

# How Private Foundations Can Avoid the Compliance Pitfalls of Fundraisers and Galas

NAVIGATING THE LEGAL ISSUES  
FROM THE IMPROPER USE OF  
FOUNDATION TICKETS

Fundraisers such as dinners, galas and concerts are popular with both donors and charities alike. However, if one chooses to pay for tickets to these types of events through a private foundation, some care is required. Because tickets have an economic value, and there are benefits associated with attendance (food, drinks, entertainment, etc.), improperly using tickets that have been purchased by or given to the foundation can result in self-dealing or even taxable expenditure violations. This resource outlines the legal issues that can arise from the improper use of foundation tickets and offers practical guidance for avoiding them.

## Self-Dealing

Many foundation managers, staff and board members understand that the self-dealing rules<sup>1</sup> generally prohibit a disqualified person<sup>2</sup> from entering into a financial transaction with the foundation. What is often not well understood is that, with few and narrow exceptions, they forbid the flow of any tangible economic benefits from the foundation to a disqualified person. Specifically, section 4941(d)(1) lists six prohibited acts of self-dealing between a private foundation and its disqualified persons. One of these prohibited acts is the “transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation” (emphasis added). When a foundation obtains tickets to an event, those tickets become assets of the foundation. Thus, the personal use of those tickets by disqualified persons or their family members will ordinarily constitute an act of self-dealing.

If tickets are obtained for personal use by or on behalf of a disqualified person, the Internal Revenue Service (IRS) can impose a penalty tax on the disqualified persons who engage in the act of self-dealing. The penalty, payable by the disqualified person who used the tickets (not by the foundation), will be equal to 10% of the amount involved.<sup>3</sup> Further, the disqualified person must pay the foundation back for the ticket or otherwise correct the self-dealing violation.

If the self-dealing act is not undone or “corrected” within a certain period of time known as the “taxable period,”<sup>4</sup> the IRS may impose confiscatory second-tier taxes, currently 200% of the amount involved. Finally, the IRS may impose an additional 5% penalty on any foundation manager who “participated” in the self-dealing transaction “knowing” that the act was self-dealing.

**WHEN A FOUNDATION OBTAINS TICKETS TO AN EVENT, THOSE TICKETS BECOME ASSETS OF THE FOUNDATION**



## Use of Tickets by Non-Disqualified Persons

The threat of self-dealing exists if the individual using or benefitting from the use of a foundation ticket meets the technical definition of a disqualified person. Thus, a close personal friend of someone on the board of the foundation may not be a disqualified person and therefore would not be liable for self-dealing penalties for using a foundation ticket to attend a charity event. However, in any case where foundation tickets are used, and there is no foundation purpose for that person to attend the event, such use could result in a taxable expenditure for the foundation.

<sup>1</sup> Section 4941(a)(1) of the Internal Revenue Code of 1986, as amended (the “Code”), imposes a tax on each act of self-dealing between a disqualified person and a private foundation.

<sup>2</sup> The term “disqualified person” includes directors, officers, trustees, substantial contributors, persons with a 20% or greater interest in an entity that is a substantial contributor, the family members of all such individuals, and certain entities partially or wholly owned, directly or indirectly, by disqualified persons.

<sup>3</sup> The calculation of the “amount involved” for an act of self-dealing varies depending on the type of transaction that triggered the self-dealing violation. See section 4941(e)(2) of the Code and the section 53.4941(e)-1(b) of the Treasury Regulations.

<sup>4</sup> Section 4941(e)(1) defines the taxable period as the period beginning with the date on which the act of self-dealing occurs and ending on the earliest of: (i) the date of mailing a notice of deficiency regarding the initial self-dealing tax, (ii) the date on which the initial self-dealing tax is assessed, or (iii) the date on which correction of the act of self-dealing is completed.

## Taxable Expenditures

In addition to the prohibition on financial transactions with disqualified persons, the Code also imposes penalties on a foundation's "taxable expenditures" (i.e., any expenditure that does not further charitable purposes<sup>5</sup>). Thus, even if the foundation's use of an event ticket confers a benefit on someone who is not a disqualified person, that use may still violate the law if it does not further a charitable purpose. If the use of a ticket is a taxable expenditure, it carries a penalty, payable by the foundation, in the amount of 20% of the expenditure. In addition to the penalty, the IRS rules and regulations governing taxable expenditure violations require that the violation be corrected (which could include having the funds returned to the foundation), as is the case with self-dealing violations.

## The "Reasonable and Necessary" Exception

Foundation board members often have excellent reasons to attend a charity fundraising event, such as a need to monitor the use of foundation grants, interact with other donors, or meet the grantee's board and staff so they can learn more about the charity and its programs. Sometimes, a charity desires the presence of foundation representatives because they might attract other influential donors. If the economic benefit received by the disqualified person is reasonable and necessary, and in furtherance of the foundation's charitable purposes, using the foundation tickets is allowable. Accordingly, it will not constitute self-dealing if, for example, a board member attends an event to represent the foundation in an official capacity and to carry out work that is reasonable and necessary for fulfilling the exempt purposes of the foundation.

It is important to note that the above exception to the self-dealing rules only applies to, and tickets should only be used by, foundation staff, officers, directors, and others who have an official role on the foundation and attend events for foundation purposes, not for personal reasons. As such, spouses or other family members who do not serve the foundation in an official capacity, and would attend the events purely for personal reasons, are not covered by this exception to the self-dealing rules and may not use foundation tickets. Because such family members likely are disqualified persons, they could be personally liable for self-dealing penalties if they were to receive the foundation's tickets.

## Disclaiming Tickets

To avoid the risk of self-dealing altogether, some foundations will simply turn down any complimentary tickets received in connection with a grant to a nonprofit. Because the foundation can often accomplish its purposes by simply making the grant and not attending the event, refusing the tickets avoids even the appearance of impropriety. Further, this may allow the charity to sell those tickets or make them available for others to attend (e.g., prospective funders or community representatives). Alternatively, after disclaiming the tickets to a nonprofit's event, the foundation may recommend people to whom tickets might be furnished instead—as long as it's clear that it is entirely up to the charity to decide who is invited, and that the invitation is not conditioned upon foundation support (past or future).

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<sup>5</sup> Among other transactions defined as "taxable expenditures," section 4945(d)(5) includes within the definition "any amount paid or incurred by a private foundation for any purpose other than one specified in section 170 (c)(2)(B)".

## Using Personal Tickets

If a foundation representative attending the charity event in an official capacity wishes to have a spouse or family member also attend the event, and that guest does not have a foundation role, it is permissible for that person to attend if he or she purchases the tickets directly from the nonprofit using personal funds. However, the ability of the family member to buy that ticket must be independent from the foundation's gift. That is, if the charity does not ordinarily make individual tickets available for purchase and only allows the family member to buy a ticket because of the foundation's support, IRS guidance suggests that the family member's attendance would be considered self-dealing, even though he or she purchased the ticket with personal funds.

## Bifurcation

Some foundations try to avoid self-dealing by splitting the cost of a ticket with a disqualified person. Often, tickets to fundraising events include a portion that covers the value of the food and entertainment, and a portion that constitutes the charitable contribution. Indeed, when individuals or corporations purchase such tickets, they are generally permitted to deduct the cost of the ticket less the value of any goods or services they receive.

Following similar logic, many believe that it is permissible to have the foundation cover only the portion of the ticket price that represents a donation to the charity and have the disqualified person cover the portion allocable to the value of goods and services received. Perhaps surprisingly, this "bifurcation" of the ticket price has been ruled by the IRS to constitute self-dealing as well. The rationale behind the rulings is that, when the foundation covers a portion of the ticket price, the foundation is relieving the disqualified person of his or her obligation to pay the entire cost of the ticket. Because the foundation is footing a portion of the bill, the disqualified person gains access to the event at a lower cost than if he or she had simply purchased the ticket without assistance from the foundation. As stated earlier, even where a disqualified person chooses to pay the entire amount of the ticket, if tickets are only available by purchasing an entire table, it could be considered self-dealing because the disqualified person would never have been able to buy a single ticket but for the foundation's expenditure.

**IF THE ECONOMIC BENEFIT RECEIVED BY THE DISQUALIFIED PERSON IS REASONABLE AND NECESSARY, AND IN FURTHERANCE OF THE FOUNDATION'S CHARITABLE PURPOSES, USING THE FOUNDATION TICKETS IS ALLOWABLE**



## Treating the Value of Tickets as Compensation

An exception to the self-dealing rules is that a foundation may pay a disqualified person compensation for "personal services" if the compensation is reasonable and necessary to the foundation's charitable operations. Personal services generally include any services that are essentially professional and managerial in nature, including foundation management, accounting, legal, investment management, and banking services. Compensation need not be only salary; it may also include fees, bonuses, retirement benefits, and other fringe benefits, as long as the total compensation package is reasonable relative to the personal services rendered.

It is possible that the foundation could give tickets to a disqualified person for personal use (including for use by family members or friends) without violating the self-dealing rules, or making a taxable expenditure, if the value of the ticket is intended as compensation to the disqualified person and is treated as income for tax purposes. Although the IRS has allowed arrangements where benefits are provided to family members of disqualified persons as part of the overall compensation arrangement for that individual, and that compensation was reasonable, such treatment has been denied where the IRS concluded that payments were not intended to be compensation and were not treated as compensation when paid. It is unclear whether characterizing the personal use of tickets as compensation can happen after the fact or if it must be determined prior to the disqualified person's using them. Accordingly, foundations should work closely with counsel if planning to treat the personal use of foundation tickets by a disqualified person as compensation to ensure that doing so will pass muster with the IRS.

## Corporate-Sponsored Foundations

Corporate-sponsored foundations have unique self-dealing concerns around the use of foundation event tickets because the pool of disqualified persons includes the corporation itself. Very often, these foundations wish to give event tickets to (or use foundation funds to purchase tickets for) directors or employees of the corporate sponsor. Typically, the foundation receives significant funding from its for-profit sponsor, making the corporation itself a disqualified person in light of its role as a substantial contributor. Where a substantial contributor is a corporation, its officers and directors likewise will be disqualified persons, even if they don't serve on the foundation in any capacity. Additionally, in the case of a foundation established by a smaller for-profit corporation, such entity could be a disqualified person itself if other disqualified persons collectively own more than 35% of the corporate sponsor, as is frequently the case. In some cases, individuals working in the for-profit sponsor's Human Resources or other departments act like foundation officers, running the foundation's daily operations even though they do not serve the foundation in an official capacity. If the foundation were to distribute an event ticket to such an individual, self-dealing could result because he or she could be deemed a type of disqualified person known as a "foundation manager."

As explained above, any use of a foundation's tickets that benefits one of its disqualified persons would violate the self-dealing rules—even if the "person" in question is actually a corporation. Therefore, although managers and employees of the corporate sponsor may not themselves be explicitly included in the definition of disqualified person, a self-dealing violation could result if giving the tickets to such persons would result in a benefit to the sponsoring corporation itself. Common examples of benefits to the corporation that can flow from allowing corporate employees to use foundation tickets include rewarding employee performance, assisting with employee recruitment and helping to retain employees.

**MANY BELIEVE THAT IT IS PERMISSIBLE TO HAVE THE FOUNDATION COVER ONLY THE PORTION OF THE TICKET PRICE THAT REPRESENTS A DONATION TO THE CHARITY**



Even if the corporation itself derives no obvious benefits from employee use of foundation tickets, if doing so furthers no charitable purpose of the foundation, the transfer of the tickets to the corporation could result in a taxable expenditure violation. For example, distributing foundation tickets in order to reward employees who have done the most charity work in the quarter would be permissible if promoting volunteerism is part of the foundation's mission (assuming disqualified persons are not eligible to win). However, tickets raffled off to employees through a lottery (and not based on job performance, recruitment or retention goals) could be a taxable expenditure, even if it is not self-dealing, because no charitable purpose of the foundation is thereby advanced. In the corporate foundation context, it may be simplest and cleanest for the corporate sponsor to purchase tickets to events directly from the charity. The corporation can always make as many tickets available to foundation staff as necessary to enable the foundation to carry out its work, and any additional tickets may be distributed by the corporation to its directors, employees or any other guests without fear of violating the self-dealing rules.

## Conclusion

In responding to the plethora of invitations to attend charitable events, foundations should have a firm understanding of the rules concerning self-dealing and taxable expenditures. Because attending fundraising events can be an effective and efficient way to evaluate grantees, gain information about their programs, interact with other funders, and demonstrate commitment to an organization or cause, foundations should continue to participate when doing so helps advance their mission. However, foundation trustees, managers and employees must exercise caution to avoid exposing the foundation and its disqualified persons to potential violations and penalties.

### ABOUT FOUNDATION SOURCE

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