

State University of New York At Buffalo  
Legal Assistance Program  
Amherst, NY

Joseph Roccisano, Not For Profit Resource Center Director  
United Way Buffalo & Erie County  
742 Delaware Avenue  
Buffalo, NY 14209

Dear Mr. Roccisano,

As part of my involvement in the UB Legal Assistance Program, I have been asked to examine the formation of a Not-for-Profit's Conflict of Interest policy. Both New York State and the IRS have set forth their own guidelines to help 501(c)(3) entities structure this part of their organization.

The first part of the enclosed memo describes the importance of a well formulated conflict of interest policy as well as the differences between the requirements set out by the state and those set out by the federal government. The second half has an example of both an IRS and a NYS conflict of interest policy.

Generally, you'll find that New York State strategy allows for more flexibility, but lacks the protection afforded by the IRS tactic. A policy created to satisfy only NYS law, though less time-consuming, may not be as helpful should the IRS challenge a perceived excess benefit transaction.

I hope that this information is of some use to you. As always, feel free to contact our offices if you have any questions or concerns.

Best regards,

Michael J. Garvey  
Student Attorney

Enclosure (1) – Conflict of Interest Memorandum

**The Importance of a Conflict of Interest Policy for 501(c)(3)  
Organizations in New York State**

Prepared by Michael Barrett  
Updated by Michael Garvey (November, 2006)

A Conflict of Interest Policy, carefully designed and followed, allows not-for-profit corporations to ensure their status as a tax exempt entity. In recent years, the IRS has enacted more focused rules on who may be penalized. Not only those interested parties who benefit from conflict of interest transactions can be held accountable, but also the corporation directors or officers who approve them. In light of a greater risk of personal liability, creating and adhering to a well formed Conflict of Interest Policy is more important than ever.

### **What is a conflict of interest?**

- The **IRS** defines a **conflict of interest** as “when a person in a position of authority over an organization, such as a director, officer, or manager, may benefit personally from a decision he or she could make.”<sup>1</sup>
- **New York State** views a conflict of interest as occurring when a not-for-profit corporation transacts with:
  - an officer/director of the corporation
  - a corporation (or other entity) of which an officer/director of the not-for-profit is also an officer/director of, or has a financial interest in.
- Having a conflict of interest policy in place is not required, though strongly encouraged by the IRS, “because it makes it more likely that [a tax-exempt organization] will operate for the benefit of the community and not for private interests.”<sup>2</sup>
- When a conflict of interest policy is in effect, an interested party to a proposed transaction must disclose that interest to the board of directors, or ensure that the board is aware of the conflict, so that the board may determine whether the transaction is fair.
- The increase in enforcement efforts by the IRS is due largely to recent instances reported in the press where individuals and private companies have benefited excessively from not-for-profit corporations, and the public’s declining perception of charitable giving as a result.
  - Such benefits may fall under the category of “excess benefit transactions.”

### **What is an excess benefit transaction, and how is it determined?**

- An **excess benefit transaction** is defined broadly, as any economic benefit provided by a tax exempt organization for the use of a disqualified person, if the value of the benefit exceeds the value of the property or services received.
  - This is most commonly found in compensation agreements for services, and exchanges of property.
- The value of the benefit is determined by **fair market value**, which is the price which would result from a willing buyer and seller in an open market, with neither side being under any pressure to sell, and with both sides being knowledgeable of all relevant facts.
- A **disqualified person** is defined as any person who at the time of the transaction, or within the last five years of that date, was in a position to exercise substantial

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<sup>1</sup> IRS Form 1023 (Rev. 2006) Instructions, p.9.

<sup>2</sup> IRS Form 1023 (Rev. 2006) Instructions, p.19.

influence over the affairs of the organization, including family members of such persons.

- Thus, situations involving the compensation of a not-for-profit corporation's president, a contract for services with the sister of a board member, or the selling of land to a former officer who left the corporation three years prior, are all potential excess benefit transactions and must be entered into carefully.

### **What are the potential penalties of an excess benefit transaction?**

- The enactment of excise taxes on excess benefit transactions in 1996 gave the IRS the power to penalize the individuals involved, without taking the harsh step of revoking the organization's tax-exempt status.
  - The **disqualified person** must pay a tax of **25 percent** of the excess benefit.<sup>3</sup>
  - The transaction must also be undone, or "corrected", meaning the organization must be placed in a financial position not worse than if the highest fiduciary standards were employed, usually involving cash repayment, with interest.
  - If this tax has not been paid, or the transaction has not been corrected in a certain period of time, a tax of **200 percent** is applied on the disqualified person.<sup>4</sup>
  - Not only is the disqualified person who benefited from the transaction personally liable, but the **management personnel** (including officers, directors, and trustees) who approved such a transaction knowing that there was an excess benefit are subject to a tax of **10 percent** of the excess benefit<sup>5</sup>, up to a maximum of \$20,000.<sup>6</sup>
- Also, the IRS retains the option of revoking the tax-exempt status of the corporation, in addition to collecting taxes, for serious offenders.

### **How can an organization avoid liability?**

Clearly, care must be taken to avoid these large potential liabilities.

- If the IRS finds that an excess benefit transaction has occurred, the organization has the burden to show that such a transaction did not occur.
- The IRS has issued regulations<sup>7</sup> which allow an organization to create a presumption that a transaction is not an excess benefit transaction.
  - The burden is then shifted to the IRS to show that an excess benefit transaction has occurred.
  - Creating this presumption involves:
    - approval of the transaction by a disinterested board (parties having an interest in the transaction would abstain from voting),

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<sup>3</sup> IRC § 4958(a)(1)

<sup>4</sup> IRC § 4958(a)(2)

<sup>5</sup> *Id.*

<sup>6</sup> IRC § 4958(d)(2)

<sup>7</sup> 26 C.F.R. 53.4958

- the obtaining of data to compare the transaction to similar transactions involving similarly situated organizations, and
    - adequate documentation of the basis for approving the transaction.
  - Since the presumption is rebuttable by the IRS, it will not provide an absolute shield from liability.
- Management can also obtain a **written opinion**, by a qualified professional (usually an attorney or accountant), as to the appropriateness of a transaction.
  - As long as all the material information involved is disclosed to the professional, this will insulate the management from the 10 percent tax for knowingly participating in an excess benefit transaction.
- A conflict of interest policy that adheres to IRS guidelines will have all of these safeguards in place.

**What should your organization’s conflict of interest policy contain?**

- There is no one set structure which must be used for an organization’s conflict of interest policy.
- The IRS sample policy (see below) is the safest, most cautious approach, but can also be time-consuming and inconvenient for some organizations.
- A policy satisfying New York State law (see sample below) can be more flexible, but may not be as helpful should the IRS challenge a perceived excess benefit transaction.
- The following table shows the major differences between the IRS sample policy, and a policy conforming with the less restrictive New York State law. An organization can enact a policy with provisions altered to suit its unique needs.

	IRS Policy	NYS Policy
Interested party can be present during discussion of the transaction	No	Yes
Interested party can be present during vote	No	Yes
Interested party can vote on transaction	No	Yes, but interested party’s vote cannot be necessary for transaction to be authorized
Annual statements regarding conflict of interest policy required	Yes	No
Periodic reviews of compensation, contracts and transactions required	Yes	No

**IRS Sample Conflict of Interest Policy**

(Hospitals – see IRS Form 1023 instructions, Appendix A, for additional provisions)

**Article I**  
**Purpose**

The purpose of the conflict of interest policy is to protect this tax-exempt organization's (Organization) interest when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the Organization or might result in a possible excess benefit transaction.

This policy is intended to supplement but not replace any applicable state and federal laws governing conflict of interest applicable to nonprofit and charitable organizations.

## **Article II** **Definitions**

### **1. Interested Person**

Any director, principal officer, or member of a committee with governing board delegated powers, who has a direct or indirect financial interest, as defined below, is an interested person.

### **2. Financial Interest**

A person has a financial interest if the person has, directly or indirectly, through business, investment, or family:

- a.** An ownership or investment interest in any entity with which the Organization has a transaction or arrangement,
- b.** A compensation arrangement with the Organization or with any entity or individual with which the Organization has a transaction or arrangement, or
- c.** A potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the Organization is negotiating a transaction or arrangement.

Compensation includes direct and indirect remuneration as well as gifts or favors that are not insubstantial.

A financial interest is not necessarily a conflict of interest. Under Article III, Section 2, a person who has a financial interest may have a conflict of interest only if the appropriate governing board or committee decides that a conflict of interest exists.

## **Article III** **Procedures**

### **1. Duty to Disclose**

In connection with any actual or possible conflict of interest, an interested person must disclose the existence of the financial interest and be given the opportunity to disclose all material facts to the directors and members of committees with governing board delegated powers considering the proposed transaction or arrangement.

### **2. Determining Whether a Conflict of Interest Exists**

After disclosure of the financial interest and all material facts, and after any discussion with the interested person, he/she shall leave the governing board or committee meeting while the determination of a conflict of interest is discussed and voted upon. The remaining board or committee members shall decide if a conflict of interest exists.

### **3. Procedures for Addressing the Conflict of Interest**

- a.** An interested person may make a presentation at the governing board or committee meeting, but after the presentation, he/she shall leave the meeting during the discussion of, and the vote on, the transaction or arrangement involving the possible conflict of interest.
- b.** The chairperson of the governing board or committee shall, if appropriate, appoint a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement.
- c.** After exercising due diligence, the governing board or committee shall determine whether the Organization can obtain with reasonable efforts a more advantageous transaction or arrangement from a person or entity that would not give rise to a conflict of interest.
- d.** If a more advantageous transaction or arrangement is not reasonably possible under circumstances not producing a conflict of interest, the governing board or committee shall determine by a majority vote of the disinterested directors whether the transaction or arrangement is in the Organization's best interest, for its own benefit, and whether it is fair and reasonable. In conformity with the above determination it shall make its decision as to whether to enter into the transaction or arrangement.

#### **4. Violations of the Conflicts of Interest Policy**

- a.** If the governing board or committee has reasonable cause to believe a member has failed to disclose actual or possible conflicts of interest, it shall inform the member of the basis for such belief and afford the member an opportunity to explain the alleged failure to disclose.
- b.** If, after hearing the member's response and after making further investigation as warranted by the circumstances, the governing board or committee determines the member has failed to disclose an actual or possible conflict of interest, it shall take appropriate disciplinary and corrective action.

#### **Article IV** **Records of Proceedings**

The minutes of the governing board and all committees with board delegated powers shall contain:

- a.** The names of the persons who disclosed or otherwise were found to have a financial interest in connection with an actual or possible conflict of interest, the nature of the financial interest, any action taken to determine whether a conflict of interest was present, and the governing board's or committee's decision as to whether a conflict of interest in fact existed.
- b.** The names of the persons who were present for discussions and votes relating to the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection with the proceedings.

#### **Article V** **Compensation**

- a.** A voting member of the governing board who receives compensation, directly or indirectly, from the Organization for services is precluded from voting on matters pertaining to that member's compensation.
- b.** A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Organization for services is precluded from voting on matters pertaining to that member's compensation.
- c.** No voting member of the governing board or any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Organization, either individually or collectively, is prohibited from providing information to any committee regarding compensation.

#### **Article VI** **Annual Statements**

Each director, principal officer and member of a committee with governing board delegated powers shall annually sign a statement which affirms such person:

- a.** Has received a copy of the conflicts of interest policy,
- b.** Has read and understands the policy,
- c.** Has agreed to comply with the policy, and
- d.** Understands the Organization is charitable and in order to maintain its federal tax exemption it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.

#### **Article VII** **Periodic Reviews**

To ensure the Organization operates in a manner consistent with charitable purposes and does not engage in activities that could jeopardize its tax-exempt status, periodic reviews shall be conducted. The periodic reviews shall, at a minimum, include the following subjects:

- a.** Whether compensation arrangements and benefits are reasonable, based on competent survey information, and the result of arm's length bargaining.
- b.** Whether partnerships, joint ventures, and arrangements with management organizations conform to the Organization's written policies, are properly recorded, reflect reasonable investment or payments for goods and services, further charitable purposes and do not result in inurement, impermissible private benefit or in an excess benefit transaction.

**Article VIII**  
**Use of Outside Experts**

When conducting the periodic reviews as provided for in Article VII, the Organization may, but need not, use outside advisors. If outside experts are used, their use shall not relieve the governing board of its responsibility for ensuring periodic reviews are conducted.

## **New York State Sample Conflict of Interest Policy**

\*Adapted from the IRS Sample Conflict of Interest Policy, this policy conforms with New York State's Not-for-Profit law, and imposes fewer requirements compared to the IRS policy. However, a policy closely aligned with the IRS policy is recommended for the greatest protection against excess benefit transactions.

### **Article I** **Purpose**

The purpose of the conflict of interest policy is to protect this tax-exempt organization's (Organization) interest when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the Organization or might result in a possible excess benefit transaction. This policy is intended to supplement but not replace any applicable state and federal laws governing conflict of interest applicable to nonprofit and charitable organizations.

### **Article II** **Definitions**

#### **1. Interested Person**

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#### **2. Financial Interest**

A person has a financial interest if the person has, directly or indirectly, through business, investment, or family:

- a. An ownership or investment interest in any entity with which the Organization has a transaction or arrangement,
- b. A compensation arrangement with the Organization or with any entity or individual with which the Organization has a transaction or arrangement, or
- c. A potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the Organization is negotiating a transaction or arrangement.

Compensation includes direct and indirect remuneration as well as gifts or favors that are not insubstantial.

A financial interest is not necessarily a conflict of interest. Under Article III, Section 2, a person who has a financial interest may have a conflict of interest only if the appropriate governing board or committee decides that a conflict of interest exists.

### **Article III** **Procedures**

#### **1. Duty to Disclose**

In connection with any actual or possible conflict of interest, an interested person shall disclose the existence of, or ensure that the directors or committee or members are aware of, the financial interest and be given the opportunity to disclose all material facts to the directors and members of committees with governing board delegated powers considering the proposed transaction or arrangement.

#### **2. Determining Whether a Conflict of Interest Exists**

After disclosure of the financial interest and all material facts, and after any discussion with the interested person, the board or committee members shall decide if a conflict of interest exists.

### **3. Procedures for Addressing the Conflict of Interest**

a. The governing board or committee shall determine whether the Organization can obtain with reasonable efforts a more advantageous transaction or arrangement from a person or entity that would not give rise to a conflict of interest.

b. An interested director may be present during the vote on the transaction, may be counted in determining the presence of a quorum, and may vote on the transaction of which he/she is an interested party.

c. If a more advantageous transaction or arrangement is not reasonably possible under circumstances not producing a conflict of interest, the governing board or committee shall determine by a majority vote whether the transaction or arrangement is in the Organization's best interest, for its own benefit, and whether it is fair and reasonable.

d. The transaction will be authorized if the governing board or committee authorizes the transaction by a vote sufficient without counting the vote of any interested party.

### **4. Violations of the Conflicts of Interest Policy**

a. If the governing board or committee has reasonable cause to believe a member has failed to disclose actual or possible conflicts of interest, it shall inform the member of the basis for such belief and afford the member an opportunity to explain the alleged failure to disclose.

b. If, after hearing the member's response and after making further investigation as warranted by the circumstances, the governing board or committee determines the member has failed to disclose an actual or possible conflict of interest, it shall take appropriate disciplinary and corrective action, including avoiding the contract or transaction under New York Not-for-Profit Corporation Law § 715(d).

## **Article IV** **Records of Proceedings**

The minutes of the governing board and all committees with board delegated powers shall contain:

a. The names of the persons who disclosed or otherwise were found to have a financial interest in connection with an actual or possible conflict of interest, the nature of the financial interest, any action taken to determine whether a conflict of interest was present, and the governing board's or committee's decision as to whether a conflict of interest in fact existed.

b. The names of the persons who were present for discussions and votes relating to the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection with the proceedings.

## **Article V** **Compensation**

Voting on compensation matters, direct and indirect, of those on the governing board inherently involve a conflict of interest. The procedure for such vote shall proceed under Article III.

## **Article VI** **Statements**

Each director, principal officer and member of a committee with governing board delegated powers shall sign a statement which affirms such person:

a. Has received a copy of the conflicts of interest policy,

b. Has read and understands the policy,

c. Has agreed to comply with the policy, and

d. Understands the Organization is charitable and in order to maintain its federal tax exemption it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.