

Recent Legal Changes Affecting the Nonprofit Community:

*Nonprofit LLCs, Property Tax
Exemption and UPMIFA*

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Overview

- Minnesota Nonprofit LLCs
 - Why and What?
- Property Tax Exemption
 - 2007/2008 Court Cases
 - 2008 Legislation
- UPMIFA
 - Impact in a Down Market
 - FASB standards

Minnesota LLCs – Business Purpose Requirement

- Prior to 2008, §322B.10 permitted a LLC to be organized “for any business purpose”
 - Non-business purpose in question
 - Cabin ownership
 - Nonprofit purpose
- Result: questions of legal standing and validity of MN LLCs formed for these non-business purposes

Amendment to Chapter 322B

- Three primary changes to 322B enacted in 2008 :
 - § 322B.10 to permit formation “for any lawful purpose”
 - New § 322B.975 authorizes a “nonprofit LLC”
 - § 322B.03’s definition of “foreign limited liability company” is changed to recognize new forms

Nonprofit LLCs

- § 322B.975
 - Nonprofit LLC is:
 - Organized under or governed by “this Chapter”, and
 - Articles of Organization state it is a nonprofit LLC governed by this section
 - Foreign nonprofit LLCs are not subject to § 322B.975

* Nonprofit LLC ≠ Tax-Exempt Entity

Nonprofit LLCs

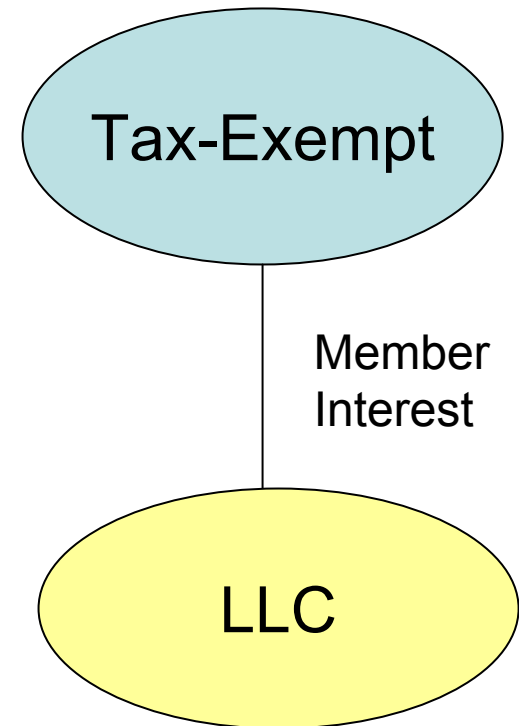
- § 322B.975 – Nonprofit LLCs
 - Members
 - Cannot be formed to benefit its members, *unless* members are nonprofits or government entities
 - No distributions to members, other than other nonprofits or government
 - Individual members are not permitted
 - Concern was individuals inadvertently using nonprofit LLC and creating adverse individual tax effects
 - Individuals **can** be members of nonprofit corporations
 - » Used in private foundation context

Nonprofit LLCs

- § 322B.975 – Nonprofit LLCs
 - Chapter 317A Provisions Imported
 - Requested by the AG’s office
 - Donations expressly permitted
 - Conflicts of interest
 - Fiduciary duty
 - Volunteer immunity
 - Change in use of assets limitations
 - Asset distribution priority in dissolution
 - Equitable relief
 - AG powers and approvals

Nonprofit LLCs - Common Uses

- Single Member LLC
 - As subsidiary of existing tax-exempt entity
 - Disregarded for tax purposes
 - Operations and finances attributed to parent
 - Treated as a tax-exempt entity, without IRS approval process
 - Often uses charitable purposes language in Articles of Organization
 - Caution, IRS has not ruled that contributions to such a single member LLC are deductible as charitable contributions under Code Section 170



Property Tax Exemption

- Minnesota Statutes Section 272.02 exempts from taxation property owned by
 - Public schoolhouses
 - Public hospitals
 - Academies, colleges and universities and seminaries of learning
 - Churches, church property and houses of worship, etc., and
 - ***“Institutions of purely public charity”***

Property Tax Exemption

- “Purely public charity”
 - Requires both *ownership* and *use* by a charity
 - Exemption application must be filed every three year with the appropriate county
 - County assessors make initial determination
 - Since 1975 - six factor “North Star Test” used by courts and assessors to determine if institution was a purely public charity

Property Tax Exemption – 2007/2008 Supreme Court Decisions

- *Under the Rainbow* (Minn. 2007)
 - Entity cannot qualify unless the organization satisfies North Star factor 3, *by providing goods or services free or at considerably reduced rates as a substantial part of its operations.*
 - Dicta: Government payments for goods or services do not qualify as donations or gifts.

Property Tax Exemption – 2007/2008 Supreme Court Decisions

- *Afton Historical Press* (Minn. 2008)
 - The Tax Court held Afton failed North Star factors 2 (supported by gifts), 3 (gives away goods or services), and 5 (beneficiaries are unrestricted), and denied exemption.
 - The Supreme Court reversed, and held that neither the North Star nor Under the Rainbow cases were controlling
 - Appeared to apply “we know a charity when we see one” standard

Property Tax Exemption – 2008 Legislation

- § 272.02, Subd. 7 revised to include a definition of “institutions of purely public charity”
- All 6 North Star factors must be satisfied unless there is **reasonable justification** for missing:
 - factor 2 (material gifts, donations or government grants);
 - factor 3 (material number of recipients receive benefits at reduced or no cost); or
 - factor 5 (beneficiaries are not unreasonably restricted)

Property Tax Exemption – Issues and Areas of Concern

- Certain organizations may not qualify as many are not supported by *material* donations
 - Nursing homes
 - Medicare supported
 - Homes for people with disabilities
 - Wholly state funded
 - Arts organizations
 - Funded by gate charges
- Requirement that recipients be provided services without charge
 - Sliding fee or governmental support not determinative
- Result might be a narrowing of historical standard

Property Tax Exemption – Administrative Process

- Department of Revenue and MN Council of Nonprofits agreed on an administrative process to assist in consistent application
 - Panel for assessors to get advice
 - Includes representative from MN Council
 - Guidance for assessors to be developed with examples
 - Ex. Nursing homes should generally be exempt, same with group homes
 - But not in the law and not required

Uniform Prudent Management of Institutional Funds Act (“UPMIFA”)

- What is it?
 - Statute applicable to “institutional funds” and “endowment funds” held by charities
 - Adopted in Minnesota effective August 1, 2008
 - Update of the Uniform Management of Institutional Funds Act (“UMIFA”)
 - Adopted in 1972 by the National Conference of Commissioners
 - In effect in 46 states and the District of Columbia
 - Prior to UMIFA
 - Ability of charities to spend appreciation earned by endowment funds was unclear
 - Resulted in investment strategy favoring current income vs. long-term capital gains

Why Do We Care Now?

- Endowments plummeting creating “underwater funds” –
 - Current value less than historical dollar value
 - Limits ability of foundations to continue funding commitments without UPMIFA
 - Because of UPMIFA MN charities have more flexibility but still may be limited in ability to pay out principal of endowment funds long-term

UPMIFA – Key Provisions

- Modernized investment and spending standards
 - Directs the officers and directors to act as a *prudent investor* would, using a *portfolio approach* in making investments and considering the risk and return objectives of the fund

UPMIFA – Investment Standards

- **Default Rules** - must be considered in managing and investing institutional funds, *unless the gift instrument provides otherwise*:
 - General economic conditions
 - Possible effects of inflation or deflation
 - Expected tax consequences, if any
 - Role that each investment plays within the overall investment portfolio
 - Expected total return from income and the appreciation of the investments
 - Other resources of the institution
 - Needs of the institution and fund to make distributions and to preserve capital
 - The asset's special relationship or value, if any, to the charitable purposes of the institution

UPMIFA – Investment Standards

- **Default Rules –**
 - Management and investment decisions not to be made in isolation
 - Decisions to be made in context of the institutional fund’s portfolio as a whole
 - As part of an overall investment strategy having risk and return objectives reasonably suited to the fund and the institution
 - May invest in any kind of property or type of investment

UPMIFA – Spending Standards

- Eliminates concept of “historic dollar value”
 - UMIFA permitted net appreciation over “historic dollar value” to be spent for purposes of endowment
- Historic dollar value appreciation calculation no longer creates a spending ceiling
 - But tracking of historic dollar value still needed for accounting purposes

UPMIFA – Spending Standards

- The following are to guide expenditure decisions of endowment funds:
 - Duration and preservation of the endowment fund
 - Purposes of the institution *and the endowment fund*
 - General economic conditions
 - Effect of inflation or deflation
 - Expected total return from income and the appreciation of investments
 - Other resources of the institution
 - Investment policy of the institution

UPMIFA – Spending Standards

- These seven criteria mirror the standards that apply to investment decision-making
- Unifies both investment and expenditure decisions more concretely

UPMIFA – Accounting Impact

- FASB 116 and 117
 - Assets divided into three categories:
 - Unrestricted
 - Temporarily Restricted (time or purpose)
 - Permanently Restricted
 - Donor-imposed restriction that requires fund be maintained permanently but permits use of a portion of the income of the fund
- FASB Staff Position 117-1
 - Requires reclassification of assets from unrestricted to permanently restricted
 - Adds disclosures for all endowments on financials which require “legal interpretation” of UPMIFA
 - Legal review of disclosures recommended
 - Form notes are more restrictive than MN law

UPMIFA – Accounting Impact

– FASB 117

- Prior to UPMIFA, the unrealized appreciation and earnings of a permanently restricted fund were considered *unrestricted assets*
- After UPMIFA, the unrealized appreciation and earnings of a permanently restricted fund (i.e., a true endowment fund) are *permanently restricted assets* until appropriated for expenditure
 - Section 4 states that the entire endowment fund is “permanently restricted” until “appropriated for expenditure” by the organization
- Creates a reclassification of funds which can affect bond covenants or other debt restrictions

Underwater Funds

- What Are Nonprofits Doing?
 - Reducing expenses
 - Evaluating all programs
 - Looking at all assets
 - Not just securities, but what other assets does the organization have – real estate?
 - Obtaining donor releases of restrictions
 - Fundraising for the “difference” between endowment-funded programs and available funds
 - Reviewing where decision-making sits and ensuring proper governance oversight

Questions?



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