Abstract

Are you unwittingly leaving your endowment fund exposed to risk of loss through litigation and other unforeseeable events? If your college, university, church, hospital or other non-profit does not use a separate legal entity to hold its endowment assets, and instead owns them directly, you are.

Fortunately, there is a tried and true way to corral this risk. Substantially all large endowments employ it. The solution has been available for decades, but many smaller and mid-sized non-profits still are not aware of this opportunity.

Investment committees and their consultants appropriately focus their attention on investment risk, taking into account the classical "risk and return tradeoff" in which risk generally is defined as volatility of expected returns. Significant risks outside the scope of their mission include organizational risks — those that are present because of the manner in which your non-profit is structured.

Risk management is a board level responsibility. Executive managers usually fulfill a leadership role in developing an enterprise risk management program. Intelligent corporate structure is the first line of defense against many significant risks.

This article reviews the advantages attendant to separating endowment fund assets from your other assets by forming a 501(c)(3) Supporting Organization to hold them on behalf of, and invest them for the exclusive benefit of, your existing non-profit enterprise. A properly structured supporting organization can go a very long way toward achieving your goal of protecting your endowment fund assets.
One of the most interesting parts of our Investment Office business is to meet so many people and such a variety of organizations as we travel about. Every campus has its own personality. Every administration has a unique “collective personality” as well, and a signature style of managing. It is particularly interesting to see how various colleges, universities, churches, hospitals and others deal with issues that are common to all institutions engaged in a public service. Considering the nature of our business, we pay special attention to the manner in which endowment assets are managed.

Throughout this paper we use the term “college” as a shorthand form of referring to all institutions with endowment funds. In fact, not only colleges but many churches, hospitals, museums and other non-profits that have endowment funds have already modified their corporate structures in order to minimize and manage the risks addressed here and thereby to protect their endowment fund assets.

From time to time, we still see what we would call a simple corporate structure. By “simple” we mean uncomplicated. The college exists as a single corporate entity, and is tax-exempt under section 501(c)(3) of the Internal Revenue Code. Assets (land, buildings, vehicles, endowment investments and so on) are held in the name of the college and are carried on the balance sheet. A small finance staff does the accounting and cash management for everything — revenues, expenses, fixed assets, accounts payable, accounts receivable, payroll, endowment assets — and handles investment and treasury operations as well. The college president and board of trustees have a straightforward and uncomplicated enterprise to manage.

Doesn’t everyone love simple solutions? When they work, life is fairly easy. When unforeseen complications arise, however, the simple structure becomes a perilous liability and headaches rush in.

A simple corporate structure does not work very well at all when endowment fund assets are folded into the mix. When you put your risk manager hat on, it’s easy to see why not.
How does organization structure affect endowment risk?

It is very convenient to have endowment assets (which are invested for the long term) segregated from operating funds (those kept liquid to satisfy the short term needs of day to day operations). Your Investment Office, or someone serving in that capacity, maintains accounts for the endowment investments which are long term in nature and often have restrictions agreed to when donors made their gifts. Your treasurer maintains checking accounts and money market funds for short term assets such as your working capital.

Operating assets and endowment assets can be kept under the same roof and managed by the same people but, paradoxically, that makes operations somewhat complex. Risk of error and fraud is higher. Without crisp financial controls the lines between working capital, endowment fund and other assets blur. It takes just the stroke of a pen to characterize an asset as long term or short term, and a bookkeeper can transfer assets from one category to another with only a journal entry. Disciplined effort and clear procedures, faithfully followed, are necessary.

In other words, the “simple structure” is manageable but actually requires more effort than a structure in which endowment assets are kept separate from other assets. The operating efficiencies that flow from separating the endowment from the college are well worth having. Some may say, however, that efficient operations fit into the “nice to have” category but the lack of them does not present a compelling reason to make a significant structural change.

The compelling argument against the college holding its endowment assets directly, and carrying them on the balance sheet, is that they are at risk of loss. In particular, there is significant risk to the endowment fund when the college is the defendant in litigation, the plaintiff prevails, and a judgment is entered against the college.

Please keep in mind that it is not investment risk that we are discussing here. Investment risks are calculated risks. The upside of potential good returns and the
downside of potential losses are estimated, weighed and measured in the classical risk and return tradeoff. The term “risk” in that context always refers to some measure of volatility of expected returns — not the risk of forfeiting your assets.

Structural risk presents no upside opportunity . . . no special potential for higher investment return accompanies structural risk. There is only a downside risk, the potential for loss. In a manner of speaking, it is the risk of losing your shirt because you carelessly neglected to button it. This is risk that can be managed, minimized or avoided completely. In most cases these risks are relatively easy, and inexpensive, to bring under control. There simply is no reason to permit them to persist.

Suppose your college keeps a few million dollars of working capital on hand and also has endowment assets of $100 million. You have a simple corporate structure, so all assets are held in the name of the college. Your finance staff records endowment assets in general ledger accounts that are separate from the working capital accounts. Still, the endowment investments are on the balance sheet of the college. It’s really the only place where they can be recorded and that does make plain that they are subject to the authority of the board and executive officers.

One purpose of your endowment is to provide some support to the current operating budget. Annually, your board of trustees authorizes a transfer of $5 million dollars or so from endowment funds to working capital. Your president tells your treasurer. The treasurer asks the Investment Committee which assets to liquidate and gives the order to the broker who then makes the trades. Your accountant transfers the cash to working capital. Debit the cash account, credit the investment account and go home for the day. Nothing could be easier.

No wonder the simple corporate structure seems so sensible . . . until the night there is a dormitory fire with serious injuries or even loss of life . . . or the day you have a chemistry lab explosion with the same results. Suppose a former football coach, chaplain, or faculty member had engaged in serious improprieties with minors on your campus, in your buildings. Foolishly, when your senior officials learned about the crimes they “looked the other way” and took no action.

Whatever the calamity there is litigation. Your college is found to be negligent. The court awards a $50 million judgment against the college. Your insurance company tells you that it is not a covered loss.
What assets are available to pay the $50 million judgment? Plaintiff’s counsel will certainly expect you to liquidate half of your endowment. After all, those assets are owned by the college and are reported in plain sight on its balance sheet.

Do endowment assets have a protected status?

As your board of trustees, president and maybe some interested alumni ponder the $50 million claim that the judicial system has just pronounced against your institution, sooner or later someone will ask “Aren't endowment fund assets already protected in some way?”

To answer that question it is necessary to define your terms. “Endowment fund” as it is commonly used refers to “that pool of assets available to be invested for the long term in order to support the mission of our non-profit entity.” That's a mouthful, so most people use “endowment fund” as a proxy. We use the term in that informal sense in this paper as well. A “true endowment” has a narrower, very specific, meaning which is defined below.

Stated briefly, some “endowment fund” assets have no protection at all. Others may have a limited amount of protection . . . or they may not. Any efforts to enforce those protections against creditors’ claims are sure to spark additional litigation.

That $100 million which nearly everyone considers to be “the endowment fund” actually is made up of many pieces. Some of them are not true endowments in the legal sense, but merely investable assets. A hundred million dollar endowment fund usually is the sum of hundreds of true endowments and small investment funds (sometimes even more than a thousand) which are dedicated to future purposes. Here is a summary of some characteristics of these various funds.

Restricted Funds. Some donations are accompanied by a document that specifies how the contribution is to be used. Such stipulations often are made by individuals who give large donations to the college. It is rare, in fact, to see a million dollar gift that is not restricted in some way. When an official of the college formally accepts the gift, the college has a contractual obligation to use it as the donor specified.

For example, an alumnus who has had a successful career as an engineer may contribute a million dollars with the stipulation that the principal is to be invested
perpetually and the earnings on it are to be used to provide scholarships to future engineering students. A donation structured in this manner, with a “hold to eternity” restriction on principal and a specified purpose for earnings, is a “true endowment” as that term is defined under law. It is classified on the balance sheet as a component of “permanently restricted funds.”

Sometimes donors stipulate that part, or all, of the principal may be expended after a stated amount of time has elapsed or a specified event has occurred. After that some portion of the donation (sometimes all of it) becomes unrestricted. A gift like this is a “term endowment” and is classified as part of “temporarily restricted funds.”

Unrestricted Funds Over the years many contributors to the college simply sent checks without any stipulations attached. The college is free to spend the money on current operations or save it for the future. Such funds, when set aside to invest for future needs, are the unrestricted part of the investment portfolio.

Unrestricted funds that are invested for the long term are often referred to as “quasi-endowments” or “funds functioning as endowment” or “board directed funds.” Essentially, the board of trustees has simply earmarked them to be invested and the board has complete discretion over the use of both principal and income.

Although a board may “earmark” assets it cannot “restrict” them. The selfsame board that deems funds to be “restricted” also has the authority to “unrestrict” them, thus rendering meaningless any “restrictions” applied by that board. Only a donor can establish a truly restricted pool of assets, a true endowment, by entering into a contractual relationship with the non-profit that accepts those assets.

Unrestricted funds (including “quasi-endowments”) usually represent a substantial percentage of total endowment assets — and they enjoy no special protections.

Are restricted funds, though, both true endowments and term endowments, off limits to creditors? You will say that they are. Plaintiffs will say that they are not. The matter will be subject to further wrangling. Your state’s attorney general may weigh in on the matter. As long as your college resists paying the judgment, there will be more litigation until the courts settle the matter. As the saying goes, “The law gives up its secrets only after a long and expensive struggle.”
By the end of the struggle you are likely to have forfeited your unrestricted funds and at least some of your restricted funds.

Operationally, it’s basically the same process as before. Have the broker sell some of your investment assets. Transfer the cash to the checking account as you always have in the past. Only this time you write a check to someone else and at the end of the day there’s a deep crater in the middle of a portfolio that took so long to build. In addition, instead of contributing $5 million per year to college operations the endowment may be able to contribute only half that amount — or less.

Your college president, your development staff, and many other people worked hard over many years to bring in the contributions that built up that endowment fund. Now they are gone, along with the future investment earnings on them that you counted on having to support your mission in the years ahead.

Now it’s time to rebuild, but there’s another sort of pain ahead. When non-profits squander endowment assets (and people will perceive this situation in that light) donors’ wallets snap shut.

The example above is entirely realistic. A quick survey of news articles from decades past will turn up many high profile cases in which universities, churches, hospital systems and other non-profits have lost large sums of money to litigation. Some of them had already put in place a corporate structure to protect their endowment fund assets. The rest learned an expensive lesson and virtually all of them subsequently modified their corporate structures to protect the (substantially smaller) endowment assets that remained after their debacle.

“Is there any way,” you ask, “to protect our endowment assets and head off losses like this?” Fortunately there is, if you act before litigation strikes. Many non-profits, including colleges, universities, churches, and hospitals have taken effective and authoritative action to insulate their endowment fund assets from litigation claims.
The Simple Solution That Works

Organizations of all types manage corporate structure to contain and control risks. For profit corporations form subsidiaries to isolate certain businesses, and protect the parent company from risks at the subsidiary level. Similarly, Investors often form limited partnerships to segregate and manage various investment risks.

Not for profit corporations can, and do, form separate legal entities to manage risk as well. Colleges, universities, churches, hospitals and other non-profits have done this for decades. The simple and time tested solution is to establish a separate legal entity to hold and invest the endowment fund assets.

Typically a non-profit (such as a college, university, church or hospital) will form a separate 501(c)(3) to hold its endowment assets for its benefit. The legal entity that holds the assets is known as a “supporting organization” and the original non-profit is known as the “supported organization.” The supporting organization manages the endowment for the benefit of the supported organization. The supported organization continues to enjoy the financial benefits generated by the endowment, and now has a new level of protection for those assets.

Most of this paper addresses the process by which a supporting organization can be formed to protect your endowment fund assets from certain risks, including the risk of litigation losses. As a beginning point, we assume that your organization is tax-exempt under §501(c)(3) of the Internal Revenue Code and is classified as a “public charity” under §509(a). [Technical terms are defined in following pages.] Most colleges and many other operating charities are organized in this manner.

Now You Have a New (and Happier) Story to Tell

Now you have two legal entities — “My College” and the “My College Foundation.” Accordingly, each entity has its own board of trustees and a separate balance sheet. The charter of the supporting organization (My College Foundation) will clearly state that it exists to provide financial support to the supported organization (My College).

In our first example, the board of trustees authorized an annual $5 million transfer from the college’s $100 million of endowment fund assets to its working capital.
accounts. Since the college had a “simple” corporate structure, all of the action took place on the balance sheet.

Now, in ordinary times the trustees of the My College Foundation will consider its mission and its financial condition and will authorize an annual $5 million grant to My College. The college will continue to fulfill its educational, research and other functions exactly as it did before.

In extraordinary times, such as an unfortunate event that results in a $50 million judgment against My College, outcomes are entirely different. Plaintiff’s may look to My College Foundation to satisfy the judgment but they will be turned away empty handed.

Trustees for the foundation will basically say “We are sorry that My College experienced this unfortunate event and you were affected by it. However, the My College Foundation is a separate corporation. The foundation was not party to the unfortunate event, is not a defendant under the lawsuit and the judgment is not against it. We are fiduciaries to My College Foundation and cannot authorize any distribution from its assets for this purpose.” The legal system most likely will agree.

My College will still have its hands full with litigation matters. There will still be some uncomfortable and unpleasant negotiations ahead. However, its endowment fund pockets (now represented by My College Foundation) will be just as full after the calamitous event as they were before it occurred.

You will still have $100 million in your endowment, and My College may reasonably expect to continue to receive a $5 million annual grant to support its operations. The trustees of My College Foundation will even have enough latitude to provide additional financial support to My College if they believe that circumstances warrant such action.

**How to Get Started and Other Practical Considerations**

Once you have gained consensus within the ranks of your board of trustees and executive management to move forward to protect your endowment assets
by establishing a 501(c)(3) supporting organization, the implementation steps fall into three categories.

- Form the new legal entity that will serve as your supporting organization.
- Obtain an Internal Revenue Service determination that recognizes your new entity as a tax-exempt supporting organization.
- Take the day to day measures necessary to operate the supporting organization in accordance with your stated intentions.

The educational process required to enable executive management and the board to understand the advantages of forming a supporting organization, and to become comfortable with endorsing that plan of action, can take some time. Implementation of the plan is the relatively quick and easy part of the process.

The process outlined in the following pages is fairly straightforward. To complete it with the precision needed for a successful outcome, however, requires considerable knowledge. You will want to engage an experienced tax practitioner to help you work your way through these implementation steps.

**Step 1 — Form the Legal Entity for the Supporting Organization**

Many forms of legal entity including corporations, trusts, community chests, some Limited Liability Companies, and unincorporated associations can seek tax-exempt status under §501(c)(3) of the Internal Revenue Code. The majority of tax-exempts are organized as corporations (specifically, as non-profit corporations).

The trust seems to be the second most favored form of organization. In the past a trust could be established more quickly than a corporation, sometimes in a matter of a few hours.

In some states, however, it is now possible to incorporate more quickly than that. Delaware, for example, will accept forms via facsimile and can issue a new corporate charter in less than an hour. To make the process amply available, the office of the secretary of state in Wilmington stays open until midnight Monday through Thursday and until 10:30 on Friday nights.
Other states have modernized their incorporation procedures also, though none of them as aggressively as Delaware, and many of them provide same day service as well. Your legal counsel will help you decide where you should incorporate.

For simplicity, this article assumes that both your “supporting organization” and your “supported organization” are non-profit corporations. In practice, your legal counsel may recommend another form of organization to you.

A non-profit corporation is formed in much the same way as any other corporation. The party interested in forming the corporation (a natural person or an artificial person, such as a business entity) files documents with one of the fifty states, usually the one in which the non-profit will operate. An individual or company experienced with forming business entities, usually a law firm, can guide you through the process and file the necessary documents on your behalf.

The process will include writing and filing Articles of Incorporation. Suitable articles may be available “off the shelf” or you may feel that your circumstances require a highly customized document. To satisfy IRS requirements, your articles will need to include certain language that restricts your new corporation’s activities to those permitted under §501(c)(3). You will also need to establish corporate bylaws, which will govern how your new nonprofit corporation operates.

As part of the process, you will appoint the initial board of trustees (or directors). The board for a supporting organization (My College Foundation) needs to be separate from that of the supported organization (My College). In the words of the IRS, however . . . “A supporting organization generally warrants public charity status because it has a relationship with its supported organization sufficient to ensure that the supported organization is effectively supervising or paying particular attention to the operations of the supporting organization.” Accordingly, it is common practice for a substantial number of the board members of the supporting organization to be chosen from the board of the supported organization.

After the necessary documents have been prepared and filed, the board of trustees for your new 501(c)(3), your supporting organization, will hold its initial meeting to handle some formalities associated with the startup. At a minimum these actions will include appointing officers, adopting bylaws and specifying the fiscal year. Often, the board authorizes the entity’s officers to take basic administrative
measures such as obtain an Employer Identification Number (EIN), establish bank accounts, set up payroll and accounting systems and similar matters.

**Step 2 — Apply for Recognition as a Tax-Exempt Supporting Organization**

To obtain exemption from federal income taxes Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, 1 will need to be filed with the Internal Revenue Service. For exemption from state taxation, you will want to check applicable law and regulations in the appropriate state. Each state has filing requirements of its own. Some states' separate filing requirements may be included under their charitable solicitation acts.

Form 1023 is also the means by which you will demonstrate that your new 501(c)(3) qualifies to be recognized as a public charity under §509 of the Code. Specifically, you will want to complete Schedule D to request recognition as a supporting organization under §509(a)(3).

A user fee will need to accompany your application. As of 2015 the IRS states that “The amount of the user fee depends on the applying organization's average annual gross receipts. If the organization's average annual gross receipts have exceeded or will exceed $10,000 annually over a four-year period, the fee is $850. If gross receipts have not exceeded or will not exceed $10,000 annually over a four-year period, the user fee is $400. An applicant must certify its gross receipts in Part XI of Form 1023.” The fee is subject to change from time to time.

You will also need to obtain an Employer Identification Number for your new entity, even if the organization has no employees. An EIN can be obtained online via the “Internet EIN Application” which is the method preferred by the IRS and is, by far, the quickest method. Alternatively you may complete Form SS-4 and send it to the IRS via postal mail or fax. Applications via facsimile usually are processed within four days and the EIN is returned by fax (if the applicant provides a fax number). Applications by postal mail can take up to a month to process.

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1 In 2014 the IRS introduced Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, which provides a simplified procedure by which small organizations may seek tax-exempt status. This streamlined procedure, however, cannot be used by supporting organizations.
By this point in the process, assuming IRS approval is forthcoming, you have formed your new 501(c)(3) corporation and applied for tax-exempt status. You have every reason to expect success. The process is very objective. Your tax practitioner will guide you through it and if your facts and circumstances conform to the applicable guidelines, your new entity will qualify.

The process has reached its successful conclusion when you receive your 501(c)(3) determination letter from the Internal Revenue Service. Your determination letter should also include a §509(a) ruling (and it ordinarily will). This is very important for a number of reasons. The following two are key.

• First and foremost is that without a §509(a) ruling a tax-exempt organization is not eligible for the preferential tax treatment that a “public charity” enjoys. Instead, it is regarded as a “private foundation” and is subject to a more restrictive regulatory regime.

• Most charitable foundations will make contributions only to public charities and usually will not contribute to another private foundation. The process of applying for grants from private foundations almost always requires that the applicant furnish proof of its 501(c)(3) status and its 509(a) public charity status. When you seek foundation grants you will want to do so as a public charity.

The following section discusses the differences between private foundations and public charities. It contains more Internal Revenue Code technical information than does the rest of this paper. If you are primarily interested in the practical measures needed to form and operate a supporting organization, and are not inclined to read technical details, you may want to skip this section.

We include this information primarily to round out our presentation of this topic. You may also find this information to be helpful in discussions with the tax practitioner who helps you set up your supporting organization and those whom you consult from time to time throughout its existence.

Private Foundations, Public Charities & Supporting Organizations

The Internal Revenue Service classifies every tax-exempt charitable organization as either a Private Foundation or a Public Charity. Code section 508 stipulates that all
tax-exempt organizations under §501(c)(3) are, by default, private foundations until they prove that they satisfy certain requirements set forth under §509(a).

In other words, your primary determination of tax-exempt status will be made under §501(c)(3). In order to enjoy the more favorable regulatory regime available only to public charities (which is outlined in the next several pages) your tax-exempt organization also needs to have a secondary determination under §509(a).

Section 509(a) defines four categories of public charities.

- §509(a)(1) includes charities that traditionally have been considered to be public in nature. Examples include colleges and universities, other schools, churches, hospitals and certain other organizations that receive public support from a wide range of donors.
- §509(a)(2) establishes a different support test from the one in §509(a)(1).
- §509(a)(3) defines supporting organizations, which exist exclusively to provide financial support to one or more other tax-exempt organizations.
- §509(a)(4) entities conduct testing for public safety.

A supporting organization is a particular type of public charity. The IRS, itself, has written a reasonably concise summary of the fundamental concepts relevant to supporting organizations. *Italics have been added for this article.*

“A supporting organization is a charity that carries out its exempt purposes by supporting other exempt organizations, usually other public charities. *This classification is important because it is one means by which a charity can avoid classification as a private foundation, a status that is subject to a more restrictive regulatory regime.*

Of course, supporting another public charity is not enough by itself to warrant status as a public charity – many private foundations support public charities as well. *A supporting organization generally warrants public charity status because it has a relationship with its supported organization sufficient to ensure that the supported organization is effectively supervising or paying particular attention to the operations of the supporting organization.*

Your college, university, church, hospital or other non-profit most likely is already deemed to be a public charity under the definitions provided in §509(a)(1).
goal now is to have your new 501(c)(3) [named “My College Foundation” in the example used throughout this article] recognized as a supporting organization under §509(a)(3). Assuming that your business objectives conform to those outlined earlier in this article, that goal is accomplished fairly easily.²

In order to qualify as a supporting organization your new 501(c)(3) will have to pass an organizational test, an operational test, a control test and a relationship test. Supporting organizations are classified as Type I, Type II or Type III supporting organizations based on how they satisfy the relationship test.

If you have not been through this process before it may sound complicated. In fact, the provisions that pertain to tax-exempt organizations are among the most intricate in the entire Internal Revenue Code.

A tax practitioner who is experienced with §509 can greatly simplify the process for you. The practitioner who assists you in forming your new 501(c)(3) will guide you through the steps needed to accomplish your goal of establishing a supporting organization that will enable your endowment fund to continue to provide financial support to your college while enjoying a new, and important, level of security.

As of 2015 the “more restrictive regulatory regime” for private foundations, which is mentioned by the IRS in the passage quoted above, includes the provisions summarized in the table on the following page.

² We note in passing that in addition to providing financial support to entities that are exempt under §501(c)(3), which is the type of supported organization addressed in this paper, a supporting organization can also be formed to provide financial support to a §501(c)(4) social welfare organization, a §501(c)(5) labor union, a §501(c)(6) trade association and/or certain foreign charities. The requirements applicable to supporting organizations for those entities differ somewhat from those applicable to §501(c)(3) supported organizations. Should you need the specialized information that applies in those situations, your tax practitioner will be able to provide it.
<table>
<thead>
<tr>
<th>Deduction limit for donations of cash</th>
<th>30% of an individual’s Adjusted Gross Income</th>
<th>50% of an individual’s Adjusted Gross Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deduction limit for donations of capital gain property (e.g., securities, real estate and other)</td>
<td>20% of AGI</td>
<td>30% of AGI</td>
</tr>
<tr>
<td>Valuation of donations of capital gain property</td>
<td>Fair Market Value for publicly traded securities. Cost basis for other assets, including real estate and closely held stock</td>
<td>Fair Market Value</td>
</tr>
<tr>
<td>Excise tax on net investment income § 4940</td>
<td>2% per year; reduced to 1% when the foundation makes grants above a certain level</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

The following excise taxes can be avoided by operating a private foundation in strict conformance with the Code. Excise taxes are “two-tiered” with a base level for the prohibited transaction and a higher level for failure to correct in a timely manner. Severe violations may cause the foundation to lose its tax-exempt status.

<table>
<thead>
<tr>
<th>Self Dealing Transactions § 4941</th>
<th>Excise tax on prohibited transactions with a “disqualified person”</th>
<th>n.a.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Required distributions § 4942</td>
<td>5% of foundation assets (after certain adjustments)</td>
<td>n.a.</td>
</tr>
<tr>
<td>Excess Business Holdings § 4943</td>
<td>Excise tax on investments that exceed certain levels</td>
<td>n.a.</td>
</tr>
<tr>
<td>Jeopardizing Investments § 4944</td>
<td>Excise tax on foundations that fail to exercise care or prudence w/r/t investments</td>
<td>n.a.</td>
</tr>
<tr>
<td>Taxable Expenditures § 4945</td>
<td>Excise tax on grants for prohibited purposes</td>
<td>n.a.</td>
</tr>
</tbody>
</table>
There also are differences between private foundations and public charities with respect to annual Form 990 reporting requirements.

<table>
<thead>
<tr>
<th>Reporting Requirements (as of 2014)</th>
<th>Private Foundation</th>
<th>Public Charity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Form 990-PF, which is the longest and the most detailed report within the Form 990 series, must be filed regardless of the size of the private foundation. The IRS requires a copy to be filed with the state attorney general where the foundation is organized, even in circumstances when that state does not have such a requirement.</td>
<td>Form 990 must be filed for organizations with gross receipts greater than $200,000 or assets greater than $500,000</td>
<td>Form 990-EZ is required for most other public charities</td>
</tr>
<tr>
<td></td>
<td>A Form 990-N electronic “e-postcard” is required if gross receipts are less than $50,000</td>
<td>Supporting organizations ordinarily may not file Form 990-N and must file Form 990 or Form 990-EZ.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Most churches and other religious organizations are exempt from filing a Form 990.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Supporting organizations for churches, however, are required to file Form 990 or Form 990-EZ.</td>
</tr>
</tbody>
</table>

Penalties for failing to file Form 990 timely and/or accurately are prescribed in §6652(c)(1).

Consistent with the provisions of §508 (mentioned previously) the IRS considers all new non-profits to be private foundations until they prove that they satisfy the requirements under §509(a). It should be noted that a public charity may use the
word “foundation” in its name (such as the hypothetical “My College Foundation” example used in this article) without any adverse effect on its public charity status under §509(a).

After the Internal Revenue Service has reviewed your application, a process which ordinarily takes a few months, it will issue a determination letter that will contain a ruling with respect to both your organization’s tax-exempt status under §501(c)(3) and its categorization under §509(a). [Older organizations may have a separate §509(a) ruling letter.] With your §501(c)(3) and §509(a)(3) rulings in hand, you are ready to begin to operate your supporting organization.

In the previous pages and paragraphs we have described, in broad terms, key Internal Revenue Code sections that apply to supporting organizations and have outlined the mechanics of forming such an entity. Our purpose has been to give to members of boards of trustees for non-profits, as well as their senior managers, a good understanding of the process.

We hope that we have not left the impression, however, that this mission is so easy that one can take it on without professional guidance. This is not a “do it yourself” project. Yes, a person not familiar with these matters could complete forms, send them off and hope for the best. Realistically, you will save a lot of time and money (and avoid setting traps for yourself to fall into in the future) by engaging the services of a professional who has been through this process many times before.

**Step 3 — Operating Your New Supporting Organization**

Now that the formalities of creating your new entity have been accomplished you will be glad to turn your attention to having your supporting organization fulfill its purpose. A fairly long paper could be written about operational topics alone, but we will touch upon only a few key points here.

You will want to give some thought to questions such as “How are the functions of our supporting organization going to be managed?” and, very closely related, “Who is going to conduct day to day operations?” As was noted earlier, one can have the same people who managed endowment operations within My College perform the same functions for My College Foundation. It is greatly preferable,
however, to separate the management of the supporting organization from that of the supported organization.

The reason, of course, is that segregation of duties is a key component of every effective system of controls, checks and balances. These systems exist to protect your organization from both errors and fraud. Every organization needs them and the stronger they are, the better.

Day to day operations of your new supporting organization can be conducted by its own staff, with personnel “borrowed” from the supported organization, with external service providers who provide vital services on an outsourced basis, or with a combination of these resources. The most important criteria are that the people you choose are knowledgeable, proficient and of excellent integrity.

Staffing and outsourcing practices vary widely. We have seen multi-billion dollar organizations with only one dedicated staff member who is supported by a number of outsourced specialists and a $15 million supporting organization with a fourteen member staff (which includes alumni relations and development personnel). To build an internal staff to provide most functions will be the highest cost solution, and rarely will be the model that brings the most expertise to bear.

Investment assets will need to be transferred from your original non-profit entity (which now is your supported organization) to your new supporting organization. This is not a trivial exercise and definitely is one that requires precision. Again, it is important to have on your team knowledgeable people who are experienced with transitions such as this.

Your master trustee, or custodian, will be a valuable ally in this process. These organizations have managed many similar transactions, and will make yours easy.

If you do not have a corporate trustee or custodian, now is the time to hire one. To operate an institutional fund without a professional trustee or custodian is an extreme example of penny wise and pound foolish behavior. The small incremental cost is well worthwhile.

Certain interactions (such as asset transfers) between your supported organization and your supporting organization may require resolutions from the board of trustees.
of one organization, or the other, or both. Your legal counsel will advise you with respect to this matter.

Your college or other non-profit organization may have a history of receiving grants from charitable foundations. You may find that some foundations do not award grants to supporting organizations. In those cases you will want to request the contribution in the name of the supported organization (in our example, My College instead of My College Foundation).

Once the funds are “in-house” you may be able to transfer them to your supporting organization. If so, great. If the grant comes with conditions that restrict your ability to make such a transfer the funds have to remain within the supported organization. This is where a master trust or custody arrangement will be extremely beneficial. It will enable your Investment Office, which now is in your supported organization, to manage both pools of assets with considerable ease.

A supporting organization is required to file a Form 990 or Form 990-EZ with the IRS annually. State law may require that an annual financial statement be filed with the state in which your non-profit operates. Some states require an independent audit of financial statements, others do not. State audit requirements vary depending, generally, on the amount of annual contributions (and sometimes other revenue) that a non-profit receives. If your non-profit receives federal funding above certain amounts it may be subject to federal audit requirements.

The details of state and federal audit requirements are beyond the scope of this article. A proficient tax practitioner can provide the necessary guidance.

Keep in mind that all of the financial reporting and audit requirements mentioned above are not incremental efforts that result from forming a supporting organization. They already apply to your existing non-profit. You are simply “carving out” certain assets that already are subject to these reporting requirements and are placing them in separate legal entity.

There is incremental effort associated with having to file a separate Form 990 and other financial statements, with or without audit. Balanced against the effort and expense to prepare reports for your new supporting organization is that the effort and expense to prepare the same reports for your existing non-profit (which now
is your supported organization) will diminish somewhat. Just as you have carved out assets from your original non-profit, you have carved out the effort required to account for them.

Your public accounting firm should take this simplification into consideration when quoting fees for their services. The costs of accounting and audit services to your supported organization should decrease compared with their historical levels.

Overall there will be a net increase in costs simply because two sets of financial reports will need to be prepared (and in some cases audited). There will be an incremental cost for services purchased by your supporting organization. As noted, however, these will be offset to some extent by reductions in cost for similar services purchased by your supported organization.

The overhead costs associated with a supporting organization are a very small price to pay compared with the significant advantages of protecting endowment assets by using one as part of your corporate structure. The risk management benefits always exceed the administrative costs by an overwhelming margin.

**Good Things Are Just Starting To Happen**

Remember that earlier we said that it is very convenient to have endowment assets separated from operating funds? Now you have that. Your finance staff conducts the financial affairs of the college and does its accounting just as it always has. An important, and pleasant, difference is that their day to day operations are not tangled with endowment fund operations.

The endowment, now in a separate 501(c)(3) corporation, has an independent set of books in which its transactions are recorded. The same people can conduct the treasury and accounting operations for both entities, although best practices require that an effective segregation of duties be established. However, simply to have two separate general ledgers, by itself, enforces a higher level of discipline over the process. More controls, checks and balances exist simply because they have to. Audit trails are crisper and more easily followed.

The board of trustees for My College Foundation will have a mission that is focused solely on the endowment and its agenda will not be cluttered by operational matters.
at the college. Likewise, the My College board of trustees can focus on the educational mission without distraction from endowment investment matters.

The fact is your board and executives have always been managing two businesses, an educational institution and a financial institution. Before, your corporate structure did not reflect that reality. Now it does.

The endowment trustees, who now have a special mission of their own as well, should see more clearly what is needed to manage the endowment in the most effective way. Your Investment Committee can sharpen its focus.

Formerly encumbered with a penny wise and pound foolish approach to budgeting for the investment function, it is now more likely that the Investment Committee will be given the resources it needs in order to maximize returns on endowment assets. The endowment portfolio should flourish.

We have seen colleges and universities that have adopted this structure take an additional step as well. They have transferred their development staff from the college to the foundation. As one college foundation executive explains, “It just seemed to make sense. These folks were out fund raising for the college and the money was being contributed to the foundation anyway. Now the fund raising people and the endowment management people are all under one roof.”

Fund raising professionals report another benefit from having a separate 501(c)(3) for the endowment. Sophisticated donors, those who are in a position to make large contributions, want assurance that their gifts will be handled responsibly. They especially want to be sure that their donations will be used for the purposes that they stipulate, will be invested prudently and will be sheltered from loss.

Such donors take comfort in seeing a well structured and well managed endowment, and are more likely to make contributions to such an organization. Just as wallets snap shut when donors fear that their gifts will be squandered, wallets open up when donors are comfortable that their gifts will be invested to support their designated purposes over the long term.

It’s a virtuous circle. The endowment will prosper. When the endowment prospers the college, the sole beneficiary of its supporting organization, will prosper as well.
How Artisan Can Help

Artisan Investor Services is in the business of providing Investment Office services to endowments and foundations that have not established this function in-house. The service is provided on an outsourced basis. Artisan provides this service at a price well below the overhead cost of an internal staff.

We believe that smaller and mid-sized endowments deserve, and need, the level of expertise that large endowments demand of their internal Investment Office. Our reason for being is to deliver superior service to growing institutional investors. Artisan brings the expertise and sophistication of a large institutional investor to organizations that have not established their own Investment Office.

Artisan takes an enterprise wide approach to endowment fund management. Substantially anything that pertains to the financial management, investment management, structure and governance of an endowment is within the scope of our services. To assist an endowment fund client to form a supporting organization is a project that Artisan would gladly support.

We can structure the project for you and manage it to a successful conclusion. If you already have legal counsel who would handle a matter like this, we will work with them. If not, we can introduce you to law firms and accounting firms with which we have worked in the past and whom we know to be experienced and proficient in this regard.

Artisan will invest its own time and expertise at each step along the way at no additional cost to our Investment Office clients. We can also work with other institutional investors on a special project basis.

In either case we will expedite the process, and minimize the cost, to help you achieve your goal of protecting your endowment fund assets.
Robert Skena is the founder of Artisan Investor Services, a firm that serves as Investment Office to institutional investors on an outsourced basis. Artisan offers its services to endowment funds, charitable foundations, retirement plans and non-profit organizations.

Before starting his firm he worked for more than twenty-five years at Mellon Bank, where he served as Chief Investment Officer for the Mellon Bank Retirement Plan, the Mellon 401(k) Plan, the Mellon Bank Charitable Foundation and a wide range of other trust funds. By the time he left Mellon to go into business for himself he was responsible for $10 billion of institutional assets.

Bob is a Chartered Financial Analyst and a member of the CFA Institute (formerly known as the Association for Investment Management and Research). He also is a Certified Public Accountant and a member of the American Institute of CPAs. He holds the Chartered Global Management Accountant (CGMA) designation, which recognizes the unique role played by individuals around the world who combine accounting and financial expertise with strategic insight to guide business decisions. He is a member of the Pittsburgh Venture Capital Association and has extensive experience with venture capital investing.

Mr. Skena holds a B.A. in English and a M.S. in Industrial Administration, both from Carnegie Mellon University. In addition to his principal occupation as an investment practitioner he has devoted a portion of his professional efforts to teaching others. He has taught the Investments course in the MBA program at the University of Pittsburgh, as well as the Financial Management course in the undergraduate program at Pitt. He has also served as an adjunct professor at Carnegie Mellon at the masters level, teaching the Investment Management course in the H. John Heinz III College of Public Policy and Management.

Bob has served as a member of the boards of directors for business corporations as well as non-profit organizations. He also has been a member of the advisory boards for a medical technology company and for a venture capital firm.

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