Code provides that the term 'self-dealing' includes any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

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

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

Section 4945(a)(1) of the Code imposes a tax on each taxable expenditure made by a private foundation.

Section 4945(d)(5) of the Code provides that the term 'taxable expenditure' includes any amount paid or incurred by a private foundation for any purpose other than one of the charitable purposes specified in section 170(c)(2)(B).

Section 53.4945-6(b)(2) of the regulations provides, in part, that any expenditures for unreasonable administrative expenses, including compensation, consultant fees, and other fees for services rendered, will ordinarily be taxable expenditures under section 4945(d)(5) unless the foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses in such amounts was consistent with ordinary business care and prudence.

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

In Situation 1, the first issue presented the foundation manager's attorney's fees, court costs, and the amount paid to settle the state mismanagement proceeding are 'expenses' within the meaning of section 53.4941(d)-(2)(3) of the regulations. As used in that section, the term 'expenses' refers to costs incurred with respect to a foundation manager's defense of a state mismanagement proceeding. The attorney's fees and court costs incurred by the manager in this case are costs incurred with respect to the manager's defense of the state proceeding and are, therefore, 'expenses' for purposes of section 53.4941(d)-2(f)(3).

The amount paid in settlement of the state proceeding is not, however, a cost associated with the manager's defense. Rather, it is a personal liability assumed by the foundation manager as part of the settlement agreement. Consequently, the settlement amount is not an 'expense' for purposes of section 53.4941(d)-2(f)(3) of the regulations.

The second issue presented in Situation 1 is whether such expenses are taxable expenditures within the meaning of section 4945(d)(5) of the Code.

The foundation's payment of expenses for attorney's fees and court costs would ordinarily be treated as part of the compensation paid to the foundation manager and, if reasonable, would not be an unreasonable administrative expense under section 53.4945-6(b)(2) of the regulations. Such reasonable administrative expenses are incurred for charitable purposes within the meaning of section 170(c)(2)(B). On the other hand, the foundation's proposed indemnification of the settlement amount would constitute a payment in satisfaction of the foundation manager's personal liability. As such, the payment would primarily benefit the foundation manager and would be unreasonable administrative expense under section 53.4945-6(b)(2). Thus, the payment would constitute an expenditure for a purpose other than one of the charitable purposes specified in section 170(c)(2)(B).

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

The provision of indemnification for liabilities through the purchase of insurance is a common practice which enable an organization to attract and retain qualified management personnel. The indemnification of a foundation manager by a foundation for liabilities arising under state laws related to the management of funds of charitable organizations is similar to the indemnification for Chapter 42 tax liabilities addressed in section 53.4941(d)-2(f)(1) of the regulations and the indemnification for liabilities arising under the securities laws addressed in Rev. Rul. 74-405. Based on the foregoing, the

foundation's payment of the premiums for such an insurance policy would not be an act of self-dealing under section 4941(d)(1)(E) of the Code as long as the premiums paid to procure the insurance do not cause the total compensation paid to the foundation manager to be excessive. Similarly, these insurance premiums are not taxable expenditures within the meaning of section 4945(d)(5) and section 53.4945-6(b)(2) because such expenses constitute reasonable administrative expenses and, thus, are incurred for charitable purposes within the meaning of section 170(c)(2)(B).

HOLDINGS

In Situation 1, the private foundation's proposed indemnification of its foundation manager for attorney's fees and costs incurred would not constitute an act of self-dealing under section 4941(d)(1)(E) of the Code as long as the requirements of section 53.4941(d)-2(f)(3) of the regulations are met. Furthermore, such indemnification would not constitute a taxable expenditure under section 4945(d)(5). However, if the amounts so indemnified cause the total compensation paid to the manager to be excessive, the proposed indemnification would constitute both an act of self-dealing under section 4941(d)(1)(E) and a taxable expenditure under section 4945(d)(5).

The proposed indemnification of the settlement amount would constitute both an act of self-dealing under section 4941(d)(1)(E) of the Code and a taxable expenditure under section 4945(d)(5).

In Situation 2, the foundation's payment of premiums for an insurance policy providing liability insurance for its foundation manager for all liabilities, including settlement amounts, arising under state mismanagement laws would not constitute an act of self-dealing under section 4941(c)(1)(E) of the Code or a taxable expenditure under section 4945(d)(5) as long as the premiums paid by the foundation are treated as compensation paid to the manager and the total compensation paid to the manager is not excessive.