

MUSE

A publication dedicated to providing ideas and education to tax exempt organizations

For full detail of the included articles or for additional articles, please visit: www.mcgladrey.com/muse.

Alternative investment strategies for not-for-profit organizations

By: *Martin Lax, Alan Alzfan and James P. Sweeney*

Many not-for-profit organizations are looking for ways to diversify their investment portfolios and improve returns on their investments. Organizations have sought to offset the effects of the financial markets over the past few years and have attempted to compensate for the reduction in revenues from other sources. This has led to an increased interest in the area of alternative investments, which include hedge funds, fund of funds, private equity funds and venture capital funds. Investors in these vehicles need to make sure they fully understand these investments, including the specific investment strategies of the entity as well as the unique accounting and tax reporting requirements. The following article intends to discuss the basic structure of these investments as well as some of the basic accounting and tax issues relating to investing in them.

There are a variety of alternative investments that not-for-profit organizations can participate in, but private investment funds are the most popular. A private investment fund, or hedge fund as they are commonly referred to, is a private fund that pools investors' capital in order to invest in securities. These investment vehicles are not registered with the Securities and Exchange Commission (SEC) pursuant to section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. Section 3(c)(1) funds are limited to 100 beneficial owners while a section 3(c)(7) fund may have an unlimited number of owners in the fund but because of other sections of the securities laws usually limit the number to 499.

An investor in a hedge fund should be an accredited investor as defined by the Securities Act of 1933. The definition of an accredited investor includes provisions providing that an investor must have at least \$1 million in net assets (excluding their primary residence per the Dodd-Frank Wall Street Reform Act) or an annual income of \$200,000 (or \$300,000 joint income) with a reasonable expectation that level of income will continue. An investor in a section 3(c)(7) fund must meet the definition of a qualified purchaser, raising the threshold to a minimum of \$5 million of investments or \$25 million for an entity.

Hedge funds may trade in any type of security that has been disclosed in their offering document, and they may have various types of structures. It is very important when you are considering investing in a particular hedge fund that you read the confidential offering memorandum, as well as other fund documents. This will allow you to get an understanding of the investment style of the manager, the types of securities they typically invest in, as well as other important provisions including fee structures, expenses

charged, liquidity provisions, gates on redemption, side-pocket provisions and risks associated with investing in the fund.

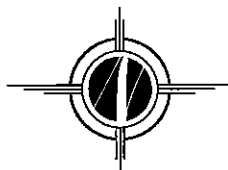
Many funds invest in publicly traded equity securities, using both long and short positions as part of their strategy; although many funds also invest in derivative securities (e.g., options, futures, swap contracts), debt instruments, asset-backed securities and private investments. There are specific advantages to investing with each individual fund, and an organization must review these investment strategies carefully to determine a fund that your organization feels comfortable with and confident in and will fit into the organization's total investment portfolio as it relates to risk, liquidity and investment philosophy.

As an investor in an alternative investment vehicle, you are going to want to make sure the fund has audited financial statements and you should review them carefully. Some key items to look for are the auditor's report (are there any qualifications?), condensed schedule of investments, footnote disclosures relating to valuation of securities, liquidity, fees and expenses, related party transactions, litigation, financial highlights and use of derivatives. From an accounting perspective, securities are required to be valued at their fair value, as discussed in ASC 820. The valuation of marketable securities is normally based on the last trade or a bid or ask quote. These are usually classified as level 1 securities within the financial statements of the fund. Securities for which there is no active market or which are being valued using significant market inputs but not direct market pricing are usually classified as level 2 securities. Investments in private securities and securities which are valued using a model comparing the securities to publicly traded securities, discounted cash flow or other indirect information are classified as level 3 securities. The valuation of level 2 and level 3 securities are subject to a significant amount of judgment by the fund's management.

As an investor, you are going to want to know the magnitude of the securities (level 2 or level 3) as well as what they actually represent. You will want to review the Private Placement Memorandum to get an understanding of how management is valuing them. There are several specific tax issues that not-for-profit organizations need to be aware of when considering investing in an alternative investment. If the entity is structured as a partnership, each investor will receive a Schedule K-1 which will detail the components of taxable and non-taxable income allocated to the individual investor for the year. The individual investor will utilize the information on that Schedule K-1 to prepare their tax return. The taxable income will be allocated in accordance with the provisions of the Internal Revenue Code and may

Alternative Investment Strategies, continued on page 3

BST



An Independently Owned Member
McGLADREY ALLIANCE

 **McGladrey**

MUSE

Merger strategies for not-for-profit organizations

By: Greg Maddux and Steve Mermelstein

Most contribution-based not-for-profit organizations are seeing increased pressure on their revenue stream, but are charged with doing the same amount as in previous years (if not more) with less. To avoid having to cut key programs, many organizations have turned to formal mergers, affiliations or shared service agreements to help alleviate the struggles that come with a reduced budget.

In the current economy and the recession of the past few years, corporate and individual donations to not-for-profit organizations have declined, and organizations have been feeling the effects. Pressure at the federal, state and local government level has also eliminated or reduced grants, with those that remain available harder to come by, and the selection process much more competitive.

In response to the current giving environment, organizations have been searching for strategies to reduce their costs while continuing to accomplish their mission. Many organizations have made cuts, but they were operating lean to begin with, so programs as well as their reach have been decreased in many cases. A growing number of organizations are making agreements with complimentary entities, either in mission or geographic location, in order to share costs and reduce their overall cost structure.

These agreements can take several different forms, but they normally fall into two categories: the formal merger and a more informal partnership agreement. In a formal merger, two organizations will legally combine in order to drive program level synergies across a broader geography or extend current programs to a larger recipient base. Support services for the new organization such as administrative, financial, human resources and IT will be combined, but even though they may be doubling a program's size, these support functions may not need to grow significantly.

Alternatively, an informal affiliation agreement allows organizations to share resources, and therefore, costs, resulting in savings for both entities. An affiliation agreement may have elements regarding the direction of the mission or strategies of the parties involved, but is primarily geared towards a support agreement to share the back office functions. Thorough due diligence, well defined service level agreements and business case analysis are critical steps to realizing meaningful cost savings while not compromising effective support and back office services.

A good match for a merger between organizations or a sharing agreement is two entities that have commonality in their mission and who they serve. If you have any sister organizations that have run independently in the past, those would typically be prime candidates as there may not be as many strategic differences.

There are several cultural issues that organizations should consider prior to entering into a merger or an affiliation agreement. The executive teams and the boards need to look closely at the culture of the two entities and how the decision-making process and strategies of the two organizations would come together. There is a significant effort to be made as far as an integration plan and what the new processes and systems will look like and how the organization will do business on a combined basis. How much change is needed to support this broader business?

An important step in a merger or agreement between two organizations is to recognize the strengths of existing programs and build upon those to increase the revenue potential. Program extension opportunities may exist that could increase the number of people that your organization may be able to reach and the level of impact that you could make. This could also potentially increase the size of the donation base and opportunities for grants due to a higher frequency of assisting others and connection to the community.

You will need to determine how compensation and benefits would be determined if differences exist between the two organizations. It is imperative to focus on the retention of key employees and get them involved in the new entity as quickly as possible. At the end of the day, some tough decisions may need to be made if a duplication of efforts exists within the new organization. These often have to be made in order for the merger to make sense and for cost savings to be realized.

We have seen a number of organizations make these tough decisions because they don't want their organization's ability to fulfill its mission to weaken. They turn to mergers or sharing agreements as a way to avoid compromising their mission while finding ways to reduce costs. To continue to have an active organization that serves its mission moving forward in a difficult economy, these strategies are moves that many organizations should consider.



Tax-exempt bond compliance report released by IRS

by: James P. Sweeney

The IRS recently published its final report on tax-exempt bond compliance by exempt organizations and government issuers. The study was developed using results from IRS bond audits and details the significant amount of noncompliance with the rules that govern the tax treatment of these investment instruments.

The report summarizes the data, analysis and findings from a soft-contact compliance check program that was initiated in 2007 by the Tax-Exempt Bonds function of the IRS Tax Exempt and Governmental Entities Division. The goal of the project was to identify the knowledge of section 501(c)(3) organizations and governmental issuers of tax-exempt bonds related to post-issuance compliance and record retention requirements.

Highlights from the compliance report include:

- 95% of responding section 501(c)(3) organizations reported having written post-issuance compliance procedures or guidelines, but the IRS found that only 49% have implemented specific written procedures (16%) or an ad hoc process (33%)
- 89% of organizations reported that they have assigned the primary responsibility of monitoring post-issuance compliance to a management official

- 97% of organizations maintain books and records necessary to substantiate compliance, but some indicate that certain types of required records are not retained
- Only a slight majority of governmental bond issuers reported having written procedures to ensure compliance with tax law requirements, but the IRS found that only 20% have implemented specific written procedures (8%) or an ad hoc process (12%)
- 65% of governmental issuers have assigned the primary responsibility of monitoring post-issuance compliance to an official, while another 38% indicated that a staff member has responsibility for monitoring compliance
- 94.29% of issuers maintain books and records needed to substantiate compliance, but up to two-thirds of issuers (depending on category) stated that some types of records were not applicable to them

The IRS will continue to utilize soft-compliance check projects and will also work to promote post-issuance compliance while developing opportunities to reduce the taxpayer burden for the tax-exempt bond arena. However, it is important for your organization to maintain post-issuance bond compliance, especially in the midst of this final report. If you are not confident in the compliance measures of your organization, any concerns should be addressed sooner rather than later.

Alternative investment strategies, continued from page 1

be allocated differently between when the income was actually earned economically versus when it becomes taxable.

Another issue for not-for-profits considering an alternative investment is that the investment may generate Unrelated Business Taxable Income (UBTI). UBTI may be generated if a fund borrows money to invest, including purchasing a security on margin, or due to the nature of the fund's investments which may cause specific types of income to flow through from an investment. The presence of UBTI will cause a not-for-profit entity to have to file an income tax return (usually Form 990-T) and depending on the situation, may have to pay taxes on the income. An investment in a fund domiciled outside the United States (offshore funds) may block UBTI from flowing through to the investor. That is because these funds tend to be organized as a corporation, and, as such, do not pass on income to their investors.

There are also several Form 990 considerations to be aware of when investing in a hedge fund which passes UBTI to the investor. Multiple areas of the form are related to UBTI activities, and these can be confusing for organizations. UBTI activity is reportable in Part I on line 7a and 7b and in the "Statement of Revenue" in Part VIII, line 3, column C. Also, there is an area in Part V, line 3a and 3b, "Statements Regarding Other IRS Filings and Tax Compliance" which should be populated with information regarding the filings of any Form 990-T, the income tax return for the organization.

Two other specific areas that organizations may have to fill out in compliance with certain investments are Schedules F and R. Schedule F discloses investment activity outside the United States while Schedule R deals with related organizations and unrelated

partnerships. The Schedule F disclosure will be required in Part I of that schedule on a per region basis. The book value of foreign domiciled investments is disclosed on this schedule while foreign investments of that foreign hedge fund are disregarded for reporting purposes. This would be a cumulative foreign investment amount on a region by region basis and not just reporting the foreign investments entered into during the tax reporting year. In addition, Part IV of Schedule F needs to be addressed. This part of Schedule F asks specific questions related to foreign investment activity reporting. Failure to file the specific forms addressed in this part of Schedule F could subject the exempt organization to significant penalties.

Schedule R disclosures may be required depending on the level of investment by the exempt organization, for example, when over 50 percent of the foreign investment may be owned by the exempt organization. In addition, if the foreign investment vehicle itself invests in other foreign entities, attribution of ownership may also require additional disclosure of those specific investments on Schedule R. All of these disclosures related to the Form 990 put the IRS on notice that there is foreign activity, and UBTI is being generated that requires the filing of income tax returns and a potential tax liability.

For a further analysis of alternative investment strategies, as well as more information on common risks, tax implications and accounting concerns for organizations, view our recent web seminar, Understanding Alternative Investments for Not-for-Profit Organizations.

For full detail of the included articles or for additional articles, please visit: www.mcgladrey.com/muse.



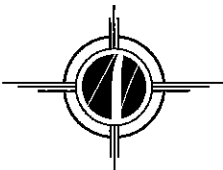
MUSE

Alternative investment strategies for not-for-profit organizations

Merger strategies for not-for-profit organizations

Tax-exempt bond compliance report released by IRS

BST



26 Computer Drive West
Albany, NY 12205

Address Service Requested

Information provided in this publication has been obtained by BST from sources believed to be reliable. However, BST guarantees neither the accuracy nor completeness of any information and is not responsible for any errors or omissions or for results obtained by others as a result of reliance upon such information. This publication does not, and is not intended to, provide legal, tax or accounting advice.

McGladrey Alliance is a premier affiliation of independent accounting and consulting firms. McGladrey Alliance member firms maintain their name, autonomy and independence and are responsible for their own client fee arrangements, delivery of services and maintenance of client relationships. McGladrey Alliance is a business of RSM McGladrey, Inc., a leading professional services firm providing tax and consulting services. McGladrey is the brand under which RSM McGladrey, Inc. and McGladrey & Pullen, LLP serve clients' business needs. McGladrey, the McGladrey logo and the McGladrey Alliance signatures are used under license by RSM McGladrey, Inc. and McGladrey & Pullen, LLP.

For extra copies, change of address or additional information, please contact BST at (518)459-6700/(800)724-6700 or visit our website at www.bstco.com.

MUSE

Printed in the U.S.A.

©2011 RSM McGladrey, Inc. All Rights Reserved. Used with Permission.

PRSRT STD
U.S. POSTAGE
PAID
Albany, NY
Permit No. 700