

Client Alert

Latham & Watkins
Tax Department

Grappling with Underwater Endowments Under CPMIFA and FAS 117-1: Potential for Conflict between Legal and Accounting Requirements

The Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA) was signed into law by Governor Schwarzenegger in California (CPMIFA) on September 30, 2008, and is applicable to institutional funds established, and to decisions made or actions taken with respect to existing institutional funds, on or after January 1, 2009. In so doing, California became the 26th US jurisdiction to adopt some version of UPMIFA. CPMIFA significantly changes California law relating to donor-restricted endowments of nonprofit corporations, unincorporated associations and other charitable entities, specifically with respect to such organizations' ability to spend, invest, manage, and release or modify donor restrictions on endowment funds.

In response to the widespread and relatively rapid adoption of UPMIFA, on August 6, 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. 117-1, "Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Organizational Funds Act, and Enhanced Disclosures for All Endowment Funds" (FAS 117-1)

to address and adjust certain accounting rules relating to donor-restricted funds.

This *Client Alert* provides a brief summary of the new rules under CPMIFA and FAS 117-1, followed by a discussion of some potential issues that may be encountered by non-profit managers and boards of directors struggling with restricted endowments that, as a result of current economic conditions, have declined below their historic dollar values (so called "underwater endowments").

CPMIFA: Spending Donor-Restricted Endowment Funds

The most significant changes effected by CPMIFA relate to expenditures of donor-restricted funds. Under the UPMIFA's predecessor, the Uniform Management of Institutional Funds Act (UMIFA), a nonprofit organization's governing board could generally spend appreciation from a donor-restricted endowment fund in excess of a fund's historic dollar value (*i.e.*, the aggregate value of all contributions to an endowment fund when made) provided that such action was prudent. UPMIFA and CPMIFA do away with this historic dollar value restriction.

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Instead, a nonprofit organization's governing board may, subject to the intent of the donor as expressed in the gift agreement, appropriate for expenditure such amounts as the board determines are prudent for the uses, benefits, purposes and duration for which the fund was established. Absent specific donor instructions to the contrary in the gift instrument, the governing board is required to make decisions regarding whether to spend or accumulate restricted endowment funds in a prudent manner taking into account the following seven factors:

1. The duration and preservation of the endowment fund;
2. The purpose of the organization and the endowment fund;
3. General economic conditions;
4. The possible effects of inflation and deflation;
5. The expected total return from income and the appreciation of investments;
6. The organization's other resources; and
7. The organization's investment policy.¹

Subject to certain listed exceptions, CPMIFA provides that the appropriation for expenditure of more than 7 percent per year, "calculated on the basis of market values determined at least quarterly and averaged over a period of not less than three years immediately preceding the year in which [an] appropriation for expenditure is made," is rebuttably presumed to be imprudent for purposes of the statute.²

While the enactment of CPMIFA arguably provides much needed additional flexibility to California nonprofit boards, given the relative lack of administrative and judicial guidance concerning the manner in

which UPMIFA generally, or CPMIFA in particular, will be applied, California charities should proceed with caution. In particular, governing boards should confirm that pre-existing gift instruments do not impose different or additional restrictions on expenditures, and review, revise and document organization policy regarding the appropriation of restricted funds for expenditure to ensure consistency with the requirements of CPMIFA and, specifically, the seven CPMIFA factors described previously.

CPMIFA: Investing Prudently

Under CPMIFA, the governing board is also responsible for managing and investing the donor-restricted endowment funds in a prudent manner.³ As with endowment fund expenditures, donor intent controls.⁴ In managing and investing funds, the governing board may incur reasonable costs,⁵ can pool two or more institutional funds,⁶ and, subject to certain exceptions, is generally required to diversify its investments and invest prudently.⁷ In addition, unless otherwise specified by the donor, the governing board should consider general economic conditions, impact on the organization's overall portfolio, anticipated tax consequences, the organization's other resources and fiscal needs, and an asset's special relationship (if any) to the charitable purposes of the organization.⁸

The governing board has the option to delegate its management and investment responsibilities to an external agent, provided that the governing board acts prudently and abides by any express restrictions of its donors.⁹ If the governing board complies with the requirements under CPMIFA in selecting an external agent, it will not be held liable for the agent's decisions or actions, even if they are subsequently determined to have been imprudent.¹⁰

CPMIFA: Releasing or Modifying Donor Restrictions

Another significant change embodied in CPMIFA is a relaxation of the rules relating to the release and modification of donor-imposed restrictions on endowments. In particular:

- If a donor consents, an institution may release or modify, in whole or in part, a restriction on management, investment or purpose contained in a gift instrument, provided such release does not purport to allow the fund to be used for a purpose other than a charitable purpose of the institution.¹¹
- A court, upon application, may modify a restriction on management or investment of a fund if the restriction has become impracticable or wasteful, if it impairs the management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund. Notice to the California Attorney General, who must be given an opportunity to be heard, is required, and, to the extent practicable, any modification must be made in accordance with the donor's probable intent.¹²
- If a particular charitable purpose or a restriction contained in a gift instrument is or becomes unlawful, impracticable, impossible to achieve or wasteful, a court, upon application and after notice to the California Attorney General, may modify the purpose of the fund or the restriction in a manner consistent with the charitable purposes expressed in the gift.¹³
- If an institution determines that a restriction contained in a gift instrument is unlawful, impracticable, impossible to achieve or wasteful, the institution, 60 days after notification to the California Attorney General and to the donor at the donor's last known address, may release or modify the restriction, in whole or part, without court approval, if:

1. The fund subject to the restriction has a total value of less than \$100,000;
2. More than 20 years have elapsed since the fund was established; and
3. The institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.¹⁴

FAS 117-1: Accounting for UPMIFA

In response to the relatively rapid and widespread adoption of UPMIFA, the staff of the FASB recently promulgated guidance, in the form of FAS 117-1, concerning the appropriate financial accounting treatment of restricted endowments under UPMIFA. Nonprofit organizations subject to CPMIFA will likely be required to follow FAS 117-1, the main provisions of which are as follows:

Net Asset Classification

A nonprofit organization subject to CPMIFA and FAS 117-1 must classify a portion of its donor-restricted endowment funds as permanently restricted net assets; all remaining restricted funds will be classified as temporarily restricted net assets until appropriated for expenditure.¹⁵ FAS 117-1 provides that the amount classified as "permanently restricted net assets" is either (a) an amount expressly required to be retained by the donor, or (b) in the absence of such a stipulation by the donor, an amount the governing board determines must be retained permanently in compliance with relevant laws.¹⁶ The FASB currently takes the position that the permanently restricted net assets portion of a donor-restricted endowment fund cannot be reduced by any investment losses (unless required by the donor) or by fund appropriations, and that losses to or appropriations from permanently restricted endowments must be charged

against temporarily restricted, and then against unrestricted funds.¹⁷ Thus, while CPMIFA does away with the notion of an historic dollar value that must be tracked and respected, the FASB, at least for the time being, essentially retains the historic dollar value construct as a mandatory accounting feature. This contradiction between CPMIFA/UPMIFA and the approach adopted in FAS 117-1 potentially creates a trap for the unwary, and, particularly in a world where underwater endowments are a real possibility, nonprofit boards may wish to proceed cautiously in classifying endowments as permanently restricted.

Enhanced Disclosures

FAS 117-1 requires nonprofit organizations, whether or not subject to CPMIFA/UPMIFA, to provide the following additional disclosures to financial statement users:¹⁸

- A brief description of their governing board's interpretation of the laws underlying the organization's net asset classification of donor-restricted funds;
- A description of the organization's policies for the appropriation of endowment assets for expenditure;
- A description of the organization's endowment investment policies, including return objectives, risk parameters, and the manner in which investment and spending policies interrelate;
- The composition of the organization's endowment by net asset class, breaking out both donor-restricted and board-restricted funds;
- An explanation of the nature and types of permanent and temporary

restrictions imposed on the organization's endowment funds, along with the aggregate amount of the deficiencies where the fair value of the assets in such endowments is less than the level required by donor stipulations or law; and

- A reconciliation of the beginning and ending balance of their donor-restricted endowment funds, in total and by net asset class, including at a minimum:
 - Investment return separated into investment income and net appreciation/depreciation;
 - Contributions;
 - Appropriations for expenditure;
 - Reclassifications; and
 - Other changes.

Effective Dates

CPMIFA is effective with respect to institutional funds established after January 1, 2009, and with respect to pre-existing institutional funds, to decisions made or actions taken after that date. FAS 117-1 is effective for fiscal years ending after December 15, 2008.

Endnotes

- ¹ Cal. Prob. Code § 18504(a).
- ² Cal. Prob. Code § 18504(d).
- ³ Cal. Prob. Code § 18503(b).
- ⁴ Cal. Prob. Code § 18503(a).
- ⁵ Cal. Prob. Code § 18503(c)(1).
- ⁶ Cal. Prob. Code § 18503(d).
- ⁷ Cal. Prob. Code § 18503(e)(4).
- ⁸ Cal. Prob. Code § 18503(e)(1).
- ⁹ Cal. Prob. Code § 18505(a).
- ¹⁰ Cal. Prob. Code § 18505(c).
- ¹¹ Cal. Prob. Code § 18506(a).
- ¹² Cal. Prob. Code § 18506(b).
- ¹³ Cal. Prob. Code § 18506(c).
- ¹⁴ Cal. Prob. Code § 18506(d).
- ¹⁵ FSP FAS 117-1, ¶¶ 5 and 8.
- ¹⁶ FSP FAS 117-1, ¶ 5.
- ¹⁷ FSP FAS 117-1, ¶ 7; SFAS 124, ¶¶ 11-12.
- ¹⁸ FSP FAS 117-1, ¶¶ 11 and A18.

The foregoing is only a brief summary of the guidance provided in CPMIFA and FAS 117-1 and does not address all aspects of these tax and accounting changes. Tax-exempt and nonprofit organizations should consult with counsel regarding the application of CPMIFA/UPMIFA and FAS 117-1

to their particular situation and circumstances. If you have questions about this Client Alert or would like additional information regarding the issues discussed herein, please contact David Kahn in our San Diego office, Jenny Allen in our Los Angeles office or any of the following:

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Abu Dhabi Bryant Edwards +971.2.495.1700	London Stephen M. Brown +44.20.7710.1000	Paris Christian Nouel +33.1.40.62.20.00
Barcelona Jordi Domínguez +34.93.545.5000	Los Angeles David O. Kahn +1.213.485.1234	San Diego David O. Kahn +1.619.236.1234
Brussels Howard Rosenblatt +32.2.788.60.00	Madrid Jordi Domínguez +34.91.791.5000	San Francisco Kirt Switzer +1.415.391.0600
Chicago Robert G. Goldman +1.312.876.7700	Milan Fabio Coppola +39.02.3046.2000	Shanghai Rowland Cheng +86.21.6101.6000
Doha Bryant Edwards +974.4101.521	Moscow Mark M. Banovich +7.495.785.1234	Silicon Valley Joseph M. Yaffe +1.650.328.4600
Dubai Bryant Edwards +971.4.704.6300	Munich Stefan Süß +49.89.20.80.3.8000	Singapore Mark A. Nelson +65.6536.1161
Frankfurt Hans-Jürgen Lütt +49.69.60.62.60.00	New Jersey David J. McLean +1.973.639.1234	Tokyo Hisao Hirose +81.3.6212.7800
Hamburg Tobias Klass +49.40.41.40.30	New York David S. Raab +1.212.906.1200	Washington, D.C. Julian Y. Kim +1.202.637.2200
Hong Kong Joseph A. Bevash +852.2522.7886	Orange County David W. Barby +1.714.540.1235	