



## **How to Avoid Conflicts of Interest**

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## How to Avoid Conflicts of Interest

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### Conflicts of Interest:

- Conflict of interest issues for a nonprofit not only include actual conflicts of interest, but the perception of conflicts of interest. Compensation of board members and staff and/or goods and services provided by either may comply with legal conflict of interest laws. However, it is the perception of the public that can greatly effect the nonprofit's success. Also, nonprofits are uniquely vulnerable to conflict of interest situations because of the use of volunteers seeking to help the organization.

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### IRS Rules on Conflicts of Interest:

- IRS rules require tax-exempt organizations to be organized and operated in a way that none of their earnings benefit any individual (private inurement). If private inurement occurs, nonprofits will be at risk of losing their tax-exempt status. The following are considered private inurement:
  - Unreasonable compensation.
  - Unreasonable fringe benefits.
  - Improper (personal) use of an organization's assets.
  - Forgiveness of debts owed by insiders.
  - Personal expenses being paid by the nonprofit.
  - Low-interest or unsecured loans to insiders.
  - Unreasonable housing allowances.
  - Purchases, sales or property rental between the nonprofit and insiders that are not arms-length fair market value transactions.
- IRS does not prohibit a nonprofit from transacting business with employees or board members, however, policies and procedures should be in place to ensure these transactions will not be considered unreasonable benefit (excise benefit).
  - Excise benefit is define as any transaction in which the nonprofit provides an economic benefit, directly or indirectly, to or for the use of any disqualified person. The economic benefit is a benefit that exceeds the value of what was received by the nonprofit in return for that benefit (typically the fair market value or the benefit).

- Disqualified persons, according to IRS, are those who are in a position to exercise substantial influence over the affairs of the nonprofit during a five year period ending on the date of the transaction. These include:
  - Presidents, executive directors and chief operating officers
  - Treasurers and chief financial officers
- An excise tax will be imposed on the individual receiving the excise benefit equal to 25% of each excess benefit transaction.
- IRS may also revoke the nonprofit's tax-exempt status based on the following four factors:
  - Repeated excess benefit transactions.
  - The size and scope of the excess benefit transactions.
  - Whether the organization had implemented safeguards to prevent future recurrences of similar transactions.
  - Whether the transaction complied with applicable laws.

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### **New Mexico's Rules on Conflicts of Interest:**

- New Mexico Attorney General statute on charitable organizations lists the specific actions board members should take to ensure their duty of loyalty is being fulfilled:
  - The interest of the nonprofit should always come before any other interest, including one's personal financial interests or those of their family members.
  - The governing body should establish a written conflict of interest policy. Procedures should also be established outlining how board members disclose any business dealings with the nonprofit.
  - If at all possible, the nonprofit should avoid transactions involving potential conflicts of interest and self-dealing situations.
- Duty of Loyalty to the Nonprofit
  - Most board members who serve on nonprofit boards have the intent to be loyal to the nonprofit; however the following situations can put a board member or employee in a place where their loyalty is split between two organizations. Below are examples of how a person may find themselves with a conflict of interest:
    - A board member is on the boards of two social service organizations. Both compete for United Way grants. The executive director of one of the nonprofits explains to the board member an innovated program that would make their nonprofit a good contender for a United Way grant. The board member accidentally mentions this idea to one of the board members of the other nonprofit.
    - One nonprofit loans an employee to another nonprofit. The employee is in a position where they are working for and should be loyal to one organization at the same time they are being paid by the other organization.

- A board member resigns and applies for the open executive director position. Her application could be perceived by the public or other staff as having an unfair advantage over other contenders.

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### **Conflict of Interest Policy:**

- Conflict of Interest Policy – Is the tool the nonprofit’s board of directors use to ensure private benefit transactions do not occur.
  - The policy and procedures should include:
    - When and how a person discloses a potential conflict of interest.
    - When, how and by whom the material facts are discussed.
    - The person who may have a conflict of interest should be excused before the decision about whether a conflict exists is made.
    - How and when the above process is documented.
  - Once the policy is in place, signed disclosures from directors, officers and key employees about actual or potential conflicts of interest should be obtained at time of election, appointment or being hired. The signed disclosure should include a declaration that the person has read, understood and intends to comply with the policy.
  - Signed disclosures should be obtained annually from all directors, officers and key employees. These annual disclosures should include a list of the nonprofit’s vendors, inquiring if the person completing the form has a financial interest or any of their family members have a financial interest in any vendors on the list. This will help to discover conflicts of interest that have not been previously disclosed.
- Conflict of Interest Policy should also address:
  - Compensation
    - Compensation includes salaries, benefits and housing allowances. It also includes not only taxable but non-taxable benefits.
    - Unreasonable compensation is when a board member or employee’s salary is greater than those in similar organizations of similar size under similar circumstances.
    - The nonprofit should have in place good compensation policies and procedures, which include how the nonprofit determines reasonable compensation.
    - To determine if you are paying reasonable compensation you must compare your nonprofit to other similar organizations. Your nonprofit and the organizations you compare to should have at least three of the items listed below in common:
      - Similar size – by budget, revenues, number of employees and/or persons served.
      - Same business type.

- Both compete for the position being evaluated out of the same pool of talent.
- Similar geography (urban vs. rural, size of area, cost of living).
- Manages similar amount of functions, departments, facilities, or entities.
- Has similar number of work time requirements (full time, part-time, etc.)
- The Board of directors should maintain appropriate oversight over compensation, reviewing key employees' compensation annually.
- Improper (personal) use of an organization's assets.
  - An organization's assets include, but are not limited to, the use of equipment, facilities and even mailing lists.
  - Example: The chief operating officer uses a company van to take his family to Disneyland.
- Personal expenses being paid by the nonprofit.
  - Example; The chief executive officer uses the nonprofit's credit card to purchase designer suits.
- Low-interest or unsecured loans to insiders and forgiveness of debts owed by insiders should be avoided.
  - Insider (board members, employees, etc.) loans are highly scrutinized by IRS. The form 990 requires disclosure of all such loans.
- Purchases, sales or rental of property and purchases or sales of goods or services between the nonprofit and insiders that are not arms-length fair market value transactions.
  - These are the hardest transactions to identify. As mentioned above, it is usually up to the person with a potential conflict of interest to disclose this conflict. Also, determining if a conflict does in fact exist can also be difficult. Some examples of these types of transactions are:
    - A board member may want to lease a building to the nonprofit.
    - A board member is a lawyer and the nonprofit wants to use these services for a fee.
    - A vendor who does landscaping for the nonprofit offers to landscape an employee's yard free of charge.
    - A nonprofit needs help to develop a website, but funds are limited. A board member arranges for her husband to provide this service to the nonprofit for a very low fee.
    - A key employee's daughter wants to sell medical insurance to the nonprofit and will receive a sizable commission if she is successful.
    - The executive director has her brother paint the nonprofit's facility because his schedule is free and can complete the job before the annual meeting.

- Reasonable profit from any of these transactions may not be considered private benefit, however IRS may not agree with the nonprofit what reasonable profit is. If any profit is made, a professional evaluation should be obtained.
  - Unless the benefit to the nonprofit is great, it is wise for the nonprofit to avoid any of the above or similar transactions because they could be perceived conflicts of interest by the public.
- Another conflict of interest trap nonprofits find themselves in is giving financial, tax or legal advice to a potential donor. It is imperative the nonprofit does not give this type of advice and if asked by the donor suggest they engage a professional.
- Private Foundations – IRS has rules against self-dealing for private foundations that are even more stringent than the excess benefit rules for other charities. It is very important, if you are associated with a private foundation, to engage a professional to assist you with these regulations.

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#### **Resources:**

IRS Phone Forum on Excess Compensation, 2006: [http://www.irs.gov/pub/irs-tege/phone\\_forum\\_5\\_2006.pdf](http://www.irs.gov/pub/irs-tege/phone_forum_5_2006.pdf)

Lang, Andrew S., Financial Responsibilities of Nonprofit Boards, Board Source, 2003.

New Mexico's statute on charitable organizations:  
<http://www.nmag.gov/office/Divisions/Civ/charity/statute.aspx>

New Mexico Guide for Board Members of Charitable Organizations:  
<http://www.nmag.gov/office/Divisions/Civ/charity/boardmembers.aspx>

Thompson & Thompson, "How to Avoid Six Conflicts of Interest in Your Nonprofit Organization":  
<http://www.t-tlaw.com/np-09.htm>

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#### **Sample Conflict of Interest Policies:**

AICPA Audit Committee Not-for-Profit Toolkit  
[http://www.cpa2biz.com/AST/Main/CPA2BIZ\\_Primary/FinancialManagement/Management/AuditCommittee/PRDOVR-PC-991004/PC-991004.jsp](http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/FinancialManagement/Management/AuditCommittee/PRDOVR-PC-991004/PC-991004.jsp)

Minnesota Sample of Conflict of Interest Policy:  
[http://www.smartgivers.org/model\\_documents.html](http://www.smartgivers.org/model_documents.html)

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**About the Author:**

Janice Moen has over 25 years of accounting experience, twelve years of which were as Chief Financial Officer or Chief Executive Officer of nonprofit agencies. Janice is currently the CFO of ARCA, a nonprofit providing service to individuals with developmental disabilities. Janice also has five years experience as an external auditor of governmental and nonprofit agencies. Janice received her BBA and Master in Accounting from the Anderson School of Management at the University of New Mexico. Janice was awarded the 2007 Outstanding Member in Corporate Practice Award by the New Mexico Society of CPA's in 2007. She was also recognized as one of the Business Weekly's Top CFO's in 2007. Janice is a member of the American Institute of CPA's and currently serves on the New Mexico Society of CPA's Course Selection Committee and the Anderson School of Management's Accounting Department Advisory Committee.



ARCA, working together to open doors for people with developmental disabilities to be valued members of the community. [www.arc-a.org](http://www.arc-a.org)

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