

## **PROHIBITION ON RECEIPT OF COMPENSATION FROM PRIVATE FOUNDATIONS (TAXES ON SELF-DEALING)**

**Prohibition.** The Internal Revenue Code prohibits payments of compensation by private foundations to certain Government employees and prohibits agreements to make payments of money or property to such employees. 26 U.S.C. §§ 4941 and 4946. The Code imposes a 5% tax on the illegal payments, with later penalties for failure to pay back the foundation, and a corresponding 2.5% tax on foundation managers under certain circumstances.

Although framed as a tax provision, the statute essentially bars high level federal employees and their assistants from receiving compensation from a private foundation defined in section 509 of the Internal Revenue Code. Private foundations are a subset of nonprofit charitable organizations described in section 501(c)(3).

**Definitions.** Nonprofit 501(c)(3) organizations are essentially divided into two categories: private foundations and public charities. Typically, the former are funded originally by a single donor, family, or corporation, and thereafter carry out their tax exempt purposes through investment income. Examples are the Ford Foundation, the Robert Wood Johnson Foundation, and the Pew Charitable Trust. The latter include churches, schools, and organizations that are funded through diversified support from governmental sources and/or the general public. Examples include the American Red Cross, the United Way, the American Cancer Society, and the National Geographic Society.

Section 509(a) of the Internal Revenue Code creates this dichotomy by first defining the entire universe of nonprofit 501(c)(3) organizations as private foundations, then excluding several categories from the definition, and finally making the exclusion contingent upon the applicant public charities' filing notices with the Internal Revenue Service (IRS) that they are covered by one of the exclusions.

**Exclusions.** The following categories of nonprofit organizations are excluded from the definition of a private foundation: (1) a church or a convention or association of churches; (2) an educational organization such as a school or college; (3) a hospital or medical research organization operated in conjunction with a hospital; (4) endowment funds operated for the benefit of certain state and municipal colleges and universities; (5) a governmental unit; (6) a publicly supported organization that normally receives a substantial part of its support from a governmental unit or from the general public; (7) certain organizations that have affiliations or relationships that support the activities of other excluded organizations; and (8) organizations that test products for public safety. See 26 U.S.C. §§ 509(a)(1)-(4).

**Status.** Private foundations are subject to: (1) an excise tax on net investment income; (2) restrictions on self-dealing between private foundations and disqualified persons, including “Government officials”; (3) requirements to distribute annually certain formula amounts of income for charitable purposes; (4) certain limits on holdings in active businesses; and (5) restrictions on investments and expenditures that are inconsistent with exempt purposes. Public charities are not subject to these provisions.

In view of these significant tax consequences, the counsel or accountant of an organization can confirm its precise legal status. Alternatively, another source from which to ascertain whether a 501(c)(3) organization is a private foundation or public charity is the IRS web page [<http://www.irs.ustreas.gov>]. The “Tax Information for Business” section contains a listing for “Exempt Organizations.” This web page includes an on-line search capability for Publication 78, which lists most 501(c)(3) organizations and their particular status as a private foundation or public charity.

**Covered Employees.** Federal Government officials to whom Internal Revenue Code sections 4941 and 4946 apply include: (1) elective officials; (2) Presidential appointees; (3) Schedule C employees; (4) individuals compensated at or above “the lowest rate of basic pay for the Senior Executive Service;” and (5) personal or executive assistants, or secretaries to any of the foregoing. The provision does not apply to special Government employees.

**Exceptions.** The provision does not apply to payment of travel expenses to Government employees with certain provisos: (1) the travel must take place within the United States; and (2) payment may not exceed the actual cost of transportation involved plus an amount for all other travel expenses not in excess of 125% of the amount allowable for Government employees traveling on official business.

The provision does not apply to: (1) agreements to employ a Government employee after the employee leaves the Government, if termination of Government employment will occur within 90 days; (2) certain prizes and awards open to the general public; (3) gifts not exceeding \$25 in any calendar year; or (4) certain scholarships and fellowship grants.

**Penalties.** The IRS will impose the tax on a Government employee only if he or she had knowledge that the compensation transaction constituted “self-dealing.” However, the employee would be required to return the funds to the private foundation.

Individuals who review financial disclosure reports, evaluate travel, gifts, and awards, approve outside activities, or counsel on employment searches should keep this prohibition in mind. Employees who require additional information should be directed to contact a tax advisor.

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