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# Non-Profit Challenges With Alternative Investments and Restricted Funds

Making Defensible Valuations and Well-Crafted Disclosures in Financials

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WEDNESDAY, SEPTEMBER 7, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

Michael Sorrells, National Director of Non-Profit Tax Services, **BDO USA**, Bethesda, Md.

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C. Scott Meyer, Partner, **Montgomery McCracken Walker & Rhoads**, Philadelphia

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# Non-Profit Challenges With Alternative Investments and Restricted Funds Seminar

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Sept. 7, 2011

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# Today's Program

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Fundamental Concepts

*[Michael Sorrells and C. Scott Meyer]*

Slide 7 - Slide 13

Tax Issues Arising From Alternative Investments

*[Michael Sorrells]*

Slide 14 - Slide 20

Roles, Responsibilities Of Investment Committee

*[Rory Cohen]*

Slide 21 - Slide 27

Additional Issues Relevant To Alternative Investments

*[C. Scott Meyer]*

Slide 28 - Slide 37

Audit Preparation

*[Rory Cohen]*

Slide 38 - Slide 40

Michael Sorrells, BDO USA

C. Scott Meyer, Montgomery McCracken Walker & Rhoads

# FUNDAMENTAL CONCEPTS



# Alternative Investments Overview

- Due to the potential for greater yields, we are seeing a groundswell in organizations involved in a wide variety of alternative investments.
- Form and structure of these vary tremendously and are often complex
- Many organizations are not aware of the possible taxes involved and/or the compliance burden.
- Often not very liquid and hard to cash in
- These operations and investments may also affect the organization financial statements (both with ASC 740-10 and other unreported liabilities).





# Foreign Alternative Investment Vehicles

- Often housed in a U.S. partnership or LLC (pass-through entity)
  - Pass-through may in turn be invested in foreign corporation(s), U.S. or foreign partnerships, or tiered combinations.
- Direct investment in foreign corporation, which then is invested in foreign partnership(s) or LLC(s)
- Passive foreign investment companies (PFICs): Defined by U.S. tax due to most income being passive investment income
- Direct investment in foreign partnerships



# Donor-Restricted Funds

- Temporarily restricted
  - Time restriction: Most often, funds are not allowed to be spent until a future year; often seen with pledges
  - Purpose restriction: Completion of project, etc. that funds were restricted for
  - Once the restriction expires, funds become unrestricted.
- Permanently restricted
  - Limit by donor that cannot expire by the passage of time and cannot be fulfilled or otherwise removed by actions of the organization. Generally these are endowments – corpus cannot be spent; only earnings may be expended.



# Primary Valuation Audience

## External Auditors

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- Management's non-delegable duty under AU 328.04
- Understanding key objectives under AU 332.01
  - Existence or occurrence
  - Completeness
  - Rights and obligations
  - Valuation or allocation
  - Presentation and disclosure
- Reliance on service providers under AU 324
- Best practices
  - Training and continuing education
  - Separate buying from valuing
  - Stable IT
  - Management assumptions process: Origination, review and monitoring, and documentation of process
  - Valuation models: Ditto





# Other Valuation Audiences

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- Board purposes
- Investment advisor assessment
- Cash management projections
- Development office performance review
- Donor relations





# Some Additional Considerations

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- Timeliness of information
- Measurement date mismatch for NAV vehicles
- Vehicle declaration of distributions as principal/income under state law



Michael Sorrells, BDO USA

# **TAX ISSUES ARISING FROM ALTERNATIVE INVESTMENTS**



# Taxation Of Pass-Through Entities: Partnerships Or LLCs

- Tax treatment is as if the organization itself conducted its portion of the activities.
- For U.S. partnerships and LLCs, K-1 will show partners' share of various income items (e.g., dividends, interest, ordinary income, rental).
- K-1s are also required to indicate UBI but sometimes don't when they should (often when partnership does not know you are an exempt organization).
- If you borrowed to make the investment, then normally excluded items such as dividends, rent, etc. all become taxable.
- Also look for partnership-level debt; it will also make things taxable.



# Taxation Of Pass-Through Entities: Partnerships Or LLCs (Cont.)

- K-1 may also report income from a variety of states; if UBI, you may have to file and pay taxes in many states other than the domicile state.
  - Most states do tax UBI.
  - Very commonly ignored and may create large liability if state return was never filed
- K-1 often has a lot of information about various US tax forms for foreign holdings that may be required. Ignore this at your peril, as penalties may be huge.





# Taxation Of Foreign Corporations

- Frequently employed as “blockers” that convert taxable income from lower-tier pass-throughs to non-taxable dividends for the non-profit investor
- Generally unlikely to generate UBI, since income to parent is generally in form of dividends, which are excluded from UBI
- *Could* generate UBI when:
  - Parent is providing services for fee, and activities are unrelated.
  - If the investment is debt financed
- PFICS have special tax rules, but in most cases won't cause tax since dividends are excluded from UBI (unless debt-financed).



## Other US Tax Forms That May Be Required By Foreign Investments

- Some forms that may be required (varying thresholds)
  - 8865: Return with respect to foreign partnership
  - 5471: Return with respect to foreign corporation
  - 926: U.S. transferor of property to foreign corporation
  - TD F 90-22.1: Report of Foreign Bank and Financial Accounts
- Rules for filing these are very complex and require specific international tax expertise – often, the requirement is generated through indirect ownership.
- Penalties for non-compliance can be huge.



# 990 Reporting For Foreign Operations/Investments

- Activities of other entities (unless single-member LLCs) are not included in the 990 income, expenses or balance sheet.
- Schedule F (foreign activities)
  - Reporting of offices, activities, employees and agents by region
  - Reporting of expenditures *and investments* by region
  - Grants to foreign organizations by region
  - Grants to foreign individuals by region
  - New for 2010: Must disclose if required to file Forms 5471, 926, 3520, 8865, etc.



# Impact Of Foreign Investment Taxation On Financial Statements

- Under-accrual of tax liability
- ASC 740-10 (FIN 48) uncertain tax positions
  - Must consider liability for foreign taxes and impact of not filing
  - State taxes are also considered, and if no returns are filed in the state, then liability can go back quite a few years.
  - Unreported or underreported UBIT: If no returns are filed, it can go back a number of years.
  - Penalty and interest also included
- Unrecorded liabilities for non-income tax items
  - Penalties for non-filing of 5417s, FBAR, 926, etc. are very high and if not filed, no statute of limitations

Rory Cohen, Venable LLP

# **ROLES, RESPONSIBILITIES OF AUDIT COMMITTEE**

# Statutory Guidance

- Uniform Prudent Management of Institutional Funds Act
  - Modernized UMIFA (initially drafted in 1972)
    - Rules governing expenditures
    - Management of investment management function
  - Incorporates many standards set forth in Uniform Prudent Investor Act (adopted in 1994)
    - Applies to trustees of trusts, including charitable trusts
  - Harmonizes standards for managing and investing institutional funds
  - Added “prudent,” to emphasize the prudence in management



# Prudent Management And Investment

- Give primary consideration to donor's intent
- Duty of loyalty: Different standards for NFP corporations and charitable trusts
  - NFP directors: "Best interests"
  - Trustees: "Sole interests"
- Duty of care
  - Prudent investor - you are not a guarantor
    - Reasonable care, skill and caution; portfolio approach
    - Good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances
      - Prudence under the facts and circumstances prevailing at the time of the action of decision
      - Consider the organization's risk/return objective
      - High standard for directors selected who have particular expertise or experience in investment management
  - Duty to minimize costs: reasonable costs to invest and manage, considering:
    - Size of assets
    - Purposes of the institution
    - Skills/sophistication of investment committee
    - Third party adviser costs should be reasonable



# Prudent Decision-Making

- In managing and investing an institutional fund, consider:  
(Sect. 3 of UPMIFA; substantially mirrors UPIA §2(c))
  - General economic conditions
  - The possible effects of inflation and deflation
  - The expected tax consequences, if any, of investment decisions or strategies
  - The role that each investment or course of action plays within the overall investment portfolio of the fund
  - The expected total return from income and the appreciation of investments
  - Other resources of the institution
  - The needs of the institution and the fund to make distributions and to preserve capital
  - An asset's special relationship or special value, if any, to the charitable purposes of the institution





# Fiduciary Responsibilities

- Duty to investigate: reasonable efforts to verify facts pertaining to investment management
  - How are the assets going to be managed?
    - By board or subcommittee
    - Delegation to another officer (e.g., CIO)
    - Delegation to third parties (e.g., RIAs, BDs, banks)
- Modern portfolio theory: Decisions about each asset in the context of the portfolio
  - E.g., consider risk and return objectives of entire fund
  - Hedge funds, private equity, real estate funds
- Diversify unless due to special circumstances
- Dispose of unsuitable assets
- Develop investment strategy appropriate for the fund and charity



# Delegation To External Agents

- Explicitly permitted by UPMIFA
- External agents include an independent investment adviser, investment counsel or manager, bank or trust company
- Duty of care in connection with selection and continued retention
  - Affirmative duty to assess the independence of outside agents and conflicts of interest before and after retaining them
  - Selection should be based on competence, experience, past performance and proposed compensation; not on business or personal relationships
  - Coordinate with conflicts of interest policy
  - Directors and investment committee members are not liable for the actions or decisions of such third parties if the selection and retention are proper.
  - Key considerations
    - Transparency of portfolio
    - Transparency of the portfolio manager
    - Regulatory filings and other disclosures



# It's All About Process

- Educate yourself
- Develop an asset allocation strategy
- Prepare and maintain an investment policy statement
- Implement an investment strategy
- Monitor and supervise implementation of investment strategy
- Procedures for controlling and accounting for expenses
- Process is key
  - Evidence competence: Be able to illustrate awareness of fiduciary responsibilities
  - Substantiation
    - Document analysis
    - Timing of reviews/analysis
    - Details of reviews and analysis (e.g., issues reviewed, persons involved, supporting calculations, background research and analysis)
    - Describe the nature and extent of considerations given to UMIFA and other factors
    - If a particular factor is deemed not relevant, consider explaining why not.
- Have a process to review your process



C. Scott Meyer, Montgomery McCracken Walker & Rhoads

**ADDITIONAL ISSUES  
RELEVANT TO ALTERNATIVE  
INVESTMENTS**



# Traps For The Unwary

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- Sect. 4958 – excess benefit
  - “Direct or indirect”
  - “Disqualified person”
    - 35% control test and attribution
  - “Flipping” transactions and private inurement
    - For larger transactions, use extra caution
  - Compare/contrast ERISA fiduciary duties





# The Big Kahuna Trap: §4965

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- §4965(b)(1)(A): **Almost strict liability – lack of knowledge is no defense – you must investigate**
- Listed transaction and prohibited reportable transaction under §6707A
- Three key points
  - Get a complete picture of related entities.
  - Any confidentiality requirement in any related entity as to any tax matter is absolute poison.
  - Follow the Buffett rule: If you don't understand it, don't invest in it.
- Remember: Your donor or advisor is not always your friend.
  - Educating your planned giving department – you now have a conflict with your donors' advisors





# Donor-Advised Funds Traps

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- 4967: “Direct or indirect” prohibited benefit
- 4966: Program-related investment issues; when is an investment not an investment?
- 4943(e): Excess business holdings rules





# Direct Investment Issues S Corp.

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- Gift from donors
  - Very often, a better result is obtained if proceeds rather than stock are gifted.
  - Complicates donors' further estate planning
- Shareholder issues
  - Tax distribution requirements
  - Exit strategies
  - Attorney general standing to review transactions
- Charitable trust tax rates on capital gains
  - Controversial? Instructions vs. Code







# Direct Investment Single-Member LLC

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- Liability shelter
  - Real estate
  - Certain joint ventures
  - “Silo” strategy
  - Co-investor concerns
- Limiting apparent authority
- Internal controls
- Fund tracking





# Considerations With Federal Partnership Entities

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- Tax payments
- Tiered debt
- Multiple state reporting
- Conflict of interest *compare* IRC §4941 and §4975
  - Cross-entity subsidies
  - Manager compensation issues
  - Opposing investor objectives





# Socially Responsible Investments

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- Value or philosophy clarification
  - Choose *for* or *against* some things, or aim for a pragmatic mix
  - Performance dimension – unimportant to relatively significant
- Communication clarification: Who is the core audience for this message?
  - Board as representative of the entity itself
  - Donors
  - Affiliated and parallel organizations
  - Service community
  - Others
- Investment authorization clarification
  - What instructions are given to advisors about investment selection and retention?
- Ongoing review of message against values, authorizations and auditing duties





# Smell Test-Type Issues

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- Stranger-owned life insurance
- Litigation finance
- IP “trolls”
- Country-specific
- Some vulture funds
- Politically connected plays
- Regulatory “gray” areas
- Even worse stuff





# Donor Restriction Compliance

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- Getting audited by donors and grant makers – not a good place to be
- Charging restricted funds on a percentage basis for operational management overhead
- Use of income on temporarily restricted funds
- Reservation of variance power
- Donor standing
- Cost-shifting



Rory Cohen, Venable LLP

# AUDIT PREPARATION

# Prepare And Maintain An Investment Policy Statement

- Best practice to draft and review “written” investment policies
- Formalizes your process, is auditable, and allows for more consistent application of process
- No one size fits all
  - Sample subjects to 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 functions
    - The investment manager’s accountability
    - Procedures for selecting and evaluating “external agents”
    - Processes for reviewing investment policies and strategies
    - Proxy voting
- Frequency of review – At regular intervals and whenever a change in the institution’s financial condition or other circumstances require



# Due Diligence In A Nutshell

- Firm/Firm history (ownership structure, investment team, AUM and AUM growth, capacity of strategy, investor composition)
- Investment strategy, objectives and process
- Review of performance
- Operational due diligence and risk management controls
- Transparency, frequency of reporting
- Conflicts of interest considerations
- Underlying document and structured features
- SEC registration and other regulation

