

Client Alert

Tax Department

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New York Approves Prudent Management of Institutional Funds Act

Will affect manner in which a charity's institutional and endowment funds may be invested and spent

On September 17, 2010, New York State enacted the New York Prudent Management of Institutional Funds Act (the "Act"). The Act will make significant changes to the way in which New York charities may invest and spend their institutional and endowment funds. This Client Alert describes what we believe are the more important changes and suggests an action plan for New York charities.

The Act permits a charity, subject to a donor's expressed wishes, to appropriate so much of an endowment as is prudent for the uses, benefits, purposes and duration for which the endowment fund is established. Prior law expressly permitted prudent expenditure of both appreciation and income of an endowment fund. Asset growth and income could be appropriated for program purposes, subject to the rule that an endowment fund could not be spent below "historic dollar value". This restriction became problematic for charities with "underwater" endowments valued at below historic dollar value. The Act eliminates the concept of "historic dollar value" for all new endowments, enabling charities to spend endowment principal.

The New York State Charities Bureau is expected to issue guidance on the New York Attorney General's interpretation of the new statute.

We recommend that all New York charities consider taking the following actions as a result of the passage of the Act:

1. Adopt a written investment policy with guidelines on investments and delegation of management and investment functions.

All New York charities are required to adopt a written investment policy that sets forth guidelines on investments and delegation of management and investment functions for the charity's institutional funds other than program-related assets. The investment policy must consider the following factors:

- A) general economic conditions;
- B) the possible effect of inflation or deflation;
- C) the expected tax consequences, if any, of investment decisions or strategies;
- D) the role that each investment or course of action plays within the overall investment portfolio of the fund;
- E) the expected total return from income and the appreciation of investments;

- F) other resources of the charity;
- G) the needs of the charity and the fund to make distributions and to preserve capital;
- H) an asset's special relationship or special value, if any, to the purpose of the charity.

In managing its institutional funds, a charity is permitted to incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the charity and the skills available to the charity. The charity must also make a reasonable effort to verify facts relevant to the management and investment of its funds.

The Act also provides that:

- each person responsible for managing and investing an institutional fund is required to manage and invest the assets of the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.
- management and investment decisions about individual assets are not to be made in isolation, but rather in the context of the institutional fund's portfolio of investments as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the fund and the charity. Within a reasonable time after receiving property, a charity must decide whether to retain or dispose of the property or to rebalance a portfolio.
- a charity may pool two or more institutional funds for purposes of management and investment.
- a person that has special skills or expertise, or is selected in reliance upon the person's representation that the person has special skills or expertise, has a duty to use those skills or that expertise in managing and investing institutional funds.

The Act continues to provide for delegation of management and investment functions to external agents.

2. Carefully document any appropriation for expenditure of an endowment fund.

An endowment fund is an institutional fund that, under the terms of a gift instrument, is not wholly expendable by the charity on a current basis. However, assets that are designated by the board of directors of the charity as an endowment fund for its own purposes are not subject to the rules applicable to endowment funds.

The Act provides that, subject to the donor's written wishes, the charity may appropriate for expenditure or accumulate so much of an endowment fund as the charity determines to be prudent for the uses, benefits, purposes and duration for which the endowment fund is established. In making a determination whether to appropriate or accumulate, the charity must act prudently and in good faith, and must consider the following eight criteria:

- A) the duration and preservation of the endowment fund;
- B) the purposes of the charity and the endowment fund;

- C) general economic conditions;
- D) the possible effect of inflation or deflation;
- E) the expected total return from income and the appreciation of investments;
- F) other resources of the charity;
- G) where appropriate and circumstances would otherwise warrant, alternatives to expenditure of the endowment fund, giving due consideration to the effect that such alternatives may have on the charity; and
- H) the investment policy of the charity.

The Act requires the charity to keep a contemporaneous record describing the consideration that was given by the governing board to each of the factors enumerated above. If, for example, a charity applies a spending rate to its endowment funds, the minutes of the governing board should carefully note each of these factors in its determination of the rate.

Most importantly, there is a rebuttable presumption that, for all new endowments, an appropriation rate greater than seven percent (7%) of the fair market value of an endowment is imprudent. This is calculated on the basis of market values determined at least quarterly and averaged over a period of not less than the five years (or less, if the fund has not been in existence for five years) immediately preceding the year in which the appropriation for expenditure is made. There is *no* presumption that appropriation rates less than or equal to seven percent are prudent.

3. Notify donors of the charity’s intention to apply the Act to endowment funds created before September 17, 2010.

Generally speaking, if the donor of an endowment fund created before September 17, 2010 (the date of the passage of the Act) is living (or in the case of an entity, in existence and conducting activities) and can be located with reasonable efforts, a charity may apply the new laws to that endowment fund only if it sends a notice to the donor at least 90 days prior to the first appropriation. This provision of the Act does not apply to a gift where the donor’s gift instrument provided specific spending restrictions, such as restrictions on spending levels, rates or amounts.

The Act provides a sample notice, in which a charity will ask the donor to check one of two boxes, indicating whether the donor will permit the charity to spend what is “prudent” (the Act), or does not permit the charity to spend below the “original (historic) dollar value” of the gift, but permits expenditure of income and appreciation if prudent to do so (the pre-Act law). If the donor does not respond to the notice within the 90-day notice period, the charity may apply the Act to the endowment. The law suggests, subject to clarification by the New York Attorney General, that no notice need be given to a donor of an endowment fund created prior to September 17, 2010 if the charity does not intend to spend below the original (historic) dollar value of the endowment fund.

4. Revise solicitation materials for endowment funds.

Charities soliciting for endowment funds must include in their solicitation materials a statement to the effect that unless otherwise restricted by the gift instrument, the charity may expend so much of an endowment fund as it deems prudent after considering the factors required by New York law.

5. Consult with the charity’s accountants as to the classification of earnings on endowment funds.

FASB rules applicable to charities suggest that earnings on endowment funds may need to be treated as “restricted” until appropriated. In addition, there may be various disclosures regarding spending from endowment funds required to be included in the financial statements.

For further information, please contact Nina Krauthamer of Olshan’s Tax Department or any partner with whom you work.

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