Is your church guilty of a conflict of interest?

By Vonna Laue and Christine Abrams

Does your church participate in any conflicts of interest? Do you know what a conflict of interest really is? What are the results to the church if there are conflicts of interest? These questions should be carefully considered.

In 2004 the Internal Revenue Service (IRS) determined excess benefit transactions had taken place between a church and its pastor, his spouse, his two sons and a son-in-law. Expense items on the church's books lacked documentation and were therefore considered taxable income by the IRS. The church had not treated them as such.

The specific expenses included personal use of cell phones, church vehicles, a church owned house (not a parsonage) and church credit cards. Because of the lack of documentation to show business use, the IRS claimed personal use. Along with the requirement to reimburse the church for the personal expenditures, the IRS assessed the statutory penalty of 200 percent of the excess benefit because the transactions were not corrected during the taxable period.

Various scenarios abound

We have seen various scenarios of individuals making no-interest loans to relatives or friends or granting funds to organizations run by relatives with no accountability. While most of these have not resulted in jail time or large penalties, it doesn't make it right. It also doesn't mean that they won't be required to give account of their actions at some time.

A conflict of interest exists when a church employee or board member has a personal interest in a transaction with the church that would be in direct competition with the interests of the church. Examples include a church loan to a pastor or a church hiring the contracting services of a board member. Not all transactions with someone considered to be an "insider" are conflicts of interest.

A related party transaction is similar in nature but has several key differences. A party transaction is approved by the governing board with the interested party abstaining from any related votes, as well as discussion, except to provide relevant information.

Also, if the transaction is in the best interest of the church and is supported by competitive bid information it is a party transaction.

A party transaction is fully disclosed in any appropriate places such as the footnotes to audited financial statements. Related party transactions are acceptable and they may serve the interests of the church. If the church is able to secure services at a discount because of a relationship within the church, it makes sense to do that. Just make sure that the related party criteria are well documented.

If a church has conflicts of interest there can be serious consequences. The IRS is allowed by legislation to impose significant penalties on any nonprofit organizations, including churches, which provide excess benefits to "insiders." An excess benefit is when the insider receives more than the fair value of the benefit he provided to the church, or when taxable compensation goes unreported.

Insiders exercise substantial influence

An insider, also known as a disqualified person, is defined as any individual who is in a position to exercise substantial influence over the affairs of the organization. The term also includes family members of a disqualified person and entities that are more than 35 percent controlled by disqualified persons. The term also includes board members who have served in the last five years, and their families.

If the IRS determines that such a transaction has occurred, aside from the requirement that the excess benefit amount be repaid, the penalties start at 25 percent of the excess benefit for the individual. Additional penalties may be assessed upon individuals in leadership and on the governing board who approved the transaction. If the excess benefit amount is not repaid within the taxable period, the penalties can become even larger.

Another potential consequence is the loss of trust by the congregation. Churches are primarily dependent on the tithes and offerings of those who attend the church services. Imagine the damage that could be done by a single bad decision. In the example given earlier, a board member's contracting company was building a new addition. If that contract is not run through the grid of a related party transaction, there could be serious fallout.

The church may have approved the contract originally because they thought it was a good deal. However, if it wasn't properly researched, approved and documented people may quickly decide that their contributions to the building campaign were misspent.

This happens all too often in the church community and often becomes front page news. Conflicts of interest are not difficult to avoid. Here are some detailed tips to help you with the process:

1. Review any potential conflicts of interest that currently exist. Don't just implement this on the go-forward and hope that everything will be okay. Determine that any existing transactions and commitments with related parties are in the best interest of the church and are board approved.

2. Implement a formal conflict of interest policy and annual questionnaire. Sample policies abound and can be found for free at places like ecfa.com. Completing the questionnaire annually is a simple reminder to current and potential leaders (governing board members, pastors, etc.) of any relationships that might be considered a conflict of interest.

It shouldn't be considered a negative reflection on the individual if there is a transaction to disclose. It is more of a protection for them and the church from any perceived wrongdoing in the future. This can be a very simple process that is quickly completed before a board meeting or at a staff meeting.

3. Develop and maintain a list of disqualified persons that accounting reviews periodically to monitor financial transactions that may be considered conflicts of interest. The accounting department sees all financial transactions that take place and while they may find questionable transactions after the fact, it's better than not at all.

4. If you don't want it made public, you should consider not doing it! Always make sure you are comfortable that the transaction is in the best interest of the church, is acceptable to the IRS and any other applicable laws and is a good use of the contributions entrusted to your church.

Conflicts of interest can happen without malicious intent. We encourage you to review the steps in this article and make sure that your church is careful that all transactions are appropriate and above reproach. Take advantage of the "good deal" — just be sure it really is.

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