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Nonprofit Loans: Reasonable or Not?

The practice of public charities making loans to their officers and directors has come under increased national scrutiny following a recent investigative report in The Chronicle of Philanthropy. Although federal and Minnesota laws allow public charities to make loans to their top officials, some industry observers question the appropriateness of the practice.

The Chronicle reviewed data on 10,700 tax returns filed by groups that indicated they had outstanding debt with their officers or directors. Through that review, the newspaper reported in its Feb. 5, 2004, issue that it had identified 2,278 nonprofit groups - including 17 in Minnesota - that made loans totaling at least $10,000 to officers, directors or key employees from 1998 through 2001. It also identified another 2,278 organizations - including 11 in Minnesota - that reported being owed at least $10,000 by their officers, directors or key employees but did not include sufficient information on their tax forms to determine whether the debts are the result of loans.

One of the Minnesota organizations mentioned in The Chronicle article that has raised the most eyebrows is the Malecha Family Foundation, which is not a private foundation but a supporting organization of other organizations. The Chronicle reported that during its first two years of operation, the nonprofit issued an $800,000 loan to the organization's founder and trustee while giving just $15,000 to the public charity that it was set up to support.

Federal self-dealing laws ban private foundations from making any kind of loan to "disqualified persons," who are defined as a foundation's officers, directors, trustees, key employees, substantial contributors, their family members and certain entities related to these individuals. There can be substantial penalties for a disqualified person who borrows from a private foundation and for a foundation manager who knowingly approves such a loan.

Public charities, on the other hand, are not barred by federal law from making loans to their directors or officers. However, 20 states have passed laws banning loans by nonprofit corporations to their directors or officers, and seven additional states - including Minnesota - have laws that place limits on such loans. In Minnesota, a nonprofit's board of directors must approve any loans that it makes to directors, officers and employees, and the board must determine that the loan may reasonably be expected to benefit the organization.

Hazen Graves, an attorney with Faegre & Benson LLP in Minneapolis, notes that a loan made by a nonprofit is not inherently inappropriate or unethical. "You really have to look at the specifics of each organization and each loan," he says.

One of the ways in which public charities can run into trouble in this area, according to Graves, is under Section 4958 of the Internal Revenue Code - known as "intermediate sanctions." This section provides for a penalty tax imposed directly on individuals who "exercise substantial influence" over a charity and who receive excessive benefit - such as excessive compensation - from the organization. Graves notes that if a nonprofit provides a low- or no-interest loan to a "disqualified person," the loan could potentially be viewed under IRC 4958 as an "excess benefit transaction," which is any transaction in which the value of the economic benefit to a disqualified person exceeds the value of what the person provided in order to receive the benefit.

The definition of "disqualified persons" for public charities under the intermediate sanctions rules

is broader than the one used for private foundations under the self-dealing rules, and includes most of the persons identified for private foundations as well as a more general category for any person who, at any time during the last five years, was in a position to exercise substantial influence over the affairs of the organization.

The most significant part of the intermediate sanctions rules, according to Graves, is that they include a "rebuttable presumption of reasonableness" procedure, where any nonprofit transaction involving a disqualified person - including a loan - is presumed to be reasonable, and the burden shifts to the IRS to prove that it is not reasonable. But the rebuttable presumption can only be applied if a loan is approved by an independent board or committee; if comparative data is used to ensure that that terms of the loan are reasonable, such as by comparing the terms of the loan with those of similar loans made by comparable nonprofits or a bank; and that the decision is documented adequately.

Even if a public charity gave a loan with a below-market interest rate to a disqualified person, it could be considered reasonable in some instances, according to Graves - if it is part of a compensation package to recruit a key employee, for example. "The intermediate sanctions rules even talk about this situation," says Graves. "You need to calculate the value of the loan discount, combine it with the other compensation being offered to the employee, and ask if the total compensation package is reasonable."

However, if a nonprofit loan can be considered reasonable in terms of its total compensation value, Graves notes that there are other important factors for a nonprofit to consider to determine if a loan is a prudent decision, including:

- Risk: Would the organization take on too much financial risk by making the loan?
- Diversification: Would the organization put the diversification of its assets at risk by making the loan?
- Opportunity Costs: How else could the organization spend the money that would go toward the loan? This is a particularly critical consideration for smaller nonprofits, says Graves.

A report released last fall by Independent Sector, a national coalition of charities and foundations, and BoardSource strongly recommends that nonprofit organizations do not provide personal loans to their directors or executives. This is one of the governance practices that the report encourages them to adopt voluntarily in order to address provisions in the American Competitiveness and Corporate Accountability Act of 2002 (known as the Sarbanes-Oxley Act), which applies primarily to publicly traded companies. The Act generally prohibits a company from making loans to any of its directors or executives.

If a nonprofit decides to make a loan, the report recommends that the loan be formally approved by the board, the process for providing the loan be documented, and the value and terms of the loan be fully disclosed. To guide the board and staff in independent decision-making, the report also states that an organization must have a conflict of interest policy with disclosure and that the policy must be enforced "without fail."

"Generally it's not a good idea for a nonprofit organization to be using its money to make loans to employees," said Diana Aviv, president and CEO of Independent Sector. "In addition to the difficulty of risk assessment and the opportunity cost, it can lead to a conflict of interest because it makes it more complicated to fire or discipline a non-performing employee who owes you money."

Aviv added that there may be rare occasions where it makes sense for a nonprofit to make a loan,

such as to help with housing as part of a recruitment package. "In those situations, it's critical for the board to be involved in comparing the package to other similar organizations and determining what's reasonable."

Rich Cowles, executive director of the Charities Review Council of Minnesota, a St. Paul-based charity watchdog group, says that just because the law allows a nonprofit to make loans to its officers and directors, that doesn't mean it should. "Public trust is paramount," he says. "You have to consider how things appear, not just whether it's within the law."

"The law is the minimum level of performance for an organization," adds Bill King, president of the Minnesota Council on Foundations. "When you're determining appropriate behavior for an organization, ethics rise above the law in doing what's right."

Before a nonprofit decides to make a loan, Cowles suggests that it ask itself the following question: "If this loan made the front page of the paper, would you be comfortable with it?"

More Information

- "Assets on Loan," The Chronicle of Philanthropy, 2/5/04.
- "Rebuttable Presumption Procedure Is Key to Easy Intermediate Sanctions Compliance," U.S. Treasury Department (PDF, 6 pages).
  This article explains the "rebuttable presumption of reasonableness" procedure in the intermediate sanctions rules.
- "Steering Clear of IRS 'Intermediate Sanctions' Violations," Faegre & Benson LLP: Written by Bruce A. Johnson, Esq., this article offers tax-exempt organizations a pragmatic approach to compliance with the intermediate sanctions rules.

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