Restricted Gifts under UPMIFA

By Susan N. Gary, JD

UPMIFA—the Uniform Prudent Management of Institutional Funds Act—is now the law in 47 states, and Florida may adopt UPMIFA in 2011, leaving only Mississippi and Pennsylvania without the Act. This article reviews the effects UPMIFA has on two types of donor restrictions: endowments and purpose restrictions. UPMIFA emphasizes the importance of donor intent in the way charities manage and spend funds, providing more detailed guidance than prior statutes.

Which assets, which charities?
UPMIFA applies only to investment assets held by charities, not to program-related assets. Paintings held by a museum, a classroom building used by a college, and athletic equipment used in a children’s sports program are excluded from the scope of UPMIFA. Although the gain from investment assets will be used for the charitable mission of a charity, and in that sense will help the charity carry out its programs, investment assets are not program-related assets. Indeed, the Act focuses on investment assets, although the provisions on prudent investment apply to short-term operating funds as well as longer-term investment funds.

UPMIFA applies only to funds held by charities organized as nonprofit corporations and not as charitable trusts, unless a charity is the trustee of a charitable trust. Trust law provides the rules that govern charitable trusts, and the trust modification rules will apply to restrictions on assets held in charitable trusts. A charitable trust will have to analyze spending from an endowment fund based on the governing state’s principal and income act.

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What Is an Endowment Under UPMIFA?
Endowments come in two types: donor-restricted and board-designated. Sometimes a board will designate unrestricted assets as “endowment.” A board-designated endowment is not truly restricted, because the board can change the designation at any time. UPMIFA’s rules on endowments apply to donor-restricted endowments. A donor-restricted endowment is a fund to which a donor or donors have contributed with the understanding that the fund will not be wholly expendable on a current basis. The endowment may have a purpose restriction as well, but the restriction that makes a gift an endowment is the time restriction.

Unless a donor specifies a shorter timeframe, most endowments are perpetual. The donor likely wants the endowment to provide a source of ongoing support for the charity over a long period of time. Sometimes a donor will create a fund to be spent during a specified period of time, for example within a 10-year period. That fund, although not intended to be perpetual, will be considered an endowment under UPMIFA. The time period specified for its use will affect the charity’s application of UPMIFA’s spending rule because the charity will need to make expenditures at a rate that causes the fund to terminate by the specified date. For an endowment fund of limited duration, spending at a rate higher than rates typically used for endowment spending will be both necessary and prudent.

The donor’s instructions to a charity to hold a gift as an “endowment” may come in a number of forms. The donor and charity may have entered into a formal gift agreement, the donor may be responding to solicitation materials prepared by the charity, or the donor may send the gift with a letter asking the charity to hold the gift “as an endowment.” The terms of the restriction will depend on the written document—the gift agreement, solicitation, or letter—which UPMIFA refers to as the gift instrument. Verbal discussions may be useful to the charity in carrying out the donor’s wishes, but legal restrictions imposed on an endowment depend on written documents.

What Do Donors Intend?
If the donor’s instructions ask the charity to “hold the gift as an endowment” or “spend only the income from this gift,” UPMIFA provides a rule of construction that guides charities in making spending decisions for the endowment. In other words, UPMIFA interprets and does not change donor intent as to what a charity should spend from an endowment. Donors and charities always

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can agree to other terms, and if the donor is clear about a different intent, the donor’s specific intent will control. UPMIFA’s rules are default rules.

UPMIFA’s rule of construction replaces the earlier rule of construction provided by UMIFA, the Uniform Management of Institutional Funds Act. Before UMIFA, charities were concerned that a direction to “spend only income” meant to spend only interest and dividends and not capital gains. UMIFA created a rule of construction that said that “endowment” meant the charity could spend the amount it considered prudent to spend, but never more than the original value of the gift. UMIFA called the original value “historic dollar value” (HDV) and that became a floor below which a charity could not spend. HDV was a fixed number that did not increase over time to reflect changes in the purchasing power of the original gift.

UPMIFA changed the explanation of what an endowment means by removing the concept of HDV and instead requiring the charity to spend the amount the charity considers prudent after considering a list of factors provided in the Act. UPMIFA does not provide a floor for spending, and a charity now can spend below HDV, if doing so is prudent. The guidance on prudent decision making is strengthened and focuses on the purposes of the specific fund as well as on the charity’s mission and general economic conditions. The Act directs decision-makers to consider in particular “the duration and preservation” of the fund. Although UPMIFA does not require the charity to maintain the spending power of the fund, one aspect of prudence is to protect the long-term value of the fund and not merely the original value of the fund.

**Spending rates.** Under UMIFA many charities adopted spending rates for their endowments, and spending rates continue to be a prudent way to approach spending under UPMIFA. For example, a charity might set an annual spending rate of 4 percent of the value of the fund. The charity then would review the rate each year, considering the factors identified in UPMIFA, to determine whether the rate continued to be prudent.

UPMIFA does not provide a safe harbor for spending at or below a specified rate. Charities vary in size and purpose, so each charity’s prudent decision making will be unique. The range of charities, the different reasons for creating endowments, and the inevitable changes in economic conditions over time made putting any specific rate in the Act impractical.

UPMIFA includes a rebuttable presumption of imprudence but only 14 of the adopting states have enacted the presumption. The presumption suggests that spending in excess of 7 percent of the assets of the fund in one year may be imprudent. Under current economic conditions a spending rate of 7 percent would be imprudent for many charities, but under particular circumstances, spending that much or more in one year might be exactly right. A charity planning a construction project might decide to spend nothing from an endowment for three years and then in the fourth year might prudently spend 20 percent of the value of the fund for construction costs. To overcome the presumption, the charity should maintain adequate records during the accumulation period and should document the decision-making process in year four. Even in states that have adopted the presumption, the presumption does not create a presumption of prudence for spending below the statutory percentage.

**Donor’s perspective.** If a donor has a particular view about how a charity should spend from an endowment, the donor can provide specific guidelines in a gift agreement. The donor has to say more than “do not spend principal,” but if the donor directs the charity to “spend up to 4 percent per year from the endowment,” and if the charity agrees to accept the gift with that restriction, then the restriction will control.

**Charity’s perspective.** A donor probably intends an endowment to provide a stream of payments over many years. To generate payments that keep pace with inflation, the endowment must continue to increase in value. In the current recession, endowments have dropped in value at the same time that many charities need more distributions. A charity will have to consider carefully whether increased or decreased spending is more prudent for that charity. Under UPMIFA a charity can spend below HDV, and that may be helpful for a charity with a new endowment. If a charity spends too much, however, the endowment may not recover. But if the charity is at risk of closing, using part of the endowment may be prudent, assuming the spending is consistent with the purposes of the endowment.

**Modification of Donor Restrictions**

Many donors impose purpose or use restrictions on their gifts. One donor might want a gift to a university to be used for a scholarship for a music student. Another donor might direct a charity to use a gift to protect the habitat of an endangered species. If the charity receiving either gift agreed to the terms of the gift, then the charity must comply with the donor’s restriction. Problems arise when the charity no longer can carry out the original intent of the donor. In some circumstances the original purpose has become impossible. Perhaps the university has closed the music school, or the endangered species has become extinct. In either case something must be done so that the gift can be used for a purpose close to what the donor intended.

Sometimes the original purpose has not become impossible, but the charity could use the gift more effectively by modifying the purpose. A fund to be
used for sports programs at one high school might have grown in size and be able to support programs at two high schools. A charity might have changed its primary mission from providing food for the poor to providing apartments for the poor. Being able to shift a restricted gift to the new mission would be helpful for the charity but might not be in keeping with the donor’s intent.

Doctrines under trust law permit modification of donor-imposed restrictions under certain circumstances. UPMIFA now applies these doctrines, cy pres and deviation, to the funds subject to UPMIFA. Courts may be willing to apply these doctrines to assets not covered by UPMIFA and not held by charities not organized as trusts, but the case law has been limited and unclear.

**Donor consent.** Under UPMIFA, a charity can release or modify a restriction without court approval if the donor agrees. However, in many cases the donor is no longer living at the time a change is needed or the fund may have had many donors and finding all of them may be impossible.

**Deviation.** A charity can ask a court to modify a restriction that has become “impracticable or wasteful” or “impairs the management or investment of the fund,” or it can ask for a modification that, “because of circumstances not anticipated by the donor,” will further the purposes of the fund. The charity must notify the attorney general (or other charity regulator for the state), who can participate in the proceeding. Deviation is considered intent effectuating because the doctrine permits a modification that will enable the charity to carry out the purposes of the fund more effectively. Any modification must be made, to the extent practicable, “in accordance with the donor’s probable intention.”

**Cy pres.** UPMIFA adopts the cy pres standard of the Uniform Trust Code, which adds “wasteful” to the traditional reasons for the application of cy pres. A court can modify a provision that has become “unlawful, impracticable, impossible to achieve, or wasteful.” The court can modify the purpose of the fund or a restriction that affects the purpose. Any modification must be made “in a manner consistent with the charitable purposes expressed in the gift instrument.” In making its determination about the appropriate modification, a court can consider releasing the restriction or requiring the charity to transfer the fund to another charity.

**Small, old fund termination.** UPMIFA adds a new tool for funds subject to the Act. Sometimes a charity may need to request cy pres for a fund, but the value of the fund may be too small to warrant the cost of a judicial proceeding. UPMIFA permits a charity to modify a restriction without going to court, but only if the fund involved is more than 20 years old and has a value of less than $25,000. Some states have increased the number to $50,000 or $100,000 and one state, Connecticut, removed the section from its Act. The requirement that a fund be “old” protects donor’s intent by addressing concerns that a charity might accept money and then turn around and modify a restriction soon after creating the fund. The requirement that a fund be “small” targets funds that have become unusable but cannot be modified due to legal costs. Anecdotal evidence suggests that a number of universities have used this provision effectively to combine small scholarship funds into fewer, larger funds that then can be used to provide scholarships. The attorney general must be notified of modifications proposed under this act, and the charity regulator typically will work with the charity to make sure the modification is in keeping with the original donor’s intent.

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**Planning—Lessons from UPMIFA**

Under UPMIFA a charity’s solicitation materials can constitute a gift instrument that will bind the charity to the purposes promised in the materials. If the charity solicits money for an “endowment” then money donated must be held in a donor-restricted endowment. If the charity commits to using the money for a particular purpose, then the solicitation materials may bind the charity. Charities should review their solicitation materials carefully to ensure that the materials are appropriate.

A donor making a gift may want to restrict the use of the gift either with respect to its purpose or as an endowment. A charity must honor a donor restriction if the restriction is in writing, so a donor may want to enter into a gift agreement with the charity to confirm the nature of the gift. A donor should think about modifications that may become necessary and decide whether to permit the charity to make needed modifications without going to court, so that the expense of a court proceeding can be avoided. The donor might require the charity to consult with the donor or the donor’s descendants should a modification become necessary.

UPMIFA does not provide for donor standing to enforce a restriction, and a Missouri case recently refused to extend the Uniform Trust Code’s donor standing provision (adopted in Missouri) to a gift made to a nonprofit corporation.” Some donors may want to include a provision for standing in a gift agreement, although the enforceability of a standing provision remains uncertain. A charity will want to be careful about agreeing to standing for “descendants” or some other grant of standing in perpetuity. Even with written documents, a charity and grandchildren of a donor may disagree about what the donor meant.

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UPMIFA provides default rules that apply to restricted gifts only if the donor and the charity do not agree otherwise. In counseling both donors and charities, advisors should be aware of UPMIFA and decide whether alternative agreements may be preferable.

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Endnotes

1 For copies of UPMIFA, comments, legislative information, and explanatory material, visit www.upmifa.org and www.nccusl.org.
2 Texas adopted a rebuttable presumption that uses different percentages for funds of different sizes. V.T.C.A., Property Code §163.005 (2009).
3 *Cy pres* is a common law trust doctrine that means "as near as possible" in Norman French (*cy pres comme possible*). Under the doctrine, a trustee can ask a court to modify a restriction that has become unlawful, impossible, or impracticable.

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