CALIFORNIA LAWYERS ASSOCIATION
TAXATION SECTION

THE I.R.S. OR THE TREASURY DEPARTMENT SHOULD ISSUE GUIDANCE CLARIFYING THAT DISQUALIFIED PERSONS ARE PERMITTED TO GUARANTEE LEGAL OBLIGATIONS OF A PRIVATE FOUNDATION.

This paper was principally prepared by Andrew S. Atkin and William C. Choi of Rodriguez, Horii, Choi & Cafferata LLP. The authors wish to thank Reynolds Cafferata of the same firm and Alyse Pelavin of Loeb & Loeb LLP for their valuable insights.

Contact Persons: Andrew S. Atkin, Esq.
William C. Choi, Esq.
Rodriguez, Horii, Choi & Cafferata LLP
777 S. Figueroa Street, Suite 2150
Los Angeles, CA 90017
Phone: (213) 892-7700
Fax: (213) 892-7777
Email: andrew@rhcclaw.com
Email: bill@rhcclaw.com

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Andrew S. Atkin, William C. Choi
EXECUTIVE SUMMARY

In many circumstances, it is advantageous to a private foundation for a disqualified person with respect to the private foundation to guarantee a legal obligation of the private foundation. For example, a lessor may be unwilling to lease necessary office space to a private foundation without a third party guarantee, or the making of the guarantee may enable the private foundation to obtain better terms for the lease. As another example, where a private foundation enters into a legally binding pledge to support a public charity and the public charity plans to take certain actions based on the pledge, the public charity may want a guarantee of the pledge from a third party, especially if the private foundation does not currently have sufficient assets to meet the obligations of the pledge. Further, a public charity seeking a guarantee of a private foundation’s pledge faces greater uncertainty and fewer alternatives to secure its pledges absent such guidance.

The existing self-dealing regulations prohibit the reverse situation, \textit{i.e.}, a private foundation cannot guarantee the obligations of a disqualified person because the foundation is considered to be using the assets of the private foundation for the benefit of a disqualified person. The regulations, however, do not specifically address the self-dealing implications of the situation where the disqualified person guarantees the obligations of the private foundation. We are also not aware of any legal authorities that have considered the self-dealing implications of such a guarantee. Given this lack of guidance and the harsh consequences that may apply if a disqualified person engages in self-dealing, counsel for disqualified persons often advise against making such guarantees, which in turn may detrimentally affect private foundations’ ability to accomplish their exempt purposes.

Accordingly, this paper proposes that either the Internal Revenue Service ("IRS") or the Treasury Department issue guidance clarifying that disqualified persons may generally guarantee legal obligations of private foundations without violating the self-dealing rules. However, as discussed below, the guidance should impose certain restrictions to ensure that such guarantees do not provide any impermissible private benefit to the disqualified person.
DISCUSSION

I. SUMMARY OF EXISTING LAW

Private foundations are generally prohibited from entering into business related transactions with persons who are “disqualified persons” with respect to the foundation. These types of prohibited transactions are referred to as “self-dealing” transactions. Disqualified persons who are subject to the self-dealing rules include “substantial contributors” to the private foundation, and “foundation managers” of the private foundation.

If a self-dealing transaction occurs, the person that entered into the transaction with the private foundation is subject to a penalty of ten percent (10%) of the amount involved. Also, any foundation manager that participated in the transaction knowing that it was self-dealing is subject to a penalty of five percent (5%) of the amount involved. The foundation must also take timely action to unwind any self-dealing transaction that has occurred or additional draconian penalties will be applicable.

A transaction can be a self-dealing transaction even if the terms of the transaction are fair to the private foundation or even beneficial to the foundation. That is, a transaction can be self-dealing regardless of whether the transaction was actually detrimental to the foundation. Thus, with respect to the issue of whether it is self-dealing for a disqualified person to guarantee the legal obligation of a private foundation, even if the disqualified person is only guaranteeing the obligation to benefit the private foundation (and not for his/her own personal benefit), this fact alone does not mean that the transaction is thereby permissible.

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3 IRC §4946(a)(1)(A). A “substantial contributor” is defined as anyone that contributed or bequeathed an aggregate amount of more than $5,000.00 to a private foundation if such amount is more than 2% of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person. IRC §507(d)(2)(A) (incorporated by IRC §4946(a)(2)).

4 “Foundation managers” include the officers, directors and trustees of the foundation. IRC §4946(a)(1)(B).

5 IRC §4941(a)(1).

6 IRC §4941(a)(2). Generally, the amount involved in a self-dealing transaction means the greater of the money and the fair market value of property given or the amount of money or the fair market value of property received in the self-dealing transaction. IRC §4941(e)(2). The amount involved is not limited to the benefit that the disqualified person received.

7 IRC §4941(b).
We believe there are two issues with respect to whether guarantees made by disqualified persons cause self-dealing. First, is it self-dealing for a disqualified person to make a guarantee of a private foundation’s legal obligation? Second, assuming the making of such a guarantee is not self-dealing, does self-dealing occur as the private foundation satisfies the guaranteed obligation, thereby reducing the disqualified person’s legal exposure under the guarantee? These issues are summarized below and discussed in greater detail in Sections II and III of this paper.

With respect to the first issue (whether the making of the guarantee is self-dealing), there are two relevant statutory provisions. The first provision is Internal Revenue Code (“IRC”) section 4941(d)(1) which provides that the “lending of money or other extension of credit between a private foundation and a disqualified person” is self-dealing. The second provision is IRC section 4941(d)(2)(B), which provides that “the lending of money by a disqualified person to a private foundation shall not be an act of self-dealing if the loan is without interest or other charge (determined without regard to section 7872) and if the proceeds of the loan are used exclusively for purposes specified in section 501(c)(3).”

There are also two relevant Treasury Regulations (“Treas. Reg.”) with respect to the first issue. The first is Treas. Reg. section 53.4941(d)-2(c)(3), which provides that “[t]he making of a promise, pledge, or similar arrangement to a private foundation by a disqualified person, whether evidenced by an oral or written agreement, a promissory note, or other instrument of indebtedness, to the extent motivated by charitable intent and unsupported by consideration, is not an extension of credit . . . before the date of maturity.” The second is Treas. Reg. section 53.4941(d)-2(c), which provides that the “lending of money or other extension of credit between a private foundation and a disqualified person” is an act of self-dealing unless “the loan or other extension of credit is without interest or other charge.” The regulations do not specifically address whether the making of a guarantee by a disqualified person is permitted. We are also not aware of any legal authorities that have addressed whether these regulations prohibit the making of a guarantee by a disqualified person of a private foundation’s obligation.

With respect to the second issue (whether self-dealing occurs as the private foundation satisfies the guaranteed obligation), the relevant statutory provision is IRC section 4941(d)(1)(E), which provides that the “transfer to, or use by or for the benefit of, a disqualified person of the income or assets
of a private foundation” is self-dealing. The relevant regulation is Treas. Reg. section 53.4941(d)-2(f) which provides in part that:

[t]he . . . use by or for the benefit of, a disqualified person of the income or assets of a private foundation shall constitute an act of self-dealing.

. . .

[I]f a private foundation makes a grant or other payment which satisfies the legal obligation of a disqualified person, such grant or payment shall ordinarily constitute an act of self-dealing to which this subparagraph applies.8

While the regulation specifies that, “the . . . guarantee (of repayment) by a private foundation with respect to a loan to a disqualified person shall be treated as”9 self-dealing, the regulation does not address the self-dealing ramifications (if any) with respect to the opposite situation, i.e., where a disqualified person makes a guarantee of a private foundation’s legal obligation. However, the regulation does provide that, “[t]he fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing.”10 We are not aware of any legal authorities which have addressed the applicability of Treas. Reg. section 53.4941(d)-2(f) with respect to guarantees made by disqualified persons.

II. IT IS NOT SELF-DEALING FOR A DISQUALIFIED PERSON TO GUARANTEE A PRIVATE FOUNDATION’S LEGAL OBLIGATION.

As stated above, Treas. Reg. section 53.4941(d)-2(c)(3) provides that “[t]he making of a promise, pledge, or similar arrangement to a private foundation by a disqualified person, whether evidenced by an oral or written agreement, a promissory note, or other instrument of indebtedness, to the extent motivated by charitable intent and unsupported by consideration, is not an extension of credit . . . before the date of maturity.” It is unclear if this provision applies to a guarantee by a disqualified person. The regulation states that the making of the promise must be “to a private foundation.”

8 Treas. Reg. §53.4941(d)-2(f)(1).
9 Id.
With respect to a guarantee, the guarantee is made to a third party, not the private foundation. However, it could be argued that a guarantee in substance is equivalent to promise made “to” the private foundation in that the disqualified person is promising to satisfy the private foundation’s legal obligations if the private foundation defaults. If a guarantee falls under this regulation then, it should be permissible so long as the disqualified person was motivated by charitable intent and did not receive any consideration for the making of the guarantee. Further, the disqualified person, the private foundation and the third party are all typically parties to the agreement at issue, such as a lease or pledge agreement.

Also, this is largely a form over substance issue. Generally, private foundations are funded by very few disqualified persons. With respect to any legal obligation, the private foundation is likely satisfying such obligation with funds contributed from the very disqualified person entering into the guarantee (or income earned on such contributions). The guarantee is, for all practical purposes, a pledge agreement between the disqualified person and the private foundation by which the disqualified person merely agrees to donate to the private foundation sufficient assets to satisfy the private foundation’s legal debts. Such a pledge agreement should fall into the exception to self-dealing described above.

Even if a guarantee is not covered by the above regulation, it appears that it would be covered by Treas. Reg. section 53.4941(d)-2(c), which as explained above provides that the “lending of money or other extension of credit between a private foundation and a disqualified person” is an act of self-dealing unless “the loan or other extension of credit is without interest or other charge.” Under existing law, it appears that the making of a guarantee constitutes an extension of credit and, therefore, the guarantee is covered by this regulation.

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11 It is interesting that the statutory provision on which this regulation is based, IRC §4941(d)(2)(B), only exempts loans where no interest is charged and the loan proceeds are used for exempt purposes; the statute does not address extensions of credit at all. The above cited regulation expands the statutory exception by also including within its purview extensions of credit without interest or other charge. The regulation, though, unlike the statute, does not require that the loan proceeds or the extension of credit be used exclusively for exempt purposes. However, it appears to be the position of the IRS that loans without interest only qualify for the exception from self-dealing if the proceeds are in fact used for exempt purposes. See Rev. Rul. 77-379, 1977-2 C.B. 387. Accordingly, any guidance issued should specify that the purpose of the legal obligation being guaranteed must relate to the exempt purposes of the private foundation.
In *Janpol v. Commissioner*, the Tax Court ruled that where a disqualified person with respect to an employee profit-sharing plan guaranteed loans made by a bank to the plan, there was an extension of credit from the disqualified person to the plan. Accordingly, the disqualified person was deemed to have engaged in a prohibited transaction under IRC section 4975(c)(1)(B), which provides that it is a prohibited transaction where there is a, “lending of money or other extension of credit between a plan and a disqualified person.” The Tax Court reached the same conclusion in *Peek v. Commissioner*, with respect to disqualified person guarantees of loans of individual retirement accounts. In both of these cases, it does not appear that the disqualified person charged the plan or the guaranteed party for the making of the guarantee.

Therefore, it appears that a guarantee by a disqualified person of a private foundation’s legal obligation is an extension of credit for purposes of applying Treas. Reg. section 53.4941(d)-2(c). However, as explained above, the regulation does permit the extension of credit from a disqualified person to a private foundation, so long as the extension of credit “is without interest or other charge.” This exception, in contrast, is not contained in the provision discussed above relevant to retirement plans, IRC section 4975(c)(1)(B).

Thus, if a disqualified person guarantees an obligation of a private foundation, the making of the guarantee should not be self-dealing so long as it “is without interest or other charge.” Therefore, it appears that the disqualified person may not charge the private foundation for the making of the guarantee or otherwise be paid for the making of the guarantee. The regulation however also requires that the guarantee be “without interest.”

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13 140 T.C. 216 (2013)
14 The IRS in fact has stated in one Private Letter Ruling (“PLR”) that the Tax Court’s view that guarantees constitute extensions of credit for purposes of IRC §4975(c)(1)(B) should also apply for purposes of the self-dealing rules for private foundations. In PLR 9627001 (Nov. 30, 1995), the IRS considered whether disqualified persons with respect to a private foundation engaged in self-dealing when they executed certain guarantee agreements which had the effect of causing a private foundation’s securities accounts to collateralize obligations of a partnership owned by the disqualified persons. The IRS applied the rule from *Janpol* which held that guarantees constituted an extension of credit, explaining that, “[w]e do not see any reason not to view guarantees any differently for purposes of the self-dealing prohibitions under section 4941.” However, although the agreements at issue in the PLR were labeled guarantee agreements, the IRS viewed the agreements as actually being cross collateralization agreements and that self-dealing occurred because of the fact that by executing the agreements, the disqualified persons pledged private foundation assets to satisfy their personal debts. The PLR did not address whether there would have been self-dealing implications if the guarantees did not have the effect of causing private foundation assets to secure debts of disqualified persons.
It is straightforward to determine whether a loan is “without interest” because the loan agreement will ordinarily address the maker’s right to collect interest. It is unclear though how to apply the requirement that a guarantee be “without interest.” Under state law, a guarantor would likely be entitled to recover interest from the guaranteed party if the guarantor was required to make good on the guarantee.\textsuperscript{15} It could be argued, therefore, that in order for the guarantee to be considered made “without interest,” the guarantor must, at the time the guarantor makes the guarantee, affirmatively waive the guarantor’s right to collect interest from the guaranteed party, either in the guarantee itself or in a collateral agreement with the private foundation. Alternatively, it could be argued that so long as the disqualified person does not subsequently attempt to recover interest from the private foundation for any payment made on the guarantee, the guarantee is “without interest.”\textsuperscript{16}

We would suggest that any published guidance adopt the latter approach. From our experience, guarantee agreements ordinarily do not address the issue of the guarantor’s rights against the guaranteed party, including whether the guarantor can collect interest from the guaranteed party in the event of default by the guaranteed party. In most cases, the disqualified persons are likely to waive their right to interest (or would likely not consider seeking interest in the first place) upon the satisfaction of the guarantee. Moreover, there would not appear to be any harm or economic detriment to the private foundation unless and until the disqualified person takes affirmative steps to collect interest from the private foundation.

III. SELF-DEALING DOES NOT OCCUR AS THE PRIVATE FOUNDATION MAKES PAYMENTS ON THE GUARANTEED OBLIGATION.

For the reasons stated above, we do not believe that it is self-dealing for a disqualified person to make a guarantee of a private foundation’s legal obligation. The next issue is whether there is self-dealing as the private foundation satisfies the primary obligation and relieves the disqualified person of his or her legal obligation under the guarantee. As stated above,

\textsuperscript{15} For example, under California law, the guarantor could recover interest if the guarantor is required to make good on the guarantee. \textit{See W. H. Marston Co. v. Central Alaska Fisheries Co.}, 201 Cal. 715, 723 (1927) (Principal is required “to reimburse the surety for the moneys expended with legal interest . . . .”).

\textsuperscript{16} There should not be any self-dealing issues though with respect to the disqualified person bringing legal action to recover the principal amount from the private foundation if the disqualified person is required to pay on the guarantee. The disqualified person would essentially be seeking to recover on an interest-free loan from them to the private foundation, which is not self-dealing under Treas. Reg. §53.4941(d)-2(c).
Treas. Reg. section 53.4941(d)-2(f)(1) provides that, “[i]f a private foundation makes a grant or other payment which satisfies the legal obligation of a disqualified person, such grant or payment shall ordinarily constitute an act of self-dealing . . . .” In this situation, does the private foundation’s payments on its own obligation indirectly result in satisfying a legal obligation of the disqualified person because such payments have the effect of reducing or eliminating the disqualified person’s financial exposure under the guarantee?

It could be argued that the guarantor has no legal obligation unless and until the guarantor is called upon to make good on the guarantee. If this is the case, then the private foundation would not be satisfying any legal obligation of the disqualified person by making payments under the principal obligation. California case law suggests that a guarantor has no legal obligation unless and until the guarantor has to make payment on the guarantee. The California Supreme Court has explained that:

[a] surety bond is a ‘written instrument executed by the principal and surety in which the surety agrees to answer for the debt, default, or miscarriage of the principal.’ In suretyship, the risk of loss remains with the principal, while the surety merely lends its credit so as to guarantee payment or performance in the event that the principal defaults. In the absence of default, the surety has no obligation.17

On the other hand California Civil Code section 2839 provides that, “[p]erformance of the principal obligation, . . . exonerates a surety.” Also, California Civil Code section 2822(a) provides that, “[t]he acceptance, by a creditor, of anything in partial satisfaction of an obligation, reduces the obligation of a surety thereof, in the same measure as that of the principal, but does not otherwise affect it.” These provisions could be read to mean that a legal obligation of the guarantor is indeed satisfied as payments are made by the principal.

From a tax law perspective, a guarantor does not recognize taxable income to the extent he is relieved of potential liability when the obligor makes partial payments in discharge of the loan:

where the guarantor is relieved of his contingent liability, either because of payment by the debtor to the creditor or because of a release given him by the creditor, no previously untaxed accretion in assets thereby results in an increase in net worth. Payment by the principal debtor does not increase the guarantor's net worth; it merely prevents it, _pro tanto_, from being decreased. The guarantor no more realizes income from the transaction than he would if a tornado, bearing down on his home and threatening a loss, changes course and leaves the house intact.¹⁸

The fact that a guarantor has no income tax consequences as the principal makes payments supports the view that no legal obligation is satisfied as the principal makes payments.

Further, the Treasury Regulation support the view that the satisfaction by a private foundation of the legal obligation of a disqualified person as it makes payments is not self-dealing. Even if we assume that the payments by the private foundation do satisfy a legal obligation of the disqualified person, under Treas. Reg. section 53.4941(d)-2(f)(2), “[t]he fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing.” Thus, if the satisfaction of the disqualified person’s legal liability provides only an “incidental or tenuous benefit” to the disqualified person, there is no self-dealing.¹⁹

We submit that any benefit flowing to the disqualified person guarantor as that person’s legal obligation is satisfied is both “incidental” and “tenuous.” The benefit is “incidental” because the assets of the private foundation are being used to satisfy the private foundation’s own obligations and the disqualified person’s legal exposure only exists in the first place because the disqualified person sought to assist the private foundation. The fact that the private foundation’s payments also reduce the disqualified person’s legal exposure under the guarantee is only a secondary effect of such payments and therefore “incidental” to the primary benefit flowing to


¹⁹ It should also be noted that Treas. Reg. §53.4941(d)-2(f)(1) does not provide a blanket rule that the satisfaction of a disqualified person’s legal liability will always be self-dealing; rather the provision states that this will “ordinarily” be the case. If, as discussed below, the benefit flowing to the disqualified person from satisfaction of the guarantee liability is only incidental and/or tenuous, then this should be a situation outside the general rule that satisfaction of a disqualified person’s legal liability is “ordinarily” self-dealing.
the private foundation. The private foundation is legally obligated to fulfill the contract at issue, regardless of whether the guarantee is in place.

Any benefit flowing to the disqualified person is also “tenuous.” As explained above, “[p]ayment by the principal debtor does not increase the guarantor's net worth; it merely prevents it, pro tanto, from being decreased.” Because the only benefit here is the avoidance of potential future legal exposure, the benefit is also properly categorized as “tenuous.”

IV. CONCLUSION

As explained above, there are many situations where it is advantageous to a private foundation for a disqualified person to guarantee legal obligations of the private foundation. However, given that there is no specific guidance on this issue, many persons may be discouraged from executing such guarantees. Setting aside policy considerations, the law and existing regulations, while not specifically addressing the issue, support the position that disqualified persons may generally enter into guarantees for legal obligations of private foundations without running afoul of the self-dealing rules. Such guidance is essential not only for private foundations to enter into essential contracts with third parties to fulfill their charitable purposes, but for public charities to have long-term secure, guaranteed pledge agreements. Therefore, the IRS or the Treasury Department should issue guidance clarifying that disqualified persons may guarantee legal

20 It is possible that a disqualified person may be motivated to provide a guarantee in order to secure public recognition, such as the naming of a building for the disqualified person. For example, if a private foundation enters into a legally binding pledge to support a public charity and the public charity will be providing name recognition to the disqualified person, by making the guarantee, the disqualified person will obtain the personal benefit of the public recognition. However, “the public recognition a person may receive, arising from the charitable activities of a private foundation to which such person is a substantial contributor, does not in itself result in an act of self-dealing since generally the benefit is incidental and tenuous.” Treas. Reg. §53.4941(d)-2(f)(2). Therefore, this should not be an issue. We would recommend however that any guidance issued specify that the disqualified person may guarantee an obligation of the private foundation with respect to which the disqualified person will receive public recognition.

21 Landreth, 50 T.C. at 813.

22 We would suggest that any guidance also clarify that the guarantor may provide collateral for the guarantee without causing any self-dealing concerns. We make this suggestion because there is some authority in the context of subchapter S corporation shareholder guarantees which could be read to mean that there are different tax basis consequences for the shareholder if the shareholder pledged assets for the guarantee. See Selfe v. United States, 778 F.2d 769, 772-73 n.7 (“[A] guarantor who has pledged stock to secure a loan has experienced an economic outlay to the extent that that pledged stock is not available as collateral for other investments. The guarantor in this example has lost the time value or use of its collateral.”). From a self-dealing perspective though, we do not see any difference in the benefit to the guarantor flowing from the private foundation’s satisfaction of the principal obligation regardless of whether the guarantor pledged collateral for the guarantee.
obligations of private foundations without violating the self-dealing rules. We recommend that the guidance include the following:

- The purpose of the primary obligation being guaranteed must relate to the exempt purposes of the private foundation;

- The disqualified person may not charge the private foundation for the making of the guarantee or otherwise be paid for the making of the guarantee;

- While the disqualified person does not need to waive any right to recover interest from the private foundation at the time of the making of the guarantee, the disqualified person may not seek interest from the private foundation if the disqualified person is required to make payment under the guarantee;

- The disqualified person may receive public recognition with respect to the guaranteed obligation, as permitted under Treas. Reg. section 53.4941(d)-2(f)(2); and

- The disqualified person may provide collateral for the guarantee.