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Rules create a minefield for non-profits' related-party deals

TAXING MATTERS
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On July 1, the Non-Profit Revitalization Act takes effect in New York, establishing significant new reporting and compliance obligations for non-profits.

While these are rules of state law, they interact with the federal tax law in a number of important ways. In complying with the new New York rules, it is important for non-profits to take IRS rules into account.

The changes under the new non-profit law can be divided into two general categories: those that streamline the operation, administration and governance of non-profit entities and those designed to prevent abuses.

It is the second category of changes that overlaps with IRS rules, particularly the extensive new rules relating to transactions between non-profits and related parties such as their directors, trustees, officers and certain employees.

Historically, the New York attorney general has had plenary authority to act on behalf of the people to ensure that the assets of a non-profit are used to further its mission. However, New York law has not had any specific procedural requirements with respect to how non-profits interact with related parties. For example, if a New York charity were to buy a headquarters building from a trustee, the old state law required that the transaction be fair but didn't have much to say about the process used to approve the deal.

The new act adds such rules to New York law for the first time. Federal tax law, however, has long contained detailed rules for related-party transactions. Unfortunately, New York State's new rules differ from the tax rules in a number of important respects, presenting significant traps for the unwary. It is important that non-profits not lose sight of the federal tax law in complying with the new state rules.

There are two important requirements under federal tax law to note. First, the so-called "excess benefit" rules, which apply to transactions between charities and related persons such as trustees, require that all such transactions be at fair market value.

While this may sound simple, the IRS rules apply to a different set of transactions than the new state law. Careful legal analysis is required to determine whether one or both regimes apply. As a matter of best practice, it makes sense to assume that both sets of rules apply to all transactions.

In addition, the two sets of rules contain different requirements for how related-party transactions must be approved.

The IRS rules contain a safe harbor which presumes that a transaction is fair if it was properly approved by disinterested board members after considering data about similar deals. In the example involving the trustee selling a building to the non-profit, the purchasing organization would need to obtain an appraisal with comparables and the trustee could not participate in consideration of the transaction.

New York does not offer a safe harbor, and a transaction can be questioned even if all of the applicable requirements are followed.

In addition, following the federal safe harbor procedures is not enough under New York law. To comply with state law, no trustee who has any business relationship with the corporation can participate in consideration of the sale. This includes any trustees who are employees of the corporation, are employed by companies that do significant business with the corporation, or have relatives in these categories.

Under these rules, it is not enough in our example for the selling trustee to recuse himself from the transaction. If the executive director of the organization sits on the board, she would have to recuse herself, as would a trustee whose great-grandson is married to an officer of the local utility, to which the charity pays large electric bills. In addition, the non-profit is required to consider alternative transactions, which is not required by the tax law.

Another key area of overlap is the "self-dealing" rules applicable to grant-making foundations.

These rules contain many specific and often counterintuitive prohibitions on transactions between the foundation and related persons, including transactions that would benefit the foundation.

For example, these rules would prohibit the organization in our example from buying the building from the trustee, even at or below fair market value, regardless of the procedures that are followed. (The trustee would be allowed to donate the building.) Just because a transaction is allowed under New York law doesn't mean the tax rules allow it.

The revised New York law requires that non-profits have a policy about transactions with interested persons that complies with the above rules. The IRS doesn't require a policy of this kind, but it has promulgated a model policy that many non-profits adopt and which contains rules that are different from the New York requirements.

It's not entirely clear whether the IRS model policy is enough to satisfy New York. There is a grandfather clause that may or may not apply. Organizations will need to consider whether to update their policies to reflect the law change.

While protecting against abuses in transactions with related parties may seem like a matter of common sense, there are many very specific regulations, both under federal tax rules and under the new state law. Unfortunately, these requirements are not always consistent with each other, presenting many opportunities for inadvertent missteps. Non-profits should establish policies that comply with both sets of rules and be sure to abide by these policies in any transactions with their directors, officers, trustees or key employees.

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