PART FOUR – DISCUSSION OF IRS REPORTING REQUIREMENTS

The Staff reviewed TNC's Forms 990 for fiscal years 1993 through 2003 (form years 1992 through 2002).[1] This part of the report summarizes the general reporting requirements for each part of the 990 and then describes TNC's reporting with respect to such requirements. Any changes in reporting made by TNC with respect to its Form 990 for the fiscal year ended June 30, 2003 are described separately, to show any reporting changes made after commencement of the investigation.

The Staff also reviewed Forms 990-T for fiscal years 1999 through 2003 (form years 1998 through 2002). A summary of the Staff's review of these forms also follows.

I. Form 990

a. Part I – Revenue, Expenses, and Changes in Net Assets

In Part I, organizations are required to list their sources of revenues, provide a summary of their expenses listed in Part II and report and explain any other changes in net assets.

1. Revenues

TNC reported $3.7 billion of contributions and grants, and total revenues of $6.1 billion for fiscal years 1993 through 2003. Contributions and grants represented 61 percent of aggregate total revenues during this period. TNC's program service revenue comprised 27 percent of total revenues during this period, and its investment income (interest, dividends, and gain from sales of investments) totaled 11 percent of total revenues. Annual revenues by category are listed in the following table.

[1] TNC's fiscal year begins on July 1. Fiscal years 1993 through 2003 include years ended June 30, 1993 through June 30, 2003. A fiscal year is referenced by the year in which it ends, e.g. FY03 references the year beginning July 1, 2002 and ending June 30, 2003. However, the fiscal year does not correspond with the Form 990 year, e.g. FY03 is reported on Form 990 for 1992.

Table 10, Summary of Revenues
TNC Fiscal Years 1993 through 2003
(in millions of dollars)

Form 990 Year	Contributions and grants (Form 990, Line 1d)	Program service revenue (Form 990, Line 2)	Interest and dividend income (Form 990, Line 4)	Net gain or loss from sale of investments (Form 990, Line 8d)	Gross profit from sales of inventory (Form 990, Line 10c)	Other sources of revenue	Total revenues
2002	480.3	272.3	3.7	0.7	1.0	3.7	761.7
2001	628.3	315.1	1.8	19.0	-0.4	8.6	972.4
2000	461.0	183.9	2.3	75.2	-0.9	10.4	731.9
1999	445.3	163.9	13.1	151.6	-1.5	11.9	784.3
1998	403.5	153.9	9.2	130.7	-0.9	7.6	704.0
1997	289.8	107.6	10.4	78.5	-0.1	7.6	493.8
1996	235.1	104.5	15.5	58.7	-0.4	8.0	421.4
1995	203.9	86.3	13.3	26.9	0.0	7.1	337.5
1994	237.5	55.6	9.8	12.1	-0.4	7.0	321.6
1993	200.3	83.9	9.2	12.9	0.0	0.4	306.7
1992	164.0	91.6	10.5	12.1	0.0	0.3	278.5
Totals	**3749.0**	**1618.6**	**98.8**	**578.4**	**-3.6**	**72.6**	**6113.8**
Totals as % of cumulative total revenues	**61.3%**	**26.5%**	**1.6%**	**9.5%**	**0.0%**	**1.1%**	**100.0%**

b. Part II – Statement of Functional Expenses

In Part II, organizations are required to list all of their expenses and provide an allocation of these expenses among Program Service (related to exempt purpose), Management and General, and Fundraising.

TNC's total expenses for fiscal years 1993 through 2003 totaled $3.8 billion (see Table 2, below). TNC's total fundraising expenses for the period were $420 million, which represents approximately 11 percent of TNC's total revenues from contributions and grants during the same period. TNC's program services expenses and management and general expenses increased at a faster rate than its fundraising expenses. The following table provides a breakdown of TNC's expenses for its fiscal years 1993 through 2003.

Table 11, Summary of Functional Expenses – Form 990, Part II
TNC Fiscal Years 1993 through 2003
(millions of dollars)

Form 990 Year	Program services expenses	Management and general expenses	Fundraising expenses	Total expenses	Fundraising as % of contributions and grants[2]
2002	453.0	63.6	52.9	569.5	11.0%
2001	520.7	57.7	54.1	632.5	8.6%
2000	334.6	50.5	48.7	433.8	10.6%
1999	306.9	40.2	45.7	392.8	10.3%
1998	285.0	33.5	40.9	359.4	10.1%
1997	211.0	29.8	33.5	274.3	11.6%
1996	181.0	25.7	34.2	240.9	14.5%
1995	180.3	24.9	30.8	236.0	15.1%
1994	169.1	21.7	28.6	219.4	12.0%
1993	185.5	18.3	25.8	229.6	12.9%
1992	177.7	16.9	24.8	219.4	15.1%
Totals	**3004.8**	**382.8**	**420.0**	**3807.6**	**11.2%**

c. Part III - Statement of program services accomplishments

Part III requires the organization to state its primary exempt purpose, and, with respect to its four largest program services (as measured by total expenses incurred), to "describe [its] exempt purpose achievements in a clear and concise manner. State the number of clients served, publications issued, etc. Discuss achievements that are not measurable." The instructions direct the organization to (a) describe program services accomplishments through measurements, (b) describe the activity's objective, for both this time period and the longer-term goal, if the output is intangible, (c) give reasonable estimates for any statistical information if exact figures are not readily available and indicate this information is estimated, and (d) be clear, concise, and complete in your description, and avoid adding an attachment. Section 501(c)(3) organizations are also required to provide the amount of grants and allocations to others, and the amount of program services expenses, for each listed program services accomplishment. Part III also requires the organization to attach a schedule that lists the organization's other program services, without most of the detailed information required for the organization's four largest program services.

<u>*Observations*</u>

TNC reported the following in its Form 990 (2001), Statement 10, as its response to the required statement of program services accomplishments:

[2] Contributions used for the denominator are derived from Table 10 above.

"Conservation Activities and Actions. Expenditures related to the broad spectrum of activities and actions critical to advancing The Conservancy's ecoregion-based approach to conservation. Expenditures related to understanding, monitoring, maintaining, restoring and managing natural areas owned by the Conservancy and others are included, as are expenditures for developing and enhancing The Conservancy's ability to gather and share ecological information and to assess and evaluate threats to the elements of natural diversity within ecoregions in which The Conservancy works. In addition, this area includes expenditures necessary for developing and implementing ecoregion-based plans and strategies to mitigate, prevent, or slow the effects of threats to the elements of biodiversity, including investments in the institutional development of domestic and international conservation organizations. Also [this section] includes expenditures related to introducing, educating, and informing members and the public at large about the mission of the Conservancy and the issues, progress and performance it has made in reaching its strategic objectives."[3]

TNC reported program expenses for this category of $486,212,309, and program grants of $34,472,290, for a total of program grants and expenses of $520,684,599 for the 2001 fiscal year. The total of grants and expenses equaled the total program services expense reported on line 13, page 1, of TNC's Form 990.

Earlier TNC's Form 990 filings had contained more categories regarding this reporting requirement. TNC's Forms 990 for its 1992 and 1993 fiscal years contained information regarding six categories: biological information management; conservation planning and implementation; stewardship, conservation, science and biological management; communications and outreach; training and support conservation partners; and government and multilateral programs. The number of categories was reduced to four for the 1994 through 1995 Forms 990 (stewardship, conservation science and biological information management; conservation planning and implementation; communications and outreach; and government/multilateral programs), and to three for the 1996 Form 990 (conservation activities and actions; communication and outreach; and government/multilateral programs). As stated above, TNC reduced the number of categories to two in 1997, and to one in 2001.

TNC took the position that TNC had only one program service - conservation activities and actions - to which all of TNC's program service expenses related. By 2001, TNC made no distinctions among expenses incurred for any of its numerous and various conservation programs conducted throughout the world.

When TNC reported multiple categories of program services, it did not provide any detail regarding its accomplishments. No actual or estimated statistics regarding the number of persons benefited or served, habitat protected, or acres preserved, were provided in any of the Forms 990 filed by TNC with respect to 1992 through 2001. TNC's reporting described general categories of expenses that generally would not assist a reader in understanding what TNC had accomplished through its program service activities.

[3] An identical description was included in TNC's Forms 990 for 1997 through 2000, except that TNC described the activities contained in the last sentence as "Communication and Outreach," and separately listed program expenses and program grants for that category. Statements 10, TNC's Form 990 (1997 through 2000) *see* Appendix L.

Part III of the current Form 990 asks the organization to be "clear, concise, and complete in your description. Avoid adding an attachment." The Staff recognizes that this instruction may place organizations in the position of discerning whether to be expansive and complete in the description of their activities, and at the same time avoid lengthy descriptions and attachments that would give the IRS and public a complete picture of an organization's activities. Staff encourages the IRS to consider the implications of the restriction on attachments and make appropriate changes to the form that will give organizations clear guidance consistent with the principal that the Form 990 serve as a valuable source of information for the public, state and local governments, and the IRS.

2002 Form 990

TNC's description of its program service accomplishments for that period was 18 pages in length, and included a narrative on mission, strategy, values and highlights of 2003 accomplishments (including a description of 16 specific projects), and a message from the organization's President. TNC did not provide the required information regarding its four largest program services, however.

d. Part VI – Other Information

Part VI requires an organization to answer questions on various topics including whether it had any material changes to its activities.

1. Reporting changes in activities

Item 76 of Part VI of the Form 990 asks the organization "Did the organization engage in any activity not previously reported to the Internal Revenue Service? If 'Yes,' attach a detailed description of each activity." The instructions require the organization to attach a statement to explain any significant changes in the kind of activities the organization conducts to further its exempt purpose, and to include new or modified activities not listed as current or planned in the organization's application for recognition of exemption, or not yet reported to the IRS by a letter or by an attachment to the organization's return for any earlier year.[4]

The IRS may revoke an organization's 501(c)(3) status if there are substantial changes in the organization's character, purposes, or methods of operation.[5] In addition, an IRS ruling or determination letter recognizing exemption may not be relied upon if there is a material change inconsistent with exemption in the character, the purpose, or the method of operation of the organization.[6]

Observations

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[4] Instructions to IRS Form 990 (2003), p. 28.

[5] Treasury Regulation section 1.501(a)-1(a)(2).

[6] Treasury Regulation section 601.201(n)(3)(ii).

For its Forms 990 filed for fiscal years 1992 through 2000, TNC responded that it did not engage in any activity not previously reported to the IRS. TNC did not respond to the question in its Form 990 for its fiscal year 2001. TNC did not submit to the IRS any letters reporting a material change in its activities, or describing an activity not previously reported to the IRS, during the period 1992 through 2001.[7]

During fiscal years 1993 through 2002, TNC commenced several new activities that it had not previously reported to the IRS, and that were significant in terms of level of expenditure, investment, resources to be committed to the activity, innovative methods and strategies, or reputational risk to TNC. Some examples include the Virginia Eastern Shore Development project, the emissions arrangements, and the Conservation Beef program. Each of these activities involved new or innovative strategies or methods that were unlike TNC's activities that TNC previously had reported to the IRS.

2002 Form 990

For its Form 990 filed for the fiscal year ended June 30, 2003, TNC responded "No" to the questions asking whether it had engaged in any activity not previously reported to the IRS, or made changes to its organizing or governing documents that were not reported to the IRS.

2. Reporting its relation to other organizations

Part VI, line 80, requires that the organization provide certain information regarding its relation to other organizations. The exempt organization is required to state whether it is related (other than by association with a statewide or nationwide organization) through common membership, governing bodies, trustees, officers, etc., to any other exempt or non-exempt organization, and if so, provide the name of the related organization and state whether it is exempt or non-exempt. The instructions state the organization is to answer "Yes" if "most (more than 50 %) of the organization's governing body, officers, directors, trustees, or membership are also officers, directors, trustees, or members of any other organization." The organization is to disregard any coincidental overlap of membership with another organization; that is, when membership in one organization is not a condition of membership in another organization.

Observations

TNC responded "Yes" to this question for each of its Forms 990 for fiscal years 1992 through 2001, and identified the following organizations as related for this purpose:

Nature Conservancy Action Fund (exempt)[8] - 1992 through 2001

Sumner T. McKnight Foundation (exempt) - 1993

STM/TNC LLC (non-exempt) - 1994 through 2001[9]

[7] TNC Narrative Response, dated November 23, 2004, *see* Appendix L.

[8] The Nature Conservancy Action Fund is TNC's lobbying affiliate that is exempt under section 501(c)(4).

Adirondack Land Trust (exempt)[10] - 1994 through 2001

VES[11] Sustainable Development Co. (non-exempt) - 1995 through 1999 (ceased operations in 1999)

Northway Corp. (non-exempt) - 1995 through 2001 (dissolved on January 16, 2003)

Dog Island Co. (non-exempt) - 1995 through 1996

Yayasan Pusaka Alam Nusantara (exempt)[12] - 1995 through 1997 (TNC withdrew in 1997)

Sustainable Forest Resources of PNG (non-exempt) - 1997 through 2001[13]

Montark, Inc. (non-exempt) - 1997 through 2001

Lake George Basin Land Trust[14] (exempt) - 1997 through 2001

Lost Island Club Corp. (non-exempt) - 1998 through 1999, 2001 (dissolved in 2001)[15]

TNC San Rafael Ranch Inc. (non-exempt)[16] - 1998 through 2001

TNC do Brasil (non-exempt) - 1998 through 2001

Clear Lake Club Corp. (exempt) - 1998 through 1999, 2001 (dissolved in 2001)[17]

PK Ranch Co. (renamed Soldier Creek Preserve, Inc.) (non-exempt) - 1999 through 2001

Delta Island Reclamation District (exempt)[18] - 1999 through 2001

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[9] TNC did not state whether this organization was exempt or non-exempt in its 1994 Form 990.

[10] Adirondack Land Trust is exempt under section 501(c)(3). TNC did not state whether this organization was exempt or nonexempt in its 1994 Form 990.

[11] "VES" stands for Virginia Eastern Shore.

[12] This organization was an Indonesian nonprofit entity.

[13] This is a limited liability company of which TNC is the sole member (i.e., is a disregarded entity of TNC); TNC reports that it has never operated and has no assets, liability, or equity.

[14] Legal name is Lake George Land Conservancy, Inc. It is exempt under section 501(c)(3).

[15] Lost Island Club Corp. was not listed in the Form 990 for 2000.

[16] Reported as a section 501(c)(2) organization beginning in 2000.

[17] Clear Lake Club Corp. was not listed in the Form 990 for 2000. TNC filed no returns for it for 1998 or 1999, due to no activity, and a corporate tax return for it for 2000.

Albany Pine Bush Commission (exempt)[19] - 1999 through 2001

Eastern Shore Enterprises LLC (non-exempt) - 2000 through 2001 (ceased operations in 2002)

Forest Bank LLC (non-exempt) - 2000 (dissolved November 2002)

Conservation Beef LLC (non-exempt) - 2000 (TNC withdrew from the LLC on February 19, 2004)

R & P Anderson Enterprises Ltd Partnership (non-exempt) - 2000[20]

Association for Biodiversity Information (NatureServe) (exempt)[21] - 2000 through 2001

Wilton Wildlife Preserve & Park (exempt)[22] - 2000

Fundacion The Nature Conservancy of Panama (exempt) - 2000

TNC did include Lost Island Club Corp. and Clear Lake Club Corp. in its Form 990 for fiscal year 2000, and Forest Bank LLC, Conservation Beef LLC, Fundacion The Nature Conservancy of Panama, and Wilton Wildlife Preserve & Park, in its Form 990 for fiscal year 2001. One organization, Sustainable Forest Resources of PNG, should have been reported as a disregarded entity on Part IX of Form 990, because TNC was the sole member of this limited liability company. Clear Lake Club Corp. should not have been listed as exempt because, although it was a nonprofit, it was regarded by TNC as a taxable corporation and filed corporate tax returns. TNC Yayasan Pusaka Alam Nusantara should not have been reported as exempt for 1995 through 1997, because it was not exempt for United States Federal tax purposes.

2002 Form 990

In its Form 990 for the fiscal year ended June 30, 2003, TNC reported eight new related organizations: Bear Mountain Lodge, Inc. (non-exempt), Conservation Farms & Ranches - Merced (non-exempt); P T Putri Naga Komodo, LLC (non-exempt); Conservation Farms & Ranches (Staten Island, CA) (501(c)(3)); Invasive Plant Council of NY State (501(c)(3)); The Nature Conservancy Limited (Australia) (exempt); The Nature Conservancy of Japan (exempt); and The Nature Conservancy of Venezuela (exempt). TNC continued to report the following as non-exempt related organizations: Conservation Beef, LLC; Eastern Shore Enterprises, LLC;

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[18] This is a California Special District.

[19] This is a New York State public benefit corporation.

[20] TNC owns less than 2 percent of this financial investment limited partnership, an interest it received as a gift. TNC no longer reports this as a related organization.

[21] This is a section 501(c)(3) organization.

[22] Described as section 501(c)(3), recognized as exempt in 2001.

Forest Bank LLC; Montark, Inc.; Northway Corporation; Soldier Creek Preserve, Inc.; and Sustainable Forest Resources of PNG. TNC continued to report the following organizations as related and exempt: Adirondack Land Trust (501(c)(3)); Albany Pine Bush Commission; Fundacion The Nature Conservancy of Panama; Lake George Basin Land Conservancy, Inc. (501(c)(3)); The Nature Conservancy Action Fund (501(c)(4)); The Nature Conservancy San Rafael Ranch Inc. (501(c)(2)); and Wilton Wildlife Preserve & Park (501(c)(3)). TNC also reported The Nature Conservancy do Brasil as exempt in 2002 (rather than as non-exempt, as reported in earlier years).

In addition, TNC reinstituted its reporting practice of including 19 separate title holding corporations in TNC's Form 990 on a consolidated basis, and listed each of the 19 organizations as a related exempt organization.

e. Part VII - Analysis of income-producing activities

Part VII of Form 990 requires the exempt organization to provide an analysis of its income-producing activities. The analysis requires the organization to list its different types of revenue, and then identify whether the revenue constitutes unrelated business income, income excluded from unrelated business income by sections 512 through 514, or related or exempt function income. For this purpose, related or exempt function income means "any revenue from activities related to the organization's exempt purpose; (i.e., income received from activities that form the basis of the organization's exemption from taxation)."

Observations

TNC reported program service revenue of over $1.6 billion for fiscal years 1993 through 2003. Of this amount, approximately 58 percent was from sales of property to governments, and 28 percent was from fees and contracts from government agencies, for a total of 86 percent of program service revenue derived from activities involving Federal, State and local governments. Activity fees accounted for approximately 12 percent of total program service revenue for this period. A breakdown of TNC's types of program service revenue for its fiscal years 1993 through 2003 is contained in the following table.

Table 12, Types of Program Service Revenue, TNC Fiscal Years 1993 through 2003 (millions of dollars)

Form 990 Year	Activity fees	Contract fees[23]	Government sales	Sale of trade lands[24]	Fees and contracts from govt. agencies	Royalty income[25]	Total program service revenues
2002	22.3	4.7	172.6	0	72.8	0	272.4
2001	23.3	2.5	181.9	2.8	104.6	0	315.1
2000	35.8	2.0	83.0	0	63.1	0	183.9
1999	18.2	3.6	81.9	0	60.1	0	163.8
1998	25.4	1.4	78.6	0	48.5	0	153.9
1997	14.1	2.3	57.7	0	33.5	0	107.6
1996	17.8	1.7	44.5	0	40.5	0	104.5
1995	12.7	2.4	37.9	0	33.3	0	86.3
1994	7.9	1.7	45.9	0	Data NA	0	55.5
1993	8.7	1.4	70.0	0	Data NA	3.8[26]	83.9
1992	12.0	0.9	76.3	0	Data NA	2.4	91.6
Total amounts for 1992 to 2002	198.2	24.6	930.3	2.8	456.4	6.2	1618.5
Totals as % of total program service revenue	12.2%	1.5%	57.5%	0.2%	28.2%	0.4%	100.0%

TNC's Form 990 reporting did not describe the nature of the activities from which these revenues were derived. TNC provided an "Analysis of Income-Producing Activities" schedule, and the following descriptions of these activities.[27] Activity fees consist of mitigation, multi-

[23] For certain years, also includes "preserve fees."

[24] TNC did not report trade land sales as program service revenue in years other than 2001. TNC averaged $8 to $10 million of gross sales from trade lands during this period. For years other than 2001, TNC reported trade lands revenue as "gains and losses from the sales of assets other than inventory" (Form 990, Part I, line 8a).

[25] After 1993, TNC reported royalties as income excludable from unrelated business income rather than as program service revenue.

[26] Includes both lease fees (e.g., grazing rights) and royalty fees.

[27] TNC Narrative Response, dated April 5, 2004, *see* Appendix L.

lateral development bank grant, fee-option assignment, hotel and lodging (excluding UBIT lodging), speaking/lecture fees, fee-meeting/field trip, data base user fee, and rent (excluding UBIT rent). Fees and contracts from government agencies included Federal government grants and overhead, and State and local grants and overhead. TNC provided no further information regarding contract fees.

In the December 2004 response, TNC stated that its "Analysis of Income-Producing Activities" schedule (previously provided in April 2004) includes the total amounts derived from a list of specific accounts in TNC's general ledger financial system. [28] TNC attached an excerpt from its Chart of Accounts to more fully describe the nature of the revenue items included in each category. The full description is provided in Appendix L. The excerpt generally describes the items as follows:

Federal government grants and contracts: Grants, cooperative agreements, or contracts from Federal or Federal pass-through agency. Includes Federal funding of Heritage programs. Excludes sale of land to government.

Federal government indirect cost recovery on grants: Indirect cost recovery on a Federal or Federal pass-through agency grant, cooperative agreement, or contract. Includes Federal funding of Heritage programs. Excludes sales of land to government.

State/local government grants and contracts: State or local government grants, cooperative agreements, or contracts, for which the source of funding is truly at the State or local level and does not involve the pass-through of Federal funds. Excludes sales of land to government.

State/local government grants indirect cost recovery: Indirect cost recovery on a State or local government grant, cooperative agreement, or contract, for which the source of funding is truly at the State or local level and does not involve the pass-through of Federal funds. Excludes sales of land to government.

Foreign government/multilateral development bank grants: Grants, contracts, or contributions from foreign governments or multilateral development banks for international programs.

Mitigation fees: Receipts of mitigation monies, e.g., a corporation is ordered by law to give money to a conservation entity such as TNC to make up for environmental damages caused by that corporation. Includes revenue received from contracts signed under the Joint Implementation Treaty for carbon mitigation. [29] Also includes mitigation bank revenue.

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[28] TNC Narrative Response dated December 22, 2004, *see* Appendix L.

[29] The Staff notes that TNC states that it reports payments under emissions agreements as contributions.

Fee-contract: Fee for service provided by TNC under contract or memorandum of understanding to a private entity or person. Also includes private matching donation part of NFWF[30] or other government payments to TNC where donor on receipt is unknown.

Fee-contract overhead recovery: Overhead recovery portion of fee for service by TNC under contract to a private entity or person.

Fee-option assignments/assists: Reimbursement to TNC for transfer of option to purchase real estate and any associated fees charged by TNC for handling the option. Includes fees for assists (land projects in which TNC is not in the chain of title).

Hotel and lodging: Income received for the use of TNC lodging facilities (guest ranch, conference center, etc).

Speaking/lecture fees: Receipt of fees or reimbursement paid by outside organization to TNC for staff to give lecture, attend seminar, participate in panel or committee, etc., including reimbursement for reports and other products and travel, not covered under formal grants and contracts. Also includes miscellaneous fees, e.g., photo contest. Also includes jury duty recovery payments.

Lease and rent: Receipts from property leases or rents. Includes leases for real estate, grazing, hunting, gas, oil, water, timber, and easements.

Fee-meetings: Receipts from TNC-sponsored meetings, such as board meetings. Does not include receipts from special fund raising events such as dances, raffles, craft fairs, or sporting events.

Fee-field trips: Receipts from TNC-sponsored field trips. Does not include receipts from special fund raising events such as dances, raffles, craft fairs, or sporting events.

Data base user fee: Fees for the use of TNC data base, such as Biological and Conservation Data System.

Related or exempt function income

TNC listed various types of related or exempt function income on its Form 990 for 1992 through 2001. The most common categories included: activity fees, contract fees, government sales, fees and contracts from government agencies, and miscellaneous income. At various times, TNC also reported as program service revenue the gain or loss on the sale of tradelands (2001 Form 990 only), and preserve fees.

Income excluded from unrelated business income

On its Form 990, Part VII for 1992 through 2001, TNC reported various categories of revenues as excluded from unrelated trade or business income by sections 512 through 514,

[30] The Staff presumes "NFWF" refers to the U.S. National Fish & Wildlife Service.

including lease or royalty fees; interest and dividend income; rental income from real estate; gain or loss from sales of assets other than inventory; and net income from special fundraising events.

Unrelated trade or business income

TNC reported lease or royalty fee income as unrelated business income in its 1992 Part VII. TNC reported no unrelated business income on its Form 990, Part VII, for 1993 through 1997. On its Form 990, Part VII for 1998 through 2001, TNC reported unrelated business income or loss from lease or royalty fees, dividends and interest from securities, debt-financed rental income from real estate, rental income from real estate, inn income or loss, and income or loss from special events.[31]

Unrelated business income is also reported on Form 990-T.[32] For 1998, TNC reported unrelated business income of $452,679 on Part VII, and a loss of $166,303 on Form 990-T.[33] For 1999, TNC reported unrelated business income of -$74,611 on Part VII, and -$78,902 on Form 990-T. TNC's unrelated business income reported on Part VII of Form 990 equaled the net unrelated business income amount it reported on Form 990-T for each of 2000 and 2001.

The Staff did not examine whether TNC accurately reported the amounts or types of its income-producing activities for these reporting periods. The Staff also did not attempt to reconcile the difference between TNC's reporting of unrelated business income for purposes of Part VII and the Form 990-T for 1999.

2002 Form 990

There was no material change in TNC's reporting of this item for this period.

f. Part VIII - Relationship of Activities to the Accomplishment of Exempt Purposes

Part VIII of Form 990 requires that the organization give a brief description of how an activity reported as generating related or exempt function income specifically contributed to the accomplishment of the organization's exempt purposes. For example, an organization that operates a school for the performing arts and that charges admission at student performances might report admission income as related or exempt function income and explain in Part VIII that performances before an audience were an essential part of the students' training and related to the exempt purpose of the organization.

[31] The classification of revenues as unrelated business income for Form 990, Part VII, differ from that as reported for purposes of Form 990-T filings. Part VII of Form 990 generally classifies revenues by type of activity, whereas Form 990-T sometimes classifies revenues by source (e.g., income or loss from partnerships and S corporations).

[32] Unrelated business income tax is calculated and paid with the filing of a Form 990-T.

[33] Part VII reported unrelated trade or business revenues before any reduction for expenses. Form 990-T reported income of $452,679 and expenses of $618,982, for a net loss from unrelated trade or business activity of $166,303. TNC changed its Part VII reporting in 1999 to report revenues on a net (rather than gross) basis, after a reduction for allocable expenses, making it more consistent with its Form 990-T reporting.

Observations

On its Forms 990 for 1992 through 2001, TNC provided a statement describing the accomplishment of exempt purposes for Part VIII.

In its Form 990 for fiscal year 1992, TNC stated the following:

"Activities Fees - This includes revenues from seven [sic] separate types of activity: mitigation fees, lodging operations, speaking/lecture fees, fees from meetings and field trips, conservation science data base user fees, and leases and rents associated with the management of protected areas. All these activities are directly related to the Conservancy's programs which contribute to the protection of biodiversity.

Royalty Fees - The Conservancy receives royalty fees from the sale of published items and other merchandise, which bears the Conservancy's logo or name. The publications and other items are all related to the communication of conservation issues and the Conservancy's programs.

Contract Fees - The Conservancy receives fees for the management of protected areas on behalf of private and public organizations. Contract fees are also received for managing and collecting scientific information for the Conservancy's science heritage programs.

Preserve Fees - The Conservancy derives fees, usually paid on a voluntary basis, from public visitation and use of certain of its nature preserves.

Sale of Land to Government and Other Conservation Agencies - The Conservancy undertakes conservation projects involving land acquisition with government agencies and other non-profit organizations. The Conservancy sells and donates conservation land to the government and other conservation agencies for future management subject to restrictions and agreements to insure the on-going protection of these areas.

Sale of inventory - The Conservancy derives revenues from the sale of low cost merchandise, which is intended to communicate information on conservation.

Miscellaneous Income - The Conservancy derives revenues from various sources in conducting the normal business operations to support its fundamental exempt purpose of preserving, protecting, conserving, and managing natural habitat, and educating the public about these matters.

Loss on tradelands - The Conservancy sells certain real property, which has little ecological value, and uses the proceeds to support the acquisition of sites which contribute to the protection of biodiversity.

Gain and Losses - Represents gains and losses from the sale of equipment and stock used in maintaining and cultivating conservation property."

TNC subsequently modified its descriptions of these activities for purposes of reporting for Part VIII. TNC no longer separately reported royalty fees in Part VIII beginning in 1994 (it combined this with sales of inventory), gains and losses on equipment or stock in 1993, or preserve fees beginning in 1999.[34] TNC's descriptions of activity fees, contract fees, and government sales revenue, were revised in 1993 and 1994 to the identical formats that have been used through 2001. TNC added a description for fees and contracts from government agencies in its Form 990 for fiscal year 1995.[35]

In its Form 990 for fiscal year 2001, TNC stated the following with respect to accomplishment of exempt purposes:

"ACTIVITY FEES - The Conservancy derives revenues from fees paid by a variety of activities associated with meetings and educational conferences on Conservancy property, which are related to the Conservancy's purpose to promote conservation and proper use of natural resources.

CONTRACT FEES - The Conservancy provides information, data, and consulting related to biological conservation science, and protected areas design and management to private organizations. This information assists these organizations in planning, implementing, and managing Conservancy programs which furthers the exempt purpose goals of the Conservancy.

GOVERNMENT SALES REVENUE - The Conservancy derives revenues from the sale of land to federal and local governments for use by these as parklands and other recreational and natural preserves in the interest of preservation, protection, and conservation of natural habitat.

FEES AND CONTRACTS FROM GOVERNMENT AGENCIES - The Conservancy provided information, data, and consulting related to biological conservation science and protected areas design and management to various government agencies.

SALE OF INVENTORY - The Conservancy derives revenues from the sale of low cost merchandise and memorabilia containing the Conservancy's logo which further promotes the educational goals of the Conservancy.

MISCELLANEOUS INCOME - During the course of operations, the Conservancy derives revenues from various sources which support its fundamental exempt purpose of preserving, protecting, conserving, and managing natural habitat, and educating the public about these matters."

Although TNC reported income of $2.8 million from the sale of tradelands for 2001, TNC did not describe this activity in its statement relating to Part VIII.

[34] In its Form 990 for fiscal year 1998, TNC's statement regarding accomplishment of exempt purposes also contained the following: "PRESERVE FEES - The Conservancy derives fees paid, usually voluntarily, for entry to certain of its preserves. Providing access to preserves increases public awareness and support for the Conservancy's conservation mission."

[35] Prior to 1995, TNC reported fees and contracts from government agencies as government contributions and grants, rather than as program service revenue, and did not describe the activity on its return. TNC's description of fees and contracts from government agencies has been identical since 1995.

TNC's earlier Statements of Accomplishments were more specific, for example, its description of activity fees used to include references to hotel and lodging fees. Later statements combined several of the earlier categories in a way that does not clearly describe the accomplishments. In one case, TNC did not describe one category for which it provided a description in its 2001 Form 990 (i.e., sale of tradelands).

TNC's statements tend to be conclusory, rather than descriptive, in terms of explaining how these activities help TNC accomplish its exempt purposes. The instructions require TNC to explain how the activity "significantly contributed to accomplishing the exempt purpose." However, TNC's recent descriptions of activity fees[36] and contract fees[37] make these activities seem commercial in nature. TNC's description of government sales revenue does not describe how selling land to governments for use as parklands or preserves actually furthers TNC's exempt purposes. TNC's description of fees and contracts from government agencies raises the question of whether TNC is deriving consulting services income that should be taxed as unrelated business income. The TNC also does not explain how miscellaneous income furthers TNC's exempt purposes.

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TNC's reporting of exempt purpose accomplishments was identical to that for the prior period, with two additional items reported. The fiscal year 2002 description of activity fees referred to mitigation fees (as had been the case in 1992). In addition, the fiscal year 2002 description of contract fees included a paragraph referring to sales of conservation real estate to a government agency.

g. Part IX - Reporting Information Regarding Taxable Subsidiaries and Disregarded Entities

Part IX of Form 990 requires the organization to provide certain information regarding taxable subsidiaries and disregarded entities.[38] Specifically, the organization is to provide the name, address, and employer identification number (EIN) of each taxable corporation or partnership and each disregarded entity in which the organization held a 50% or greater interest at any time during the year. If a disregarded entity does not have its own EIN, the organization

[36] The mere fact that TNC receives "activity fees" for "activities associated with meetings and educational conferences on Conservancy property" does not mean those activities further TNC's exempt purposes.

[37] TNC's description of contract fees does not make clear how providing "information, data, and consulting related to biological conservation science, and protected areas design and management to private organizations" to assist private organizations "in planning, implementing, and managing Conservancy programs" actually furthers TNC's exempt purposes.

[38] A business entity that has a single owner and that is not a corporation may be disregarded as an entity separate from its owner for Federal tax purposes under the "check-the-box" entity classification regulations. Treasury Regulation sections 301.7701-1 through -4. Such an entity is a "disregarded entity." Part IX of Form 990 was revised in 1999 to require reporting of disregarded entities, in addition to taxable subsidiaries.

is to state that it uses the organization's EIN. The organization also is to report the total income and end-of-year total assets of the corporation, partnership, or disregarded entity in Part IX.

On its Form 990 for 1993 through 1995, TNC reported no taxable subsidiaries on Part IX of Form 990. TNC reported the following taxable subsidiaries or disregarded entities in its Part IX during 1996 through 2002:

Northway Corporation - 1995 through 2001 (dissolved on January 16, 2003)

Dog Island Company - 1995 through 1996

Montark, Inc. - 1997 through 2001

San Rafael Cattle Co. - 1998 through 2000[39]

PK Ranch (renamed Soldier Creek Preserve, Inc.) - 1999 through 2001

Clear Lake Club, Inc. - 2000 through 2001

Lost Island Club Corporation - 2000 through 2001

Forest Bank LLC - 2001[40]

Conservation Beef LLC - 2001

STM/TNC LLC - 2001

Eastern Shore Enterprises, LLC - 2001[41]

TNC did not include Virginia Eastern Shore Sustainable Development Corporation (VESC) as a taxable subsidiary at any time prior to the corporation's dissolution in 1999. TNC obtained control of the board of directors of VESC on July 17, 1996, and attained majority ownership of all of the shares of the corporation's stock on March 11, 1998. Based on records provided by TNC to the Committee, TNC was a majority shareholder of this corporation for taxable subsidiary reporting purposes no later than March 1998. It appears that TNC should

[39] TNC reported as an exempt title holding corporation for 2001.

[40] TNC reported its ownership interest in Forest Bank LLC as 10 percent of Class M and A shares. At this time, however, TNC was the only owner of membership interests in Forest Bank LLC. TNC was listed as the owner of 100 percent of the profits, losses, and capital on Schedule K-1 (Form 1065) for the LLC's 2001 taxable year.

[41] TNC reported its ownership interest in Eastern Shore Enterprises LLC as 100 percent, making TNC the sole owner of the entity at this time. This LLC was formed in 1999, and had owners other than TNC from its inception. TNC's stated percentage interest under the LLC's initial operating agreement was 91 percent. TNC's Schedule K-1 (Form 1065) for 2000, 2001, and 2002, showed TNC's ownership interest ranging from 91 percent to 100 percent. Eastern Shore Enterprises LLC filed partnership tax returns for 2000 through 2002. It dissolved in October 2002. It is unclear whether TNC regarded Eastern Shore Enterprises LLC as a disregarded entity, or as an association taxable as a corporation, once the LLC ceased to be a tax partnership upon TNC's becoming the sole member. TNC reported to the Committee that the LLC was terminated with the Commonwealth of Virginia in 2002.

have reported VESC as a taxable subsidiary for its 1997 Form 990, once it acquired majority ownership of the VESC stock in March 1998, and should have continued to report VESC as a taxable subsidiary until VESC dissolved and liquidated in October 1999 (i.e., for TNC's 1998 and 1999 Forms 990).[42]

TNC did not include Eastern Shore Enterprises, LLC as a taxable subsidiary or disregarded entity for 1999 or 2000. TNC was a majority owner of this LLC from its formation on October 15, 1999, until the LLC dissolved in October 2002.

TNC did not report Sustainable Forest Resources of PNG-US, LLC, as a disregarded entity on this schedule for any of the years it has been in existence (1997 and thereafter).[43]

Based on records provided by TNC to the Committee, TNC acquired all of the membership interests of Clear Lake Club, Inc., a taxable nonprofit hunting club, from its former members in 1998. TNC did not report this organization as a taxable subsidiary for 1998 and 1999. The organization was dissolved in 2001. TNC was reported as the 100 percent owner of the club on the Form 1120 filed by the corporation for the period beginning January 1, 2000, and ending July 31, 2001. The club included 18 months of activity in its final corporate income tax return.

Based on records provided by TNC to the Committee, TNC acquired all of the membership interests of Lost Island Club, Inc., a for-profit hunting club, in 1998. TNC did not report this organization as a taxable subsidiary for 1998 and 1999. The organization was dissolved in 2001.[44]

TNC did not report Conservation Beef, LLC as a taxable subsidiary for 1999 or 2000, despite its ownership of a 50 percent membership interest in the LLC from its inception in October 1999 until it withdrew from the LLC in February 2004.

TNC did not report Forest Bank, LLC as a taxable subsidiary or disregarded entity for its 2000 fiscal year. The LLC was formed in January 2001, and TNC owned the entire interest of the LLC from its inception until it was dissolved in November 2002.

TNC did not report TNC do Brasil, a non profit Brazilian corporation that conducts TNC activities in Brazil, as a taxable subsidiary. Based on records provided by TNC to the Committee, TNC controls 100 percent of this entity through 100 percent control of its board. TNC do Brasil is not recognized as tax exempt by the IRS, and is reported as non-exempt by TNC on TNC's schedule of related organizations.

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[42] TNC was not listed as an owner of 50 percent or more of the corporation's stock on the corporate tax returns filed by VESC for 1996 through 1999.

[43] TNC reported this organization as a related organization, however, on its schedule for related organizations.

[44] TNC was reported as the 100 percent owner of the club on each of the corporate tax returns filed by the corporation for 1998 through 2001.

It is unclear why TNC reported STM/TNC LLC as a taxable subsidiary in 2001. TNC had owned a 35 percent ownership in the LLC during the period 1993 through 2001, and did not report the organization as a taxable subsidiary prior to 2001.

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TNC reported 10 organizations as taxable subsidiary corporations, partnerships or disregarded entities on its Form 990 for the fiscal year ended June 30, 2003. These included four newly reported organizations: Sustainable Forest Resources of PNG-US, LLC (100%); Conservation Farms and Ranches-Merced (100%); Bear Mountain Lodge, Inc. (100%, but to be dissolved in 2004); and Putri Naga Komodo JV (100%). TNC also reported Montark, Inc. (100%); Soldier Creek Preserve, Inc. (100%); Northway Corporation (100%, but dissolved in 2003); Forest Bank LLC (100%, but dissolved in 2003); Conservation Beef (50%); and Eastern Shore Enterprises, LLC (91%, but dissolved in 2003).

II. Form 990 – Schedule A

In their annual returns on Schedule A of Form 990 or 990-EZ, section 501(c)(3) organizations must disclose information regarding their direct or indirect transfers to, and other direct or indirect relationships with, other section 501(c) organizations (except other section 501(c)(3) organizations. This requirement helps prevent the diversion or expenditure of a section 501(c)(3) organization's funds for purposes not intended by section 501(c)(3). All such organizations must maintain records regarding all such transfers, transactions, and relationships.

a. Statements of Activities with Related Parties

Part III, Question 2 of Form 990, Schedule A, requests whether during the year, the organization, either directly or indirectly, engaged in any of the following acts with any substantial contributors, trustees, directors, officers, creators, key employees, or members of their families, or with any taxable organization with which any such person is affiliated as an officer, director, trustee, majority owner, or principal beneficiary: (1) sale, exchange, or leasing of property; (2) lending of money or other extension of credit; (3) furnishing of goods, services, or facilities; (4) payment of compensation (or payment or reimbursement of expenses if more than $1,000); or (5) transfer of any part of its income or assets. If the organization entered into any of such transactions, then the organization is required to attach a detailed statement explaining the transactions.

Observations

TNC reported numerous transactions involving a TNC board member, or a company which was affiliated with a TNC board member.

Sale, exchange, or leasing of property

TNC reported "Yes" to this question for each fiscal year from 1992 through 2001. TNC generally reported in the Form 990 schedules whether the board member recused himself or herself from participating in or voting on the transaction.

TNC reported various arrangements with companies of which TNC board members were officers, directors, or principals. These included: (1) rental of membership mailing lists by General Motors Corporation from TNC reportedly at fair market value (1993); (2) agreements by General Motors Corporation to provide cash, vehicles, potential gifts of land, data systems equipment, and other miscellaneous assets to TNC (1993 through 2001); (3) an arrangement with AOL Enterprises pursuant to which TNC was a content provider on AOL and maintained a forum that provided information regarding TNC's work (1995); (4) a contract with S.C. Johnson Wax which permitted the company to use TNC's trademark in a national product promotion in exchange for $100,000 (1995);[45] (5) the acquisition by TNC of 1,000 acres of land from an affiliate of Georgia Pacific reportedly at fair market value (1996); (6) the acquisition by TNC of property from Quentin Corporation (1996); (7) an arrangement with the Orvis Company pursuant to which the company conducted general activities on TNC property (Mays Pond) and sold fly fishing tackle to one of TNC's programs (Belize Program) (1996); (8) an arrangement with Discovery Communications, Inc. pursuant to which TNC, in cooperation with the National Audubon Society, licensed TNC's name and logo to Discovery Communications for use in connection with a television series, and TNC and National Audubon Society received royalty rights, credits, and certain other programming rights with respect to the series in exchange for providing funding and editorial consulting services to the series (1997);[46] (9) an acquisition by TNC of 1,108 acres from a Georgia Pacific affiliate; (10) the acquisition by TNC of computer upgrades and purchases from Cisco Systems, Inc. at a substantial discount (1998-2001);[47] (11) the acquisition by TNC of a conservation easement covering approximately 1,622 acres from an affiliate of The Orvis Company, Inc. (1998); (12) the acquisition by TNC of approximately 14,959 acres of land from two separate affiliates of Georgia Pacific (1999);[48] (13) an agreement with General Motors Corporation "to undertake a climate change project under which TNC received $10 million and General Motors may potentially receive greenhouse gas mitigation offsets" (1999);[49] (14) the retention of a law firm of which a board member is a partner for

[45] This agreement was extended in 1996 for an additional year and added two royalty streams paid by the company to TNC. Also, in its 1998 Form 990, TNC reported that S.C. Johnson & Son, Inc. "paid $100,000 to The Nature Conservancy in a promotion."

[46] This agreement was modified in 1998 to grant Discovery Communications permission to use TNC's name to promote the Discovery Channel credit card, in exchange for revenues generated from the card. The terms of credit card deal were not disclosed.

[47] TNC reported that "[b]efore any orders are placed Mr. Morgridge [the TNC board member and chairman of Cisco Systems, Inc.] reviews the order and approves the discounts." In its 2001 Form 990, TNC stated that it paid a total of $145,477 to Cisco Systems, Inc. for the following transactions: "From July 2001 to around March/April 2002 the arrangement was: 1) CISCO gives TNC an automatic 30% off their list price[;] 2) TNC purchases its equipment DIRECTLY from CISCO[; and] 3) TNC submits to Mr. Morgridge the amount paid to CISCO[.] This resulted in an effective 76% discount from list to TNC."

[48] One of the purchases was for $7.5 million. The price of the other purchase was not disclosed.

[49] TNC reported that Mr. Smith, the Chief Executive Officer and Chairman of General Motors as well as a TNC board member, did not participate or vote on said transactions. This is inconsistent with records provided by TNC to the Committee, including a Conservation Committee vote record which showed Mr. Smith approved the transaction, and a copy of the agreement which showed Mr. Smith signed the agreement on behalf of General Motors Corporation and GM's Brazilian affiliate.

certain legal services (2000);[50] (15) payment of a $1,200 consulting fee to a board member for his attendance at a two-day sustainable conservation seminar (2000); (16) the acquisition by TNC of an integrated forestry management system from a subsidiary of Georgia Pacific for $65,000 plus a user fee that was half the current market price for the fee (2001); and (17) the acquisition by TNC of numerous personal property items from The Orvis Company, Inc. at a 40% discount (2001).

TNC also reported on its 1996 Form 990 a transaction with a Procter and Gamble affiliate, Millstone Coffee. Mr. John Sawhill, TNC's President and Chief Executive Officer at the time, was also a board member of Procter and Gamble. Under the agreement, TNC granted Millstone the rights to use TNC trademarks on licensed product packaging, advertisements, point-of-purchase displays, and other material. The license was exclusive for whole bean coffee for a five-year term. Millstone was to pay TNC royalties of a minimum of $400,000 over five years plus two percent of net sales of licensed product. The agreement was not reported in the 1997 Form 990. TNC reported this transaction on the Forms 990 for each of 1998 through 2000, though the description of the licensed product changed somewhat in the 1998 report.[51]

TNC reported acquisitions of real estate and conservation easements in transactions involving TNC board members in various years. A 1993 transaction involved a sale by a board member of his ranch to a third party, who in turn sold a portion of the ranch to TNC and gave TNC a conservation easement on a portion of the acreage retained by the third party. Another 1993 transaction involved the sale by TNC of land to an affiliate of one of TNC's board members, subject to the legal condition that most of the acreage be donated back to TNC for conservation purposes. A 1997 transaction involved the purchase of property by TNC from a board member for the property's original purchase price. In 2000, an affiliate of one of TNC's board members donated a conservation easement to TNC reportedly valued at $3.95 million.

Lending of money or other extension of credit

None reported prior to 2001.

In 2001, TNC reported loan receivables from Stephen McCormick (President and Chief Executive Officer of TNC), Graham Chisholm, John Wiens and Beatrice Van Horne (TNC managers), all relating to the financing of acquisitions of principal residences.

Furnishing of goods, services, or facilities

TNC reported arrangements during 1992 and 1993 with companies of which TNC board members were officers. Some of these arrangements included free office space use by TNC, reductions in consulting expenses provided to TNC, or free use of various real or personal property by TNC. Others involved arrangements awarded through competitive bidding, or other arrangements reportedly made at fair market value.

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[50] TNC reported that it also negotiated with a client of this firm for the acquisition by TNC of certain real estate.

[51] TNC reported the same transaction twice on the 1998 report because it had two P&G officers on the TNC Board at that time (Messrs. Sawhill and Jager).

Payment of compensation (or payment or reimbursement of expenses if more than $1,000)

TNC reported compensation, fringe benefit, and expense account and other allowances information regarding its officers and regional directors, for all fiscal years from 1992 through 2001.

For each of the years 1992 through 2001, TNC reported that no compensation, contributions, expense accounts, or other benefits were received by any members of the TNC Board of Governors.

Transfer of any part of its income or assets

None reported.

TNC reported numerous transactions involving board members, or companies with which TNC board members were affiliated. The Committee did not attempt to determine whether TNC regularly disclosed all transactions involving board members or officers, and limited its review to those transactions that were disclosed by TNC on the Forms 990.[52] Often TNC's description of the disclosed transaction provided sufficient detail to disclose the material aspects of the transaction. In several instances, however, TNC's description did not provide a clear and complete picture of the nature of the transaction. Examples include TNC's description of the agreement with General Motors Corporation regarding emission credit offsets, and the arrangement with Cisco Systems, Inc. pursuant to which TNC received discounts on purchases.[53] The description of the Cisco Systems, Inc./Morgridge transaction in the 2001 Form 990 did not mention the involvement of the Morgridge Foundation. Another example is that of the S.C. Johnson, Inc. transaction in the 1998 Form 990, which states that the company paid TNC $100,000 "in a promotion."

TNC's description of the General Motors Corporation emissions arrangement fell short of even the most minimal standard of reporting and disclosure. TNC's disclosure regarding this arrangement consisted of the following: "General Motors signed an agreement with TNC to undertake a climate change project under which TNC received $10 million and General Motors may potentially receive greenhouse gas mitigation offsets. Mr. Smith did not participate or vote on said transactions." The General Motors Corporation emissions arrangement is a complex 35-

[52] In response to a question from the Committee, TNC stated that "[t]o the best of our knowledge, all transactions involving a corporation with an executive serving on The Nature Conservancy's Board of Governors at the time of the transaction are set forth in the Conservancy's 990s, previously supplied to the Committee." TNC SFC II Response, XIV. Transactions With Board Members, April 2004, Question 2. Appendix K contains a copy of the relevant schedules from TNC's Forms 990 for its fiscal years 1992 through 2001. In addition, Appendix K contains a copy of information provided by TNC to the Committee in response to a request regarding TNC transactions with three companies of which company officers were members of TNC's Board of Governors or Leadership Council: Georgia Pacific Corporation, International Paper Company, and Orvis Services Company. It appears that one of the transactions included in the supplemental information should have been disclosed in the Form 990 (1999). TNC Narrative Response, Transactions With Board Members, questions 1b and 1c (acquisition of 1807.70 acres from Georgia Pacific Company for $406,732 on September 27, 1999), dated April 23, 2004, *see* Appendix K.

[53] The Cisco Systems and General Motors transactions are discussed in Part Three of this Report.

page agreement involving a 40-year relationship among four parties, and is difficult to describe easily.[54] In particular, TNC failed to characterize the nature of the arrangement among General Motors, TNC, and their respective Brazilian affiliates (e.g., as a management services agreement, joint venture, charitable contribution, or other arrangement) or the nature of the activity (e.g., a description of what is meant by a climate change project and whether it was a conservation project consistent with TNC's exempt purposes), and to disclose that TNC ceded certain of its operational control unrelated to the project, as well as the value of all emissions credits to be generated by the project, to General Motors Corporation. Further, TNC's statement that Mr. Smith "did not participate or vote on" the General Motors Corporation emissions offset agreement is misleading and inaccurate. TNC records provided to the Committee show that Mr. Smith voted on the transaction as a member of TNC's Conservation Committee, and executed the agreement on behalf of General Motors Corporation and GM's Brazilian affiliate. Perhaps TNC only meant to say that Mr. Smith did not participate or vote on the transaction as a member of the TNC Board of Governors. Regardless of TNC's intentions, TNC should have disclosed that Mr. Smith voted on the transaction as a member of TNC's Conservation Committee, recused himself from voting on the transaction as a TNC Board member, and executed the agreement on behalf of General Motors Corporation and GM's Brazilian affiliate.

In other instances, TNC failed to disclose the amount of consideration received or paid by TNC in the transaction, or whether the amount paid or received reflected fair market value. For example, TNC did not disclose the value of the items provided by General Motors Corporation to TNC pursuant to the ongoing agreement for cash, vehicles, and other assets.

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Sale, exchange, or leasing of property

TNC reported three separate items in this category for the fiscal year ended June 30, 2003: (1) receipt of $59,000 from Orvis for licenses to conduct two experimental ecotourist fishing trips to TNC's Paylmyra Atoll property; (2) the purchase by TNC of computer equipment directly from Cisco Systems, Inc. for $8,366; and (3) the five year cash, vehicle and miscellaneous asset agreement with General Motors, and the $10 million greenhouse gas mitigation offset arrangement with General Motors.[55]

Lending of money or other extension of credit

TNC reported that a note receivable from the President and CEO in the amount of $1,550,000 was repaid in full on April 25, 2003.

Furnishing of goods, services, or facilities

[54] The explanation provided to the TNC Board of Governors was a three page summary and a one page budget plan. The preliminary project plan was 26 pages in length. The forms of agreement between TNC and TNC's Brazilian nonprofit affiliate were 8 pages in length.

[55] TNC again reported that Mr. Smith did not participate in or vote on said transactions.

None reported.

Payment of compensation (or payment or reimbursement of expenses if more than $1,000)

TNC reported compensation, fringe benefit, and expense account and other allowances information regarding its officers and regional directors, for fiscal year 2002.

Transfer of any part of its income or assets

None reported.

b. Transactions and Relationships with Noncharitable Exempt Organizations

Part VII of Form 990, Schedule A, requires the organization to provide certain information regarding transfers to, and transactions and relationships, with noncharitable exempt organizations, including the following: (1) transfers from the organization to a noncharity of cash or other assets; (2) sales or exchanges of assets with a noncharity; (3) purchases of assets from a noncharity; (4) rental of facilities, equipment, or other assets; (5) reimbursement arrangements; (6) loans or loan guarantees; (7) performance of services or membership or fundraising solicitations; or (8) sharing of facilities, equipment, mailing lists, other assets, or paid employees. If the organization engaged in any of such transactions, it is required to complete a schedule providing the amount involved, the name of the noncharity, and a description of transfers, transactions, and sharing arrangements. Part VII also requires the organization to describe any relationship it has pursuant to which it is directly or indirectly affiliated with, or related to, one or more exempt organizations that are not charities.

Transfer of cash or other assets to a noncharity

TNC reported that it transferred cash (but not other assets) to its exempt lobbying organization, The Nature Conservancy Action Fund, for fiscal years 1993 through 2003, and to certain other lobbying organizations in 2002 and 2003.

TNC did not report any of the following activities for during this time:

- Sales or exchanges of assets with a noncharity
- Purchases of assets from a noncharity
- Rental of facilities, equipment, or other assets
- Reimbursement arrangements
- Loans or loan guarantees
- Performance of services or membership or fundraising solicitations

Direct or indirect relationships with exempt organizations that are not charities

TNC reported its relationship with The Nature Conservancy Action Fund, its lobbying organization exempt under section 501(c)(4), for fiscal years from 1993 through 2003. TNC did not report relationships with any other noncharitable exempt organizations with respect to these periods.

Sharing of facilities, equipment, mailing lists, other assets, or paid employees

TNC reported that it paid for administrative support services of, and provided administrative support services to, its exempt lobbying organization, for fiscal years 1993 through 2003.

c. Reporting of certain corporate subsidiaries on a consolidated basis

Explanation of reporting requirement

Section 1504(e) provides that two or more organizations exempt from taxation under section 501, one or more of which is described as a title holding corporation within section 501(c)(2), and the others of which derive income from such corporation, shall be considered as includible corporations for the purpose of the application of the consolidated return filing rules.

A parent organization and one or more of its subsidiaries may file a group return on a Form 990 if certain conditions are satisfied. In order to file a group return, the subsidiary must, among other things, be exempt from tax under a group exemption letter that is still in effect.[56]

Observations

TNC included a number of controlled corporate entities in its Form 990 on a "consolidated basis" for several of its reporting years.[57] Initially, TNC reported that these controlled entities were formed for the sole purpose of passively holding title to land (and engaging in no other activity), apparently as title holding corporations within section 501(c)(2). In its 1999 Form 990, TNC stated that these entities were established for business and legal reasons which assist TNC in accomplishing its corporate goals in various states, with goals and objectives identical or quite similar to those of TNC.

The Staff did not review whether these entities properly were included in TNC's Forms 990 as title holding corporations that could be reported on a consolidated basis under section 1504(e). The Committee did request that TNC provide an explanation regarding why it changed its reporting of such entities beginning in its 2000 Form 990.[58] TNC responded:

> "As disclosed on Statement 22 of the Forms 990's for the years ended June 30, 1993 through June 30, 2000, TNC reported between 19 and 21 corporate subsidiaries on a

[56] Treasury Regulations section 1.6033-2(d); Instructions to IRS Form 990, pp. 13-14.

[57] TNC listed between 19 and 21 separate wholly-owned corporate subsidiaries as being included in its Form 990 for fiscal years 1992 through 1999. TNC discontinued the practice of reporting these corporations in a consolidated Form 990 for its 2000 Form 990.

[58] The Committee requested TNC provide information regarding TNC's reporting changes with respect to these organizations. SFC Letter to TNC, Question 22, dated October 27, 2004, *see* Appendix B.

consolidated basis. On Form 990 for the year ended June 30, 2001, the corporate subsidiaries were again reported on a consolidated basis. However, the Statement 22 disclosure inadvertently omitted the language relating to the consolidated reporting for this year. These corporate subsidiaries represent the state corporations covered by TNC's group exemption ruling and are not corporations described within IRC section 501(c)(2) that are includible corporations within the meaning of IRC section 1504(e)."[59]

[59] TNC Narrative Response, dated January 14, 2005, *see* Appendix L.

III. Form 990-T

1. Summary of UBIT Reporting

TNC provided the Committee its Forms 990-T, *Exempt Organization Business Income Tax Return*, for fiscal years 1999 through 2003. Although the Staff did not review any Form 990-T filings made by TNC prior to this period, the Staff did review TNC's unrelated business taxable income information as reported on TNC's Forms 990 for earlier periods. Based on these reports, TNC paid no unrelated business income tax for fiscal years from 1993 through 2001, and paid unrelated business income tax of approximately $214,000 for fiscal years 2001 and 2002.[60] All of TNC's unrelated business income tax liability for fiscal years 2002 and 2003 resulted from unrelated debt financed income. TNC reported total unrelated business taxable income of approximately $664,000 for its fiscal years 1993 through 2003. TNC reported no unrelated business taxable income within the following categories during this 11-year period: (1) capital gain or loss (except for 2002); (2) rent income; (3) other income; or (4) interest, annuities, royalties, and rents from controlled organizations.

The following table provides certain unrelated business income information for TNC for its fiscal years 1993 through 2003.

Table 13, Unrelated Business Income Information,
TNC Fiscal Years 1993-2003[61]
(in thousands of dollars) (incorporate expense info)

Form 990-T year	Gross profit from sales	Income from partnerships or S corporations	Unrelated debt financed income	Other income	Net operating loss deduction	Total unrelated business income	Total unrelated business income tax
2002	0	-60,937	272,547	-11,429[62]	0	199,981	55,972
2001	26,217	-52,375	504,310	-2,392[63]	-11,460	464,300	157,862
2000	-101,822	-32,058	367,625	0	-233,745	0	0
1999	-183,089	0	104,187	0	0	-78,902	0

[60] The Committee was unable to determine whether TNC paid unrelated business income tax for 1992, because it did not obtain a copy of a Form 990-T for that year.

[61] As noted above, the information for fiscal years 1999 through 2003 is derived from TNC's Forms 990-T for such years. The information for 1992 through 1997 is derived from TNC's Forms 990, Part VII, Analysis of Income-Producing Activities, for such years. *See* Appendix L.

[62] Includes $1,285 of capital gain and net expenses of $12,714.

[63] Advertising income.

1998	0	0	-166,603	0	0	-166,603	0
1997	0	0	0	0	0	0	0
1996	0	0	0	0	0	0	0
1995	0	0	0	0	0	0	0
1994	0	0	0	0	0	0	0
1993	0	0	0	0	0	0	0
1992	0	0	0	80,317[64]	0	80,317	NA

During TNC's most recent five-year period, TNC's reported unrelated business income tax liability represented less than 0.1 percent of its total revenues from all sources (and of total revenues other than from contributions and grants). During this same five-year period, TNC reported investment income of $410.0 million. Its excess of revenues over expenses totaled $1.56 billion, which approximated TNC's aggregate of revenues (other than from contributions and grants) for the period of $1.54 billion. Put another way, TNC's total contributions and grants of $2.42 billion during this five-year period (see Table 1, above) exceeded TNC's total expenses during this period of $2.39 billion (see Table 4, above), and TNC was able to retain the entire $1.5 billion of revenues it derived from sources other than contributions and grants.

A comparison of TNC's program service revenues and its unrelated business income, as reported for its fiscal years 1999 through 2003, is contained in the following table.

Table 14, Unrelated Business Income as a Percentage of Revenues (Other than Contributions and Grants) or Excess of Revenues over Expenses, TNC Fiscal Years 1999 through 2003 (dollars in millions)

Form 990 Year	Program service revenue	Investment income	Unrelated trade or business income (before NOL deduction)	Other income (other than contributions and grants)	Total revenues (other than contributions and grants)	Excess of revenues over expenses (including contributions and grants)	UBI as % of revenues (other than contributions and grants)	UBI as % of excess of all revenues over expenses
2002	272.4	7.1	0.3	1.6	281.4	192.1	0.1%	0.2%
2001	315.0	20.8	0.5	-0.4	344.1	339.8	0.1%	0.1%
2000	183.9	77.5	0.2	-0.9	270.9	298.0	0.0%	0.0%
1999	163.9	164.7	-0.1	-1.5	339.0	391.5	0.0%	0.0%
1998	153.9	139.9	-0.2	-0.9	300.5	344.6	-0.1%	0.0%
Totals	1089.1	410.0	0.7	-2.1	1535.9	1566.0	0.0%	0.0%

In its notes to its financial statements contained in TNC's Annual Report for the fiscal year ended June 30, 2004, TNC reported it "pays a nominal amount of tax relating to several unrelated business income activities, primarily rental income from debt-financed property. At

[64] Royalty income.

June 30, 2004 and 2003, [TNC] had a cumulative unrelated business income net operating loss of $0."[65]

TNC Analysis of UBIT

In response to the Committee's request for information regarding TNC's process for characterizing UBIT, TNC provided a volume internal e-mail correspondences in which UBIT is raised for the years 2000 through 2005.[66] Because the Committee did not request e-mail correspondence, it did not determine whether the volume contained *all* e-mails regarding UBIT for this time period. Further, in one e-mail, TNC refers to an internal audit of UBIT activities apparently conducted in or prior to 2000 that TNC did not provide to the Committee.

In addition to these e-mails, TNC provided its Standard Operating Procedure (SOP) on UBIT, four memos providing legal analysis of four separate travel tour programs, and an internal newsletter article submitted by TNC's controller's office which provides UBIT guidance for field offices.[67] TNC's SOP requires consultation with TNC's General Counsel prior to commencing any activity with UBIT implications and immediate reporting to the Finance Function after the activity is commenced.

The Staff reviewed all e-mails provided by TNC regarding potential UBIT liability. Various activities and projects were discussed in these e-mails including: rental income from leased properties, corporate sponsorships, affinity cards, consulting services, timber sales, merchandise sales, travel tours, sale of water rights, an airplane lease, and advertising.

Although review of the e-mail correspondence suggests that TNC does discuss whether certain activities are related to its exempt purpose, it appears that activities that the Staff believes may be unrelated were not discussed or analyzed. For example, the Staff did not find any discussion or legal analysis of potential UBIT liability arising from TNC's participation in Conservation Beef, LLC or the emissions credits projects.

The Staff notes that a few of the e-mails discuss whether income from the Trade Lands program is related income. However, none of the e-mails contain a legal analysis. Some state that TNC does not regard Trade Lands revenue as unrelated and that using real estate brokers to market the Trade Lands properties can "shelter the Trade Lands program from UBIT". [68] TNC does not generally market Trade Lands properties but rather lists the properties with brokers to keep TNC's role "sufficiently passive".[69]

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[65] The Nature Conservancy, Consolidated Financial Statements as of June 30, 2004 and 2003, Together With Report of Independent Auditors, note 14 at p. 20.

[66] Certain of these e-mails are included in Appendix L.

[67] *See* Appendix L.

[68] *See* Appendix L.

[69] *See* Appendix L.

TNC also provided e-mails that mention the UBIT implications of conducting timber sales and providing consulting services. However, similar to the e-mails regarding the Trade Lands program, the Staff did not find any analysis involving the application of UBIT law to the pertinent facts.

The e-mails provide insights into TNC's UBIT tax planning strategies. TNC repeatedly states that revenues from transactions with other 501(c)(3) organizations are not UBIT because the activities are connected with TNC's exempt purposes. Another e-mail states that "as a rule, TNC treats all merchandising as mission-related, on the theory that any revenues are 'insubstantial' … To do otherwise …would be a significant departure from prior practice."[70]

An e-mail from TNC in-house counsel states that:

> "We do not want to be particularly aggressive on the UBIT front when dealing with revenues that are not directly related to conservation projects. We are not interested in picking fights with the IRS on these topics. Thus, we will declare some revenues from certain travel tours, overnight accommodations of the bed-and-breakfast variety, and merchandise sales, depending on circumstances. We do, however, want to be aggressive when the revenues in questions are directly connected to TNC's core conservation mission and are prepared to defend this position vigorously to IRS if necessary. (So far it has not been necessary.) Thus to date we have not declared revenues from timbering and other forest management activities as far as I know."[71]

In another e-mail, TNC states: "[w]e should also consider how aggressive a position TNC wants to take. As a practical matter, there are perhaps not too many $$$ at issue here. We might be well-advised not to push the envelope and save our bargaining strength with something bigger and more important from a Conservation by Design standpoint."[72]

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[70] *See* Appendix L

[71] *See* Appendix L.

[72] *See* Appendix L.