



Proposed Revisions to the Uniform Management of Institutional Funds Act

Specialists in the charitable planning and nonprofit fields should be aware that proposed revisions to UMIFA, which are expected to be enacted in 2005, will have a significant impact on the management and spending of charitable funds.

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Proposed revisions to the Uniform Management of Institutional Funds Act (“UMIFA”), which are expected to be enacted in 2005,¹ will “modernize” the methodology that determines how charitable funds may be invested and spent in accordance with Modern Portfolio Theory,² the Uniform Prudent Investor Act,³ the Uniform Principal and Income Act,⁴ and the Uniform Trust Code.⁵ Practitioners in the charitable planning and nonprofit arenas should be aware of and understand these proposed revisions to UMIFA, which will affect significantly the way that nonprofits invest and spend their charitable funds. The failure of charities to invest and spend their charitable funds in accordance with UMIFA, as adopted under applicable state law, may give rise to liability risks and concerns. This article sets forth a general explanation of UMIFA and summarizes the important proposed revisions to UMIFA.

Background

UMIFA, which was first promulgated in 1972 by the National Conference of Commissioners on Uniform State Laws (“NCCUSL”), governs the spending of charitable “institutional funds.”⁶ Although UMIFA has been adopted in whole or in part by the vast majority of the states, it is rare to find an article or publication addressing

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UMIFA.⁷ Furthermore, it is the author's experience that many estate and charitable planning professionals either have never heard of UMIFA or know little about it. This is rather surprising, considering UMIFA's critical importance in the charitable planning and nonprofit sector.

The major goals in the enactment of UMIFA by NCCUSL in 1972 included:

1. Providing a prudence standard that nonprofits could rely upon in spending the appreciation of their endowment funds;
2. Providing a standard for investment authority and decision making;
3. Authorizing the delegation of investment decisions to outside investment managers;
4. Providing a standard of business care to guide nonprofit boards of directors in the exercise of their duties under UMIFA; and

5. Providing a method of releasing restrictions on the use of charitable funds by obtaining the donors' acquiescence or court approval.⁸

Prior to UMIFA, there was little guidance for nonprofits regarding the investment and spending of their charitable funds. It was thought that the same rigid fiduciary standards that applied to trustees also applied to both incorporated and unincorporated nonprofit organizations. Numerous questions and concerns existed in such areas as: permissible investments, the ability to delegate investment authority, use of total return investing to achieve growth, and spending of the appreciation of charitable funds.

As one illustration of this, before UMIFA was enacted, managers of charitable funds believed that their investments of charitable funds had to be limited to strictly "safe" investments such as cash, bonds, and low-risk stocks. As a result, the funds were not able to experience significant growth, which severely curtailed the spending ability of the charities for their intended pro-

grams and missions. This, in turn, jeopardized the effectiveness and purposes of the charities.

UMIFA permits a charity to "appropriate appreciation, to make and retain investments, and to delegate investment management of institutional funds" subject to the fiduciary standard of "ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision."⁹ This standard of care is analogous to the standard of care applicable to a for-profit corporation, and is unlike the stricter standard of care applicable to a trustee.

The failure to understand the rules under UMIFA, as adopted under applicable state law, may give rise to liability risks and concerns.

However, UMIFA also sets a safe harbor ceiling known as "historic dollar value" on a charity's ability to use appreciation for spending of its "endowment funds."¹⁰ "Historic dollar value" is defined as "the aggregate fair value in dollars of (i) an endowment fund at the time it became an endowment fund, (ii) each subsequent donation to the fund at the time it is made, and (iii) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the fund."¹¹ In other words, the appreciation of an endowment fund may be spent only if it is in excess of the value of the endowment fund at the time that it was originally funded plus subsequent donations to the endowment fund. If the endowment fund has declined in value below its "historic dollar value," then all future spending is barred.

Many endowment funds established by charities during the past few years have fallen below their "historic dollar value" due to the severe market downturn. An endowment fund which has fallen below its "historic dollar value" has no appreciation to spend. As a result, many charities have been prohibited from spending their endowment funds, which in turn has hampered their abilities to fulfill their charitable purposes.

Furthermore, because the purpose of UMIFA was to provide flexibility and discretion to managers of charitable funds, there is a need to update UMIFA to comply with Modern Portfolio Theory, and the passage of the Uniform Prudent Investor Act, the Uniform Principal and Income Act and the Uniform Trust Code, which were all enacted subsequent to the enactment of UMIFA.

UMIFA as enacted in 1972

Institutions and not charitable trusts. Only the charitable funds of "institutions" are governed by UMIFA. "Institutions" are defined as "incorporated or unincorporated organization[s] organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes, or a government organization to the extent that it holds funds exclusively for one of these purposes."¹² Charitable trusts are excluded from UMIFA, unless the trustee itself is an "institution." Thus, even a charitable trust with a corporate trustee, such as a bank, would not be governed by UMIFA.

Nevertheless, as with all Uniform Acts, the application of UMIFA varies from state to state. For example, some states exempt all private foundations from UMIFA.¹³ Other states exempt certain educational institutions from UMIFA.¹⁴ Still other states apply

¹ The revisions were expected to be enacted in 2004, but were delayed to provide further time for comments.

² Modern Portfolio Theory was universally introduced by Professor Harry Markowitz of the City University of New York in his article entitled "Portfolio Selection," which was published in the *Journal of Finance* in 1952.

³ Enacted by NCCUSL in 1994.

⁴ Enacted by NCCUSL in 1997.

⁵ Enacted by NCCUSL in 2000.

⁶ See the later section in this article on "UMIFA as enacted in 1972," "Institutions," for a definition of "institutional funds."

⁷ The only states that have not adopted UMIFA in some form or another are Alaska, Arizona, and Pennsylvania.

⁸ See UMIFA, Prefatory Note at p. 2, NCCUSL, 1972.

⁹ UMIFA § 6.

¹⁰ See the later section in this article on "UMIFA as enacted in 1972," "Endowment funds," for a definition of "endowment funds."

¹¹ See UMIFA §§ 1 and 2.

¹² UMIFA § 1(1).

¹³ See, e.g., Okla. Stat. § 60-300.3(4)(c).

¹⁴ See, e.g., Mo. Rev. Stat. § 402.010(4)(a).

UMIFA only to organizations and governmental entities that are operated exclusively for educational purposes.¹⁵

Endowment funds. While UMIFA applies to all institutional funds, the “historic dollar value” ceiling applies only to an institutional fund that is also an “endowment fund.” An “endowment fund” is defined as a fund that is “not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument.”¹⁶ A “gift instrument” is defined as a “will, deed, grant, conveyance, agreement, memorandum, writing, or other governing document (including the terms of any institutional solicitations from which an institutional fund resulted) under which property is transferred to or held by an institution as an institutional fund.”¹⁷ In other words, if a fund is temporarily or permanently barred from spending some or all of the principal amount by the language of the gift agreement, the organization’s governing instruments, the fund’s policy statements and representations made in connection with the solicitation of the gift, then it will be subject to the ceiling on spending.

Releasing restrictions. A charitable institution may release a restric-

tion imposed by the applicable gift instrument with the written consent of the donor.¹⁸ If the charity cannot obtain the written consent of the donor because of the donor’s “death, disability, unavailability, or impossibility of identification,” the charity can petition the courts for release of the restrictions.¹⁹ However, in such case, notice is required to the state Attorney General, who must be given an opportunity to be heard.²⁰ Whether the release on restrictions is obtained through the donor’s written consent or through court approval, the funds must still be used for educational, religious, charitable, or other eleemosynary purposes.²¹

Perhaps the most significant of the proposed revisions to UMIFA will eliminate the ‘historic dollar value’ ceiling and will use a prudence standard.

It is important to note that UMIFA, as adopted under applicable state law, is in essence a “default” statute for charitable funds. A donor can always set the terms of his or her gift through a gift instrument and override UMIFA. For this reason, it is critically important that the donor’s advisors understand the rules pertaining to charitable funds, so the wishes and objectives of the donor can be imposed.

Proposed revisions to UMIFA

The following discussion examines the proposed revisions to UMIFA, pursuant to the 8/25/04 Draft prepared by NCCUSL’s Drafting Committee. The revisions—while not

yet adopted—are expected to be enacted in 2005. The Drafting Committee continues to seek input and discuss the current draft. Therefore, readers should be cautioned that there may be further changes before the revisions appear in final form.

Historic dollar value. Perhaps the most significant of the proposed revisions to UMIFA will eliminate the “historic dollar value” ceiling and permit an institution to spend or accumulate as much of an endowment fund as is “prudent under the circumstances,” with guidance provided by a series of factors to be considered.²² These factors will include the duration and preservation of the endowment fund; the purposes of the institution and the endowment fund; general economic conditions; the possible effect of inflation or deflation; the expected total return from income and the appreciation of investments; the institution’s other resources; and the investment policy of the institution.²³ There will be no floors, ceilings, or safe harbors on the spending of endowment funds. This will free up spending for many endowment funds which have not achieved growth in recent years.

Eliminating the “historic dollar value” ceiling is not without concern. In a letter to NCCUSL’s Drafting Committee dated 8/19/03, William Josephson, head of the Charities Bureau of the New York State Attorney General’s Office, expressed concern that replacing



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¹⁵ See, e.g., Fla. Stat. § 1010.10(2)(c).

¹⁶ See UMIFA § 1(3).

¹⁷ UMIFA § 1(6).

¹⁸ UMIFA § 7(a).

¹⁹ UMIFA § 7(b).

²⁰ *Id.*

²¹ UMIFA § 7(c).

²² Proposed UMIFA § 4.

²³ *Id.*

the "historic dollar value" standard with a general prudence standard may create uncertainty which may cause "good fiduciaries" to become paralyzed with regard to spending their endowment funds by the lack of clear rules, and may cause "bad fiduciaries" to act imprudently with regard to spending.²⁴ Moreover, Mr. Josephson's letter expressed concern that applying a general prudence standard will make it difficult for government regulators to determine violations on spending.

While NCCUSL's UMIFA Drafting Committee has acknowledged these concerns, the Committee has determined that replacing "historic dollar value" with a prudence standard is a better approach for a number of reasons. These include the following:

1. Charities using "historic dollar value" have been unable to spend endowment funds created over the past few years.
2. "Historic dollar value" is not adjusted for inflation, so the real value of the endowment fund is not preserved.
3. Charities are all of different sizes and purposes, and it would not make sense to have one standard for all charities.
4. With the advent of Modern Portfolio Theory and total return investing, setting fixed limits on spending is not in accordance with the Uniform

Prudent Investor Act and the Uniform Principal and Income Act.²⁵

Application to charitable trusts. The proposed revisions would make UMIFA applicable to all wholly charitable trusts, as well as other incorporated and unincorporated organizations.²⁶ This would include split-interest trusts after the non-charitable interests have ended.²⁷ The proposed revisions recognize that the rules for managing and investing charitable funds should be the same regardless of the structure of the institution.²⁸ Additionally, since many of the rules applicable to trustees of trusts are growing increasingly similar to the rules applicable to directors of nonprofit corporations, the standard for management of charitable funds should also be similar for both.²⁹

Modifying or releasing restrictions. The proposed revisions would continue to permit an institution to release or modify a restriction with the donor's consent, but will go a step further by allowing an institution to release or modify a restriction upon notice to the state Attorney General even without the donor's consent and even without court approval if (1) the restriction has become "unlawful, impractical, impossible to achieve or wasteful;" (2) the total fund value is less than \$25,000; and (3) more than 20 years have elapsed since the fund was established.³⁰

In such case, the institution must still use the funds in a manner consistent with the charitable purpose expressed in the gift instrument.³¹ Even if the fund does not meet the size and age requirements, a court may still release the restrictions on the fund if the restrictions have become "unlawful, impractical, impossible to achieve or

wasteful" and the state Attorney General is notified and afforded an opportunity to be heard.³² In all cases, the funds must still be used for the charitable purposes of the institution.³³

The Drafting Committee considered requiring notice to the donor even where a court releases the restriction, but found that this would become impractical if a fund had multiple donors. Additionally, the Drafting Committee felt that the institutions would be concerned about donor relations and would notify the donors when feasible if a restriction was released, even if not mandated by statute. Furthermore, the state Attorney General still must be notified and be given an opportunity to be heard. So, the interests of the donors will still be protected.

²⁴ A copy of the letter can be found on the NCCUSL website, www.nccusl.org.

²⁵ See Prefatory Note to Proposed UMIFA. See also Memorandum from Professor Susan N. Gary dated 8/25/04, which can be found on www.nccusl.org.

²⁶ Proposed UMIFA § 2(4).

²⁷ *Id.*

²⁸ *Id.* See also Preliminary Comments to Proposed UMIFA § 2, subsection (4).

²⁹ *Id.* See also Prefatory Note to Proposed UMIFA.

³⁰ See Proposed UMIFA § 6(d).

³¹ Proposed UMIFA § 6(c).

³² *Id.*

³³ Proposed UMIFA § § 6(b), 6(c), and 6(e).

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Standard of care. The proposed revisions provide for a standard of care³⁴ blending elements of the Uniform Prudent Investor Act and the Revised Model Nonprofit Corporation Act ("RMNCA").³⁵ UMIFA imposes a duty of loyalty and a duty of care using language from the RMNCA. The duty of loyalty provides that the management and investing of institutional funds must be conducted in a manner that the individual "reasonably believes to be in the best interest of the institution."³⁶ However, to the extent that trust law may impose a greater duty of loyalty, trust law will still govern the actions of trustees of

charitable trusts in the management and investing of trust funds.³⁷

The duty of care provides that the management and investing of institutional funds must be conducted in "good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances."³⁸ This is the precise language that is found in the RMNCA.³⁹ However, the proposed revisions also list a series of factors that an institution should consider in managing and investing its funds. These factors are derived from the Uniform Principal and Income Act⁴⁰ and include: the terms of the gift instrument; the charita-

ble purpose; the purpose of the fund; the general economic conditions; the possible effect of inflation or deflation; the expected tax consequences, if any, of investment decisions; the role that each investment plays within the overall investment portfolio of the fund; the expected total return from income and appreciation; other resources of the institution; the needs of the institution and the fund to make distributions and to preserve capital; and an asset's special relationship or special value, if any, to the charitable purpose of the institution.⁴¹

Conclusion

Practitioners in the charitable planning and nonprofit sectors should be aware that proposed revisions to UMIFA, which are expected to be enacted in 2005, will have a significant impact on the management and spending of charitable funds. Because UMIFA is still relatively unknown to many practitioners, now is an appropriate time to focus on and understand how UMIFA affects charities, donors, and their advisors. The failure to understand the rules under UMIFA, as adopted under applicable state law, may give rise to liability risks and concerns. ■

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³⁴ Proposed UMIFA § 3.

³⁵ Revised Model Nonprofit Corporation Act (1987). See Kestenbaum, "Duties and Liabilities of Nonprofit Directors and Officers," 31 ETPL 218 (May 2004).

³⁶ See Proposed UMIFA § 3(a).

³⁷ See Preliminary Comments to Proposed Revisions to UMIFA at § 3(a).

³⁸ Proposed UMIFA § 3(a).

³⁹ See Revised Model Nonprofit Corporation Act § 8.30.

⁴⁰ See Uniform Principal and Income Act § § 2(a) and 2(c).

⁴¹ *Id.* at § 3(e).