

# THE PPC NONPROFIT UPDATE

## How Large Is Your Endowment—Or Is It?



Organizations are often ranked by the size of their endowment funds. Fairly or unfairly, the size of an organization's endowment is thought to correlate with its financial health. But when the size of the endowment is examined more closely, the numbers that are quoted by the media often aren't the endowment at all, but instead are the sizes of the investment portfolios. Although the media (as well as many organizations) casually use the term *endowment* to refer to the size of the investment portfolio, it's important to remember that these are very different things.

Organizations hold investments for many reasons other than endowment. Because of an organization's fiduciary responsibilities and because the disclosures required in financial statements often apply only to subsets of the investment portfolio, knowing why investments are held is equally important to knowing the worth of those investments.

### Fiduciary Responsibilities

An organization's management accepts a fiduciary responsibility to use assets as stipulated when it accepts a donor's gift, borrows money to construct a building or advance a student loan, or otherwise subjects itself to donor-imposed or contractual limitations on the use of assets. In addition, organizations may place internal designations on the use of certain investments.

When an organization accepts a restricted contribution, it accepts a fiduciary responsibility to use the gift for the purpose(s) for which it was given. If that purpose is to create a permanent endowment fund, the organization must have a method of identifying the investments purchased with that gift and determining the return generated by those investments, a process for appropriating the amount to be spent, and a process for determining that the amount is spent for the purpose specified by the donor. If, instead, the gift is a remainder interest in a charitable

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unitrust for which the organization serves as trustee, the organization must have a method of identifying the trust assets and determining the return generated by those assets, a process for determining the fair value of the trust assets and the amount to be sent to the beneficiary, a process for terminating the trust at the appropriate time, and a process for using any remaining trust assets in accordance with the terms of the trust agreement.

The organization also accepts fiduciary responsibilities when it enters into a contractual agreement that limits the use of its assets. For example, if the organization borrows for the purpose of constructing a building, the lender generally requires that the proceeds of the debt be invested separately (often in a trust) and that disbursement of the proceeds be supported by invoices for the construction costs.

Although organizations don't have fiduciary responsibilities to external parties when the governing board designates assets to be used for a particular purpose, tracking those designations and determining that the governing board instructions are followed is also important.

**Tracking Activity.** One way of tracking restrictions, contractual limitations, and governing board designations is fund accounting, which segregates resources into funds consistent with the restrictions and other limitations on them. (Although there are other methods, such as subsidiary ledgers and project accounting systems, this article uses the term *fund* to refer to accounting for restrictions, limitations, and designations.) When organizations have many individual funds, they typically combine the assets into one or more investment portfolios called *pools*. The reasons organizations combine the assets of many funds into investment pools include the following:

- Diversifying the market risk for each endowment fund.
- Reducing the risk of having to sell an investment during a market downturn. (The organization can choose among the many investments of the pool rather than selling the only investment of a particular fund.)
- Potentially reducing management fees.
- Minimizing uninvested cash.

In many ways, an investment pool is similar to a mutual fund, although it is managed by the organization rather than an investment company. Just as it's important for a mutual fund to be able to identify the value of each investor's interest and the investment return attributed to that interest, it's important for an organization to be able to identify the value of each fund's interest and the investment return attributed to each fund. To do so, the organization assigns ownership interests (typi-

cally through unitization or dollarization) to the various funds in the pool based on the fair value of the cash and securities placed in the pool by each fund.

Not all assets can be pooled with other assets for investment. In some cases, donors will contribute noncash assets that can't be sold currently or a donor may require that the gift be invested in a particular manner for a specified time. In other cases, a lender or regulatory authority may require assets to be invested separately.

Regardless of whether the assets are invested as part of a pool or are separately invested, not all investments are part of the organization's endowment. To meet its fiduciary responsibilities, the organization should be able to identify the investments of—

- excess operating cash;
- gifts to purchase capital assets, by type of asset to be purchased;
- each individual split-interest agreement;
- each individual donor-restricted endowment;
- each individual board-designated endowment; and
- other assets whose use is limited or restricted.

Often, those investments are identified by the portion of the investment pool the fund owns, such as "Able Endowment fund owns 243 units of the Long-term Investment Pool."

## Presentation and Disclosure

In addition to requirements to disclose information specific to the investments themselves, accounting standards include disclosure requirements that vary depending on why the investments are held. Those disclosures provide information about liquidity, assets whose use is limited, split-interest agreements, and endowment funds.

**Liquidity.** Paragraphs 3.09 through 3.23 of the AICPA Audit and Accounting Guide, *Not-for-Profit Entities*, explain that certain donor restrictions, governing board designations (which are presumed to reflect management intent), and legal limitations affect the classification of, or disclosures about, investments (or both). As a result, an organization should consider not only the types of investments and their maturity dates, but also the effects on liquidity of donor-imposed restrictions, management's intent to meet those restrictions, and management's intent to use assets for long-term purposes (such as liquidation of long-term debts, payments to sinking funds, establishment of quasi-endowment funds, etc.). For example, cash invested temporarily in a 90-day certificate of deposit isn't a cash equivalent if that certificate of deposit is held as part of an

investment pool composed of permanent endowment funds. The liquidity of the organization's investments is impacted by the organization's responsibility to hold an appropriate composition of assets to comply with donor-imposed restrictions, contractual limitations, and internal designations.

Thus, when presenting the information about liquidity required by FASB ASC 958-210-45, investments identified by the organization as held to meet a donor restriction or a board designation for noncurrent purposes could be identified by one of the following:

- Displaying investments held for noncurrent purposes separately from similar investments available for current operating purposes, and arranging the line items according to their relative liquidity on the face of the statement of financial position (that is, using descriptions that identify the nature of the asset and the reason for the classification, such as "operating investments," "investments held by bond trustee," and "endowment investments," with "endowment investments" displayed lowest of the three in the list of assets).
- Displaying investments on the face of the statement of financial position using a separate line item, such as "assets whose use has been limited or restricted," and including that line item in a position of relative liquidity consistent with its noncurrent purpose.

**Assets Whose Use Is Limited.** An organization might include certain investments in a line item indicating that the use of the assets is limited. For example, if an organization has received cash contributions and unconditional promises to give in response to a campaign to build a new facility, the organization might include both the promises to give and any investments purchased with the cash contributions in a single line item, "assets held for construction of new facility." Because the nature of those assets isn't clear from the line item description, the kinds of assets should be described in the notes to the financial statements.

**Split-interest Agreements.** If an organization holds investments as the trustee for charitable remainder trusts or as annuity reserves required by state law, the organization is required to disclose information about those donor restrictions and legal limitations. In addition, the assets recognized under split-interest agreements are required to be disclosed in notes to the financial statements if they aren't separately reported on the face of the statement of financial position. (FASB ASC 958-30-50 has a comprehensive list of the disclosures required for split-interest agreements.)

**Endowment Funds.** FASB ASC 958-205-50-1A and 50-1B require disclosures about the organization's

endowment. The extensive disclosures are designed to enable financial statement users to understand the classification and composition of endowments, the changes in net asset composition, the organization's spending policies for its endowments, and related endowment investment policies. In addition, organizations are required to provide a description of their interpretation of the laws underlying the net asset classification of donor-restricted endowment funds. The disclosures are required even if the organization only has board-designated endowment funds.

If an organization tries to make the endowment fund disclosure agree to the value of the investment portfolio or to the total net assets, the required disclosures will, in most cases, be incorrect. As this article has shown, not all investments owned by the organization are endowment investments. Further, the endowment funds generally hold assets in addition to investments—the most common of these are contributions receivable and cash that is temporarily uninvested.

To get the required endowment disclosures correct, it's very helpful to reconcile the investment portfolio to the related restrictions and designations on net assets, including the net assets of the endowment funds. In addition, that reconciliation helps the organization identify the appropriate caption(s) to indicate the effects of donor restrictions on liquidity and determine whether the organization has maintained an appropriate composition of assets in amounts necessary to comply with donor restrictions.

### Practical Consideration:

An example of the reconciliation between the investment portfolio and the related restrictions and designations on net assets is illustrated in *PPC's Guide to Preparing Nonprofit Financial Statements*. That *Guide* also contains more information on endowment funds. To order, visit [tax.thomsonreuters.com/products/brands/checkpoint/ppc](http://tax.thomsonreuters.com/products/brands/checkpoint/ppc).

### Conclusion

Next time you see an article stating that an organization's endowment is \$X million (or billion), you might want to look at the organization's financial statements to see if that's really accurate. You may find that the endowment is a significantly different amount because the size of the endowment and the size of the investment portfolio are very different things.



## Good Governance Requires Current Relationship Data

Charitable (and certain other exempt) organizations can inadvertently violate tax rules and/or file incorrect Forms 990 or 990-EZ if certain data is not current. Consequently, there are several relationship lists that should be updated regularly or, at the very least, annually.

### Disqualified Persons

**The Problem.** An excise tax (25% of the excess benefit) is imposed on disqualified persons (DPs) who receive economic benefits from Section 501(c)(3), (c)(4), and (c)(29) organizations in excess of the value of the consideration given for the benefits. If a tax is assessed against a DP, any organization manager who participated knowingly, willfully, and without reasonable cause in the excess benefit transaction is subject to a tax of 10% of the excess benefit [IRC Sec. 4958(a)].

**Prudent Action.** A list of DPs should be maintained by a covered organization as one of the first steps in avoiding excess benefit transaction (EBT) penalties.

DPs for purposes of the EBT rules are individuals and entities in a position to have substantial influence over the organization. See the November 2013 issue of *The PPC Nonprofit Update* for more discussion.

**Note:** One category of persons who are not deemed to have substantial influence over an organization are employees of the organization in question who receive total benefits (salary, bonus, fringe benefits, etc.) from it of less than \$115,000 for 2014 (and \$120,000 for 2015) (IRS Notice 2014-70, 2014-48 IRB 905).

### Former TDOKEs and HCEs

**The Problem.** Section A, Part VII, of Form 990 requires disclosure of the compensation of *former* trustees, directors, officers, key employees (TDOKEs), and highest compensated employees (HCEs) when compensation exceeds specified amounts.

**Prudent Action.** An organization should maintain a cumulative list of TDOKEs and HCEs, including beginning and ending service dates, to maintain the five-year "lookback" for determining whether they are *former* TDOKEs or HCEs.

A *former* TDOKE is any person (1) the organization reported (or should have reported) as a TDOKE on any of its five prior Forms 990, 990-EZ, or 990-PF according to the instructions in effect for such years, but who did not serve in any of those positions at any time during the current year; and (2) who received, in the calendar year ending with or within the organization's tax year, reportable compensation from the filing organization and any related organizations that exceeded the threshold amount for listing in Section A, Part VII, of Form 990 (i.e., \$100,000 for a former officer or key employee that is received for any reason or \$10,000 for services as a director or trustee).

A person who was a TDOKE in any of the five prior years is considered a *former* TDOKE even though he or she was (1) employed during the organization's tax year in a lesser capacity other than TDOKE or HCE, or (2) employed by a related organization (but not the filing organization) in any capacity and received reportable compensation in excess of the threshold amounts.

A *former* HCE is an individual with respect to whom the following four conditions apply:

1. The individual was not the organization's employee at any time during the calendar year ending with or within the organization's tax year.
2. The individual was, or should have been, reported as one of the five HCEs on any of the organization's five prior Forms 990, 990-EZ, or 990-PF.
3. The individual's reportable compensation exceeded \$100,000 for the calendar year ending with or within the organization's tax year.
4. The individual would be one of the organization's five HCEs based on reportable compensation if he or she had been an employee during the calendar year ending with or within the organization's tax year.

### Independent Directors

**The Problem.** Part VI, Section A, line 1b, of Form 990 asks for the number of *independent* voting members of the organization's governing body.

This seemingly harmless question must be answered carefully. The IRS is increasingly focusing on the number of an organization's independent voting members, often citing the lack of an independent governing body as one of the reasons for denying tax-exempt status (see Ltr. Ruls. 200828029, 201252021, and 201325017).

**Prudent Action.** An organization must make a *reasonable effort* to obtain the necessary information to determine whether a voting member is independent. The September 2014 issue of *The PPC Nonprofit Update* discusses the requirements for independence.

An organization is deemed to have made a reasonable effort if it requires that the voting members of its governing body complete an independence questionnaire. Such questionnaire must include a summary of the applicable rules. Checklist C508 in *PPC's 990 Deskbook* includes the criteria for trustee and director independence and could serve as the basis of an independence questionnaire.

## Family and Business Relationships

**The Problem.** Part VI, Section A, line 2, of Form 990 asks whether any TDOKE has a family relationship or a business relationship with any other TDOKE of the same organization.

**Prudent Action.** As in the case of determining director independence, an organization must make a *reasonable effort* to determine the existence of family and business relationships. This can also be done through a questionnaire.

In determining whether a family relationship exists, the family of an individual includes only his or her spouse; ancestors; brothers and sisters (whether whole or half-blood); children (whether natural or adopted); grandchildren; great-grandchildren; and spouses of brothers, sisters, children, grandchildren, and great-grandchildren.

Business relationships between two persons include the following:

- One person is employed by the other in a sole proprietorship or by an organization with which the other is associated as a trustee, director, officer, or greater-than-35% owner even if that organization is tax exempt.
- One person is transacting business with the other (other than in the ordinary course of either party's business on the same terms that are generally offered to the public) directly or indirectly, in one or more contracts of sale, lease, license, loan, performance of services, or other transaction involving transfers of cash or property valued in excess of \$10,000 in the aggregate during the organization's tax year.

*Indirect transactions* are transactions with an organization with which one person is associated as a trustee, director, officer, or greater-than-35% owner. These transactions do not include charitable contributions to tax-exempt organizations.

- The two persons are each a director, trustee, officer, or greater-than-35% owner in the same business or investment entity.

Ownership is measured by stock ownership (either voting power or value, whichever is greater) of a corpora-

tion, profits or capital interest in a partnership or limited liability company, membership interest in a nonprofit organization, or beneficial interest in a trust. Ownership includes indirect ownership (e.g., ownership in an entity that has ownership in the entity in question). Consequently, there can be ownership through multiple tiers of entities.

## Interested Persons

**The Problem.** Schedule L (Form 990 or 990-EZ), Transactions with Interested Persons, requires the disclosure of business transactions between the organizations and *interested persons* if—

- all payments during the year from a single transaction between the parties exceeded the greater of \$10,000 or 1% of the organization's total revenue for the year;
- total payments (regardless of the amounts of individual transactions) between the parties during the organization's tax year exceeded \$100,000;
- compensation payments during the tax year by the organization to a family member of a current (or former) TDOKE listed in Form 990, Part VII, Section A, exceed \$10,000; or
- in the case of a joint venture with an interested person, the organization has invested \$10,000 or more in the joint venture (whether or not during the tax year).

**Prudent Action.** An organization must make a reasonable effort to determine the identity of its interested persons. An example of a reasonable effort is the annual distribution of a questionnaire to each current or former TDOKE that contains the pertinent instructions and definitions for Schedule L, Part IV. The organization need not distribute the questionnaire to organizations or individuals with which it does business if they are not current or former TDOKEs in order to have made a reasonable effort.

An *interested person* is—

- a current or former TDOKE listed in Form 990, Part VII, Section A (or his or her family member);
- an entity [other than a Section 501(c)(3) organization, a Section 501(c) organization of the same subsection as the filing organization, or a governmental unit or instrumentality] more than 35% owned, directly or indirectly, or controlled by (a) one or more current or former TDOKEs listed in Form 990, Part VII, Section A, and/or (b) their family members; and
- an entity [other than a Section 501(c) organization or a government unit or instrumentality] of which a current or former TDOKE listed in Form 990, Part VII, Section A, or any of his or her family members, was serving at the time of the transaction as (a) a trustee, director, or officer; (b) a partner or member with a direct or

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indirect ownership interest in excess of 5% if the entity is treated as a partnership; or (c) a shareholder with any ownership interest in excess of 5% if the entity is a professional corporation.

For the previous 35% control test, a nonprofit is more than 35% controlled when more than 35% of its directors or trustees either (a) consist of interested persons of the filing organization, or (b) serve as directors or trustees subject to powers held by one or more interested persons of the filing organization to elect or appoint, or remove and replace, such directors or trustees or the members that elect or appoint them.

An indirect business transaction also includes a transaction between the organization and a management company of which a former TDOKE of the organization (within the last five tax years, whether or not listed in Form 990, Part VII, Section A) is a direct or indirect 35% owner or an officer, director, or trustee.

### Practical Consideration:

Maintaining reliable relationship data (1) can assist in the proper completion of Form 990 or 990-EZ, and (2) should reduce the cost of return preparation if done by an outside preparer.



## Tax Briefs

**PARSONAGE ALLOWANCE.** In the July 2014 issue of *The PPC Nonprofit Update*, we discussed a district court case that held the exclusion of a parsonage allowance

from a minister's income [under IRC Sec. 107(2)] to be a violation of the Constitution's First Amendment prohibition against the establishment of religion [*Freedom From Religion Foundation, Inc. v. Lew*, 112 AFTR 2d 2013-7103 (DC WI)].

The critical issue on appeal to the Seventh Circuit was whether the plaintiffs in the case had standing (i.e., the legal grounds) to challenge the exclusion of the allowance [*Freedom From Religion Foundation, Inc. v. Lew*, 114 AFTR 2d 2014-6570 (7th Cir. 2014)]. The appeals court reviewed the three ways that it believed individuals could establish standing in an Establishment Clause case and determined that the plaintiffs in this case could not satisfy any of the tests. As a result, the appeals court vacated the district court's decision and remanded it with instructions to dismiss for lack of jurisdiction.

**IRS OKAYS DOMICILE CHANGE.** In Ltr. Rul. 201446025, a Section 501(c)(3) organization (X) proposed to change its state of domicile from State 1 to State 2 by filing Articles of Domestication and a Certificate of Conversion. The laws of State 2 provided that such filings would not affect X's date of incorporation and that it would be the same corporation as the one that existed in State 1. The governing law of State 1 provided that after filing the Certificate of Conversion, X would continue to exist without interruption.

Under these circumstances, the IRS ruled that X's change of domicile would not be a substantial change in its character, purpose, or methods under Reg. 1.501(a)-1(a)(2) or create a new legal entity that would require the filing of a new exemption application.

