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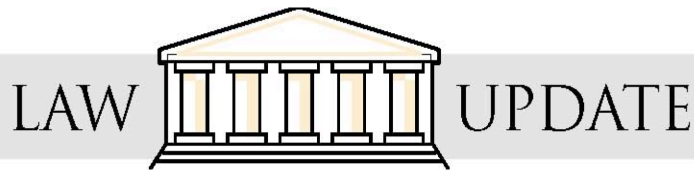

Staying Within the Bounds of the Income Tax Code and Public Perception: Conflict of Interest and Excess Benefit

By Bill Silberstein and Jessica Jay

In the spring edition of *Exchange,* we discussed two issues that affect the charitable, tax-exempt status of a land trust: private inurement and private benefit. In this article we discuss two issues that can affect the public's perception and the tax-exempt status of a nonprofit organization: conflict of interest and excess benefits.

Conflict of Interest

The likelihood that a land trust would suffer from the appearance of or actuality of a conflict of interest is probably much greater than the likelihood of running afoul of private inurement, private benefit or excess benefit regulations. It is important to understand conflict of interest and avoid it, since even the appearance of a conflict of interest can result in bad publicity, substantial time devoted to trying to maintain or restore good public relations, and the possibility of liability for board members and staff.

Conflicts of interest may occur in several ways. One example is self dealing, where a director or a staff member stands to benefit financially from involvement with the trust. For example, a board member may propose providing services to the land trust, such as preparing baseline inventory reports for a fee.

A conflict of interest might also arise among directors or staff whose individual business or personal interactions conflict with or oppose the land trust's interests. For example, if a board member wishes to buy land trust property, his or her personal interest would be to buy the property at the lowest possible price, while it would be in the land trust's interest to sell it at the highest possible price. If not properly handled, conflict of interest situations can give rise to liability of board members, and can create public perception problems, which could be very damaging to the land trust's credibility.

To ensure that such conflicts of interests do not occur, land trust board members and staff are always bound to place the interest of the land trust ahead of their own private interest. Land trusts should educate their boards and staff about their duty of loyalty and responsibility. [See practice 3A of LTA's *Standards and Practices Guidebook*.]

Land trust boards should also be aware of their state laws on conflict of interests. Usually such statutes require directors to disclose information about their conflict of interests and their projected impacts on the land trust transaction. These statutes usually require the entire board or reviewing committee of the land trust to approve the action by a "disinterested majority"—or a majority of those directors without a conflict of interest—who must judge whether the transaction is appropriate and fair, despite its apparent conflict with an individual director. Land trusts should incorporate their state's requirements through the development of conflict of interest policies.

Conflict of interest policies generally should include a requirement of disclosure of any perceived or actual conflicts by directors, officers, and staff members of the land trust, as well as requirements that individuals with perceived or actual conflicts refrain from voting on and/or discussing the conflicted transaction. Policies might also include a requirement that transactions involving financial gain or loss be fair to the land trust and may also include requirements to explain the conflict of interest policy to new directors and staff members, and to enforce the policy.

[See Appendix 3.1 of LTA's *Standards and Practices Guidebook* for sample conflict of interest policies.]

Land trusts should keep conflict of interest in mind when soliciting new board members. In seeking directors who are active and influential in the community, it may be impossible to find candidates without conflicts. Nevertheless, it is important to be aware of their potential conflicts, and it is wise to steer clear of candidates with extensive conflicts.

Most importantly, land trust board members and staff should remember their basic duty of loyalty that requires them to have an undivided allegiance to the land trust's goals and mission. Keeping this duty of loyalty in mind and disclosing any perceived or actual conflicts of interest should insulate board members and land trusts from the public perception of, or actuality of, conflicts of interests.

Excess Benefit Transactions

In 1996 Congress added a level of intermediate sanctions structured as penalty excise taxes related to private inurement and private benefit transactions. [For information on private inurement and private benefit, see page 22 of the Spring 1999 *Exchange*.] The Internal Revenue Service may use these sanctions in lieu of, or in addition to, the revocation of an organization's tax-exempt status for violating the rules on private inurement, but are generally intended to address cases in which the excess benefit does not rise to the level of challenging the basic function of an organization's charitable status. This means the IRS has new tool available to penalize nonprofits for more minor transgressions. The IRS issued proposed regulations on July 30, 1998, to explain and flesh out these rules. It is not known when these proposed regulations will become final. However, it would be advisable to comply with these regulations even now.

An excess benefit transaction may occur between a "disqualified person" and a tax-exempt organization if the dis

qualified person improperly benefits from a transaction with the organization. (Disqualified person are defined as any person who, at any time during the five years prior to the date of the transaction in question, was in a position of influence over the affairs of the organization, or was a close relative of an individual in a position of influence.) Such transactions may take the form of unreasonable compensation from the organization, a non-fair market value transaction between a "disqualified person" and the organization, or financial arrangement made under which a disqualified person receives compensation based on the organization's income in a transaction that violates the private inurement rules. Tax sanctions may be imposed on the disqualified person and/or the organization managers who participated in the transaction knowing that it was not proper. (Organization managers are defined as trustees, directors, and officers of an organization, or individuals with similar powers.)

The proposed regulations refer to a "rebuttable presumption of reasonableness" when considering a non-fair market value transaction or compensation arrangement with a disqualified person. This "presumption of reasonableness" occurs when three conditions are satisfied:

The arrangement is approved by a board of directors or trustees or a committee of the board comprised of individuals who are not related to, and not subject to the control of, the disqualified persons involved.

Appropriate comparable data is examined and documented as a basis for the board's determination. For example, a board determining compensation for a disqualified person may examine compensation levels paid by similarly situated organizations, both tax-exempt and taxable.

The board's determination on compensation is adequately documented, including an evaluation of the individual whose compensation is being established, and the basis for determining that compensation was reasonable in light of both the evaluation and the data. Written or electronic records of the governing body or committee should include the terms of the transaction approved, the date of approval, and the members of the governing body or committee present during the discussion about a transaction or arrangement, any data used by the committee, and a record of those who voted for it. It should also be recorded if a member discloses a conflict of interest and/or recuses himself or herself from the vote and discussions. If the governing body or committee determines that reasonable compensation or fair market value is higher or lower than that determined to be the comparable data, the governing body or committee should record the reason for their determination.

When these three conditions are met, a penalty excise tax will be imposed by the IRS *only* if it develops evidence contrary to that presented.

If the IRS determines that compensation or other transactions are not reasonable, they will be treated as excess benefit transactions. (This includes any form of compensation provided by a tax-exempt organization in exchange for the performance of services, such as forms of cash and non-cash salary, fees, bonuses and severance payments, forms of deferred compensation that are earned and vested, insurance and other benefits, as well as payment or reimbursement by the organization for expenses, fees or taxes.) Financial arrangements under which a disqualified person receives payment based on the organization's income is known as a "revenue sharing" arrangement. A

revenue-sharing transaction may be an excess benefit transaction, depending on the facts and circumstances, regardless of whether payments to a disqualified person exceed the fair market compensation values. The IRS may be issuing guidance to tax-exempt organizations by providing examples of revenue sharing arrangements that violate the private inurement rules in the near future.

Generally, compensation for the performance of services will be reasonable *only* if such amount would ordinarily be paid for like services by like entities under like circumstances existing at the date when the contract for services is made. Certain economic benefits are not considered for these purposes, including the payment of reasonable expenses for an organization's board members to attend board meetings, economic benefits received by disqualified persons through their membership or volunteer status with the organization, and any economic benefit provided to a disqualified person who is a recipient of a charity's benefits relating to its tax-exempt purposes.

If the IRS determines that an organization manager or a disqualified person engaged in an excess benefit transaction, it may impose an excise tax on these individuals. The excess benefit is determined to be the amount by which a transaction exceeds a fair market value, the amount compensation exceeds reasonable compensation, or the amount of private inurement resulting from the transaction. A disqualified person who is determined to have benefited from an excess benefit transaction must pay an initial excise tax equal to 25 percent the amount of the excess benefit received. A disqualified person has a specific period of time to correct the excess benefit and if he or she fails to do so, may receive an additional excise tax for failure to correct the original excess benefit. An organization manager who is determined to have knowingly participated in an excess benefit transaction must pay an initial excise tax of 10 percent of the excess benefit. The maximum excise tax for an organization manager is $10,000.

While these regulations are not finalized, it is advisable to follow them now because they provide guidance on how to avoid private benefit and private inurement issues in addition to excess benefit.

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