

Client Alert

Tax Department

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New York Prudent Management of Institutional Funds Act IMPORTANT UPDATE

On September 17, 2010, New York State enacted the New York Prudent Management of Institutional Funds Act (the “Act”). The Act made significant changes to the way in which New York charities may invest and spend their institutional and endowment funds. In October 2010, we issued a Client Alert describing what we believed were the more important changes and suggested an action plan for New York charities. This Client Alert provides an update to the October 2010 Client Alert in response to the New York State Charities Bureau’s recently issued practical guidance reflecting its interpretation of the Act.

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.

We recommend that all New York charities consider taking the following actions as a result of the passage of the Act and recent guidance from the New York State Charities Bureau:

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 take into consideration 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; and
- 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 (of Board members and others) 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.

The New York Charities Bureau has advised that a charity's investment policy will reflect several factors (unique to each charity) including the extent of the financial resources of the charity, the types of investments it holds, its charitable purposes and the nature and scope of the activities or programs. The following subjects addressed by the policy may include general investment objectives; permitted and prohibited investments; acceptable levels of risk; asset allocation and diversification; procedures for monitoring investment performance; scope and terms of delegation of investment management function; the investment manager's accountability; procedures for selecting and evaluating external agents; processes for reviewing investment policies and strategies and proxy voting. The investment policy should be reviewed at regular intervals and whenever a change in the charity's financial condition or other circumstances so require.

Governing boards of charities should be diligent in assessing the independence of outside investment agents, both before and after retaining those agents. Investment agents should be selected on the basis of the agent's competence, experience, past performance and proposed compensation, and not be selected based on business or personal relationships between the agent and board members or other insiders. At a

minimum, an institution should have a meaningful conflict of interest policy and follow the policy. While not required by the law, the Charities Bureau strongly urges that institutions adopt policies that require full disclosure of relationships with outside agents and implement practices that ensure objective oversight by the board.

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 the governing board of the charity designates 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 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.

The New York Charities Bureau has advised that the governing board must consider each of the eight factors to determine whether or not it is relevant. If the board determines that any factor is not relevant, it should document (in a contemporaneous record, which may be in the form of minutes) how it reached that conclusion. If a factor is relevant, the board should consider to what extent the factor affects the decision

whether or not to appropriate or how much to appropriate. In addition to consideration of individual factors, the board should also look at the “big picture” and consider how the factors, considered together and weighted appropriately, affect its determinations.

The governing board must consider whether there are alternatives to an appropriation from an endowment and should not automatically decide to appropriate. For example, if an endowment fund has diminished in value, a board should consider other steps, such as fundraising, expense reductions, sale of non-essential assets, or reductions of non-essential staff. The board should identify and document all such alternative steps, discuss whether these steps are feasible as an alternative to endowment spending and the impact of such alternatives on the charity’s operations and programs.

The governing board is permitted to make a single decision to appropriate from multiple endowment funds. This decision may be documented in a single contemporaneous record. The board must develop procedures to determine that the endowment funds are similarly situated, considering such factors as the purpose of the fund, spending restrictions and duration, all as set forth in the gift instrument, and the financial condition and investments of the fund and other factors that may be relevant.

The Charities Bureau may request production of the records described above as part of the New York Attorney General’s supervisory authority.

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 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 old 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 New York Charities Bureau has advised that notice must be given to all donors of endowment funds created prior to September 17, 2010 (except as described above) whether or not the charity intends to spend below the original (historic) dollar value of the endowment fund. During the 90-day notice period, a charity may appropriate income and net appreciation over historic dollar value. Even if a donor elects not to permit the charity to spend below the original (historic) dollar value, the other provisions of the new statute will nevertheless apply. If a donor cannot be located from a charity’s own records, the charity should keep a record of efforts to locate the donor and should perform Internet searches and should attempt to make contact with known associates of the donor (e.g., the donor’s attorney who represented the donor when the gift was made).

The Charities Bureau has issued additional guidance for those charities wishing to release donor-imposed restrictions. Special procedures apply for “small, old funds” (fund value less than \$100,000 and more than twenty years have elapsed since establishment of the 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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