INTRODUCTION

Charitable Trusts have been used for centuries to protect assets and to provide for the benefit of another. However, it is within the last 30 years that trusts have been used extensively by religious institutes. This article will refer exclusively to trusts used in this latter context. Three phases can be identified in the maturing of trusts. The first phase is the development of the trust with all its legal aspects, the second phase is funding the trust, and the third phase is paying from the trust. Many trusts are now in the third phase. All parties to the trust have discovered numerous considerations that need to be addressed, particularly in the area of implementing the trust. Primary considerations need to be given to separation and control in the legal and accounting relationships between the corporation of the religious institute and the trust.

Two major occurrences in recent times will have a significant impact on how separation and control are understood and manifested between the corporation of the religious institute and the trust. One is the issue of transparency that was raised by the 2001 Enron bankruptcy case and the auditor’s method of disclosure in the financial statements, and the second is the heightened focus on misconduct among clerics and religious in the Catholic Church. Enron is pertinent because FASB will be working to avoid misclassification of assets and to prove transparency, or appropriate disclosure. Misconduct issues create heightened awareness because lawsuits abound and under some conditions the trust could be subject to pursuit in the payment of judgment against the religious institute. The concepts that will be tested in both examples are control and separateness.

The purpose of this paper is to explore the circumstances under which the assets of the trust may be consolidated or combined into the statement of financial position of the corporation of the religious institute. In the context of this discussion, the consolidation issue is raised only when the corporation of the religious institute is the primary Donor to the trust. Therefore, throughout this paper the Donor will refer to the corporation of the religious institute, and will be considered the recipient of the audit. In addition, if financial statements are consolidated, we will look at the implications for greater exposure to risk.

The separation of assets of a religious institute through the use of a trust has never been tested in the legal system. Therefore, this analysis of the impact and methodology of consolidation is based on current FASB regulations (second quarter 2002) and the interpretation of control, as well as the concept of separateness between the Donor and the trust. Currently, experience indicates that auditors view the separateness and control issues around trusts in a case specific environment. If a question has not been raised about consolidation, it is in the best interest of the Donor to maintain that separation of financial statements.
HISTORY OF USE OF TRUSTS BY RELIGIOUS INSTITUTES

1960's
To get a sense of the climate into which trusts were introduced to religious institutes, we need to go back to the 1960's. Following the Second Vatican Counsel, there was a major exodus from religious communities of young, vibrant, members who had been ministering in the institutions of the religious orders. At the same time, the members of religious institutes were aging and beginning to retire. For the first time in the history of U.S. Religious, there was a shortage of earning members to support these newly retired members. Religious institutes started talking together about some of these retirement issues, which was also a new phenomenon.

1970's
In 1971 the National Catholic Education Association started a series of workshops on retirement costs and possible funding through a national pension program through the dioceses. This was not pursued, but a conversation was begun.

In 1972 Congress passed Social Security legislation that permitted religious institutes to enroll their members in Social Security. Many communities took advantage of that buy-in opportunity.

In 1974-75 LCWR started conducting surveys of the dioceses and gathered information on benefits offered to religious.

In 1979 CMSM and LCWR compiled reports on the property divestment activities of religious institutes and discovered that as much as one-third to one-half of all property sales were being absorbed by current retirement needs.

About this time, there were several cases of sexual misconduct surfacing and raising possible liability questions for religious institutes. This was a critical component of the reasoning to protect assets for the future care of retired members.

1980's
In 1983 LCWR and CMSM gathered a group of ten consultants to work with religious institutes who were in crises and to give recommendations on how to address their pressing financial needs, including retirement.

One important element in the history of the use of charitable trusts by religious institutes is that Brother Peter Campbell, CFX was one of those first ten consultants. As a civil lawyer, he recognized the value of the trust in protecting retirement assets from suits against the civil corporation. At this time Brother Peter was also working in the Legal Office of CMSM, and was influential in developing the trust as a means to protect assets.

In addition to protecting assets from suits against the corporation of the religious institute, it also separated funds from the corporation that could not be reassigned for other uses by subsequent actions of the community. In this way the trust was making retirement monies available for future generations of retirees.

In 1984 Sister Lois Vanderbeke and Arthur Anderson, Inc. developed a tool called Guidelines for Self-Evaluation: Financial Viability and Accountability to measure past service liability - the amount of money that should be set aside for care of retired members, given the age of the members, anticipated return on investments, projected inflation rate, etc. National data was collected in 1984 and hit the Wall Street Journal on May 15, 1985. The Catholics of the U.S. were stunned to learn of a $2.5 billion unfunded past service liability among religious across the country. As a direct result of this awareness of retirement shortfall, the Tri-Conference Retirement Office (NRRO today) was founded in 1986 and launched its

During this period there was much emphasis on building retirement funds AND on protecting assets, so tools such as charitable trusts came into use in many religious institutes. In the beginning years of the trusts, major emphasis was given to putting money into the trusts and letting them grow. The target amount for the trusts was some amount not to exceed the past service liability needs of the community.

Another important factor that impacted the financial statements of religious institutes and other not-for-profit organizations is the FASB (Financial Accounting Standard’s Board) decision in the mid 1980’s to standardize the accounting practices of not-for-profit (NFP) organizations to be on par with those of the public sector. Up until this time, NFP organizations claimed many exceptions to the FASB rulings that didn’t apply to the NFP environment.

FASB identified several areas in which it made rulings specifically for NFP organizations. They include:

- depreciation of fixed assets,
- financial statement display, including the use of the categories of permanently or temporarily restricted assets or unrestricted assets,
- market value rather than purchase price for investments to be listed in financial statements,
- acknowledgement of donor contributions
- consolidation of the financial statements over which the NFP has control.

1990’s
In the 1990’s and beyond, finalization of a FASB regulation on consolidation in the statement of financial position has not yet occurred, even though the first draft was written in 1991. The most recent Exposure Draft was written in 1999, but again FASB postponed consideration of this draft until after further review of some of the underlying components of the draft. For example, a definition of “control” needs to be finalized.

In the February 28, 2002 issue of The FASB Report the Chairman of FASB, Edmund L. Jenkins, is quoted in his address to Congress, “The Board ...will propose significant improvements to existing requirements, including a project to improve the accounting for consolidation... With respect to the project on consolidation, which the FASB has struggled with for far too long, the FASB plans to issue a proposal on an expedited basis in the second quarter of this year which will resolve some of the more common issues encountered by some entities in present practice...” This FASB ruling will aim for consistency among methods used by auditors to determine when consolidation is necessary. Transparency will likely be an important element in generating consolidation guidelines.

CURRENT CHALLENGES

The two areas of separateness and control are the focus of current challenges. The article in the February 2002 issue of Legal Bulletin, a journal of the Legal Resource Center for Religious (LRCR), focuses on the legal separateness between the Donor and the trust. There needs to be a clear legal distinction between the three parties of the trust: the Donor, the Trustees, and the Beneficiaries. After proving separateness, the auditor will then look at control.

The accounting industry is receiving a clear message that generally accepted accounting principles apply to all Not-For-Profits, so auditors work to identify the entities that are controlled by the NFP corporation. In particular with SOP 94-3 and FASB 136, the auditor seeks to acknowledge all legal entities that are under the control of the corporation they are auditing. In the case of the relationship between the Donor and the legal entity of the trust, the control
issue needs to be evaluated.

FASB’s original definitions of control is stated below, followed by its more comprehensive definition:

1. “Control is defined as direct or indirect ability to determine the direction of an organization’s management.”
2. “Control is the non-shared decision-making ability of one entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity’s activities.”

CONTROL AND SOP 94-3

The Donor’s control over a trust can be evaluated through the use of Statement of Position 94-3 (SOP 94-3). As required by SOP 94-3, Reporting of Related Entities by Not-for-Profit Organizations, an organization should consolidate the activities of an interrelated nonprofit entity into its financial statements if the organization has one of the following:

- A controlling financial interest in the other not for profit organization through direct or indirect ownership of majority voting interest

or

- An economic interest in another entity

Evaluation of the two parts of the definition:
The first criteria is to prove a controlling financial interest in the other Not-For-Profit organization. This is found in one of two ways:
1. through direct or indirect ownership of majority voting interest, OR
2. a majority voting interest in the Board of the other entity.

Examples of an appearance of a controlling financial interest may be:

- The Donor’s investment committee also makes decisions about trust investments
- The trustees have no authority to guide the ongoing activities of the trust, including how the assets are invested and payments are made

- The members of the Donor corporation (the named members on the Articles of Incorporation may also be the leadership team of the congregation) make up a majority of the trustees for the trust
- The members of the corporation can dismiss and appoint trustees at will

The second element in the SOP 94-3 guidelines about consolidation looks for circumstances where an economic interest exists:

1. the other entity (trust) holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the Not-For-Profit organization...
2. the reporting organization is responsible for the liabilities of the other organization should it cease to exist.

Point 1: In the case of a trust in which the Donor realizes some economic benefit through reduction or reimbursement of expenses, an argument could be made that the Donor has an economic interest in the trust, although they are separate legal entities.

Point 2: If a trust ceases to exist and its primary purpose is the care of the aged and infirmed of a community, where does the burden of ongoing care lie? Going back to the parties in the trust, the reporting organization in this scenario is the Donor. If the trust runs out of money, does the Donor have the civil law responsibility to pay for the full cost of retirement for members of the Congregation? In fact, many religious institutes (equated to Donor in this context) rely on government programs for retirement and health care assistance. There is no civil law that requires the corporation of the religious institute to pay for the care of its members. However, there is a canon law provision for this care, but it is outside the realm of civil law. Therefore, the Donor does not bear the full
burden of those costs if the trust ceases to exist, so this test fails.

Examples of an appearance of an economic interest may be:
- All the payments are made directly from the trust to the civil corporation (the donor)
- The beneficiary class is narrowly defined and it gives the appearance of corporate interest

Methods used on audits when SOP 94-3 is applied:
1. Total consolidation of assets: cash, investments, and other assets and liabilities from the Donor and the trust are added together and shown in the audit as a single entity.
2. Combined financial statements in which separate columns identify each entity (preferable to number 1 because it acknowledges a greater degree of separateness between the legal entities.)
3. A note in the audit of the Donor referencing the trust (preferable to number 1 and 2 because the figures do not appear in the statement of financial position.)

CONTROL AND FASB 136

A second regulation that addresses the control issue is FASB 136. It has been used in audits in two ways: first to prove control, and therefore consolidation of financial statements, and second, to include a beneficial interest on the part of the Donor to the assets of the trust. As we explore the wording of FASB 136, the first use in establishing a controlling relationship is parallel to SOP 94-3 in content except for its definition of the parties involved, as discussed below. Therefore SOP 94-3 has greater relevance when looking at control. In reviewing its second use, the structure of the legal entity of the trust and its relationship to the beneficiaries would not allow the Donor to be considered a beneficiary without contradicting the basic tenets of the trust.

The two paragraphs of FASB 136 that have been referenced in questioning the relationship between the Donor and the trust are paragraphs 13 and 15. FASB 136, Paragraph 13 establishes conditions for consolidation of financial statements between a trust and its beneficiaries.

"The recipient organization (the trust) and the specified beneficiary (the members of the congregation, etc.) are financially interrelated organizations if the relationship between them has both of the following characteristics: One organization has the ability to influence the operating and financial decisions of the other, and One organization has an ongoing economic interest in the net assets of the other.” (Italics added.)

Paragraph 13 defines the parties as being the trust and the beneficiaries. It says nothing about the Donor. The Donor is being audited, not the members of the congregation, who are the beneficiaries. This paragraph looks at control, using the same determinants as SOP 94-3, but from the perspective of the trust and the beneficiary class. This paragraph also looks to ultimate responsibility for care of members, which we also addressed in SOP 94-3, but is again seeking the relationship between the trust and the beneficiaries, not the trust and the Donor. Therefore, this paragraph should not apply if control is the determinant for the decision about consolidation. If separateness between the Donor and the beneficiaries is an issue (e.g. the money from the trust flows directly from the trust to a bank account with the same EIN number as the Donor, or the corporate members of the Donor corporation are also the trustees of the trust,) then steps need to be taken to establish separateness before addressing the control issue.

Paragraph 15 establishes a standard for the beneficiary to report its rights to trust assets - its beneficial interest in the charitable trust. FASB 136, Paragraph 15 states:
Paragraph 15 raises the new concept of beneficial interest, which may be incorrectly interpreted by some to mean that the Donor can reasonably expect to be a beneficiary of the trust monies. This interpretation is inaccurate when applied to the trust and the beneficiaries. All trust documents should clearly differentiate between members of the beneficiary class and the Donor. The Attorney General of each state is charged with enforcing public charitable trusts.2 By the nature of the trust, the Donor and the Beneficiaries cannot be one and the same. By concluding that the Donor has a beneficial interest in the trust, the auditor would be contravening this basic tenet of the trust.

When this concept of beneficial interest is used in an audit, the statement of financial position indicates that the assets of the Donor reflect an interest in the net assets held by the Charitable Trust at market value of the trust. The audit notes then indicate that these funds are temporarily restricted for care of retired members. This improperly represents the legal relationship between the parties. A second method used may be to indicate in the audit notes a beneficial interest to the proceeds from the trust, again an incorrect relationship.

**EXPOSURE TO RISK**

*If the financial statements of the trust and the corporation are combined or consolidated, does that put additional exposure to risk on the total assets of both entities should one of them be involved in legal action?*

We are actually testing two separate concepts. It is possible to have legal separateness, yet maintain some control. There are many examples in corporate America where several separate legal entities, usually subsidiary corporations, are consolidated onto the financial statements of the parent corporation. The subsidiaries are under the control of one parent company, therefore consolidation of financial statements is appropriate.

This does not negate the fact that they are separate legal entities and the corporate veil would not be pierced if the parent company were sued. However, a trust stands in a different legal relationship to the Donor than a parent/subsidiary relationship. The Donor does not own the trust, and is therefore in a different relationship than the parent/subsidiary corporations. In the case of a Donor and a trust, there may be some control maintained, but they are separate legal entities, so liability should not pass from the Donor to the Trust, even if the statements are combined. As you may know, to date there is no legal ruling on how this relationship will be viewed in court.

**RETIREMENT LIABILITY**

Another question that has been raised by some auditors is whether the corporation of the religious institute (whether or not a trust is involved) has a financial liability for the retirement care of its members. They argue that this liability figure should be entered on the statement of financial position. A retirement liability should not be included on the statement of financial position for a number of reasons:

1. Members of the religious institute are not in a pension plan. There is no specific calculation of a retirement benefit due to them or their dependent. Therefore, the figure that would be included in the financial statement would be fictitious and based on assumptions rather than facts.
2. Liabilities are not included in financial statements until they are incurred. There would only be a liability if current expenses had not yet been paid.

3. The religious institute may need to turn to government assistance for some of its retirement expenses, so an expression of full liability may not reflect the future reality.

RESPONSES
Methods Used to Separate the TRUST from the DONOR

In both accounting principles, FASB 136 and SOP 94-3, control of trust monies seems to be the determining factor in the auditor's representation of trust monies on the corporate audits.

Following is an incomplete list of methods used by religious institutes to separate the trust from the corporation. These may not satisfy the auditor’s questions about control, but they do indicate that the religious institute recognizes and works out of two separate legal entities. This list was collated from information that treasurers sent in response to a question posted on the NATRI ListServ in January 2002.

Accounting practices
1. Pay retirement costs directly from the trust to vendors
2. Pay beneficiaries directly from the trust
3. Deposit trust payment into a trust checking account (a sub-account) for distribution of funds - possibly by someone in the finance office who is not in a position of control
4. Reimburse the corporation for overhead retirement expenses when the payments are a small portion of total disbursements, but the corporation is not the recipient of the majority of the trust payments
5. Deposit gifts for the trust from third parties directly into the trust rather than through the books of the corporation to establish a larger donor base
6. Establish a third corporation to administer the trust monies for beneficiaries (please note that this does not negate the control question, and could still result in consolidation; however, it does show separateness.)

7. Make the check from the trust payable to the Major Superior and have him/her endorse it to the Corporation (this may raise questions about taxable income to the individual religious.)

8. Conduct a distinct audit for the trust so everything is separate

Note 1: Many commented that several years ago their religious institutes received separate EIN numbers for their retirement centers, convicts, Motherhouses, etc. to assure that monies are not deposited into the donor account. Although the entities have distinct EIN’s, this method is legally ineffective to show separateness. In addition, NATRI and LCR do not recommend acquiring multiple EIN’s today for units in the same corporation, so this is not feasible for those just starting to distribute funds. 

Note 2: One community indicated that they had deposited all proceeds from the sale of property into a neutral corporation, which then became the donor to the trust. The corporation that oversees care of retired members then receives the retirement checks, thereby establishing separateness.

Trust administration practices
1. The investment committee, money managers, investment policy, accountant, EIN, and checking account are different for the trust from those used by the Donor corporation
2. Trustees are not members of the corporation (leadership team of the religious institute in many cases)
3. Trustees have specified terms and are not subject to removal except for cause
4. Trustee meetings are held regularly with minutes indicating action of the trust
5. Beneficiary class is defined to be broader than the care of the members of one religious institute
Possibilities for Separation and No Control

This paper spends considerable time discussing the establishment of trusts and the relationship between the trust, the donor corporation, and the beneficiaries. For the legal consultant, the question is separateness. For the auditor, the question is control. Is there any way that the auditor will acknowledge no control? Possible ways to prove there is no control of the trust by the corporation would be:

1. Establish a trust that holds funds from more than one religious institute (e.g. a Federation) that has a broad beneficiary base and has no control questions for the individual corporations. We are seeing this begin to happen.
2. Self-perpetuating trustees for the trust. This is possible, but it may not be prudent to relinquish control of the trust when other options are available.
3. A possible variation for self-perpetuating trustees is to have an odd number of trustees, with one less than the majority appointed by the Donor (leadership team). Those trustees would then appoint the other trustees for a specified term. When the terms for the Donor appointed trustees are finished, the corporation appoints their replacements, and the cycle continues.

In addition, there is always the option to accept a qualified opinion on the audit in which the auditor indicates that the trust assets exist but are not consolidated into the statement of financial position.

CONCLUSION

We are aware of FASB’s intent to issue a new consolidation statement in the second quarter of 2002. This new statement could have a significant impact on current interpretations of consolidation issues. Hopefully this regulation will add clarity to the treatment of financial statements of the religious institute and other separate entities over which the religious institute may have some control, but which are legally separate. These entities extend beyond trusts to sponsored works as well.

With proper attention to separateness and to the organizing documents of the trust, the question of control may never be raised in the course of an audit. If questions are raised about consolidation, your lawyer and your auditor may need to discuss together how separateness and control will impact your financial statements and the best way to address any concerns. This will add clarity for all parties in understanding the end product.

As another option, it is always possible to take a qualified opinion on the audit if you do not want the trust monies disclosed. However, it may not be necessary to do so if you believe that consolidating or combining statements of financial position will not expose trust assets in the event legal action is taken against one of the entities.

Endnotes:
1. Greatest preference from the perspective of separateness would be no inclusion of the trust in the audit of the Donor.
2. The attorney general has the discretion to come in and defend the beneficiary class, since it is by definition an indefinite class, and there is a public interest in defending it. However, the mere establishment of a trust does not bring the full backing of the AG’s office. This is probably more of a symbolic than real benefit. But lawsuits are built and destroyed on impressions.
3. In addition the IRS does not allow this practice, although there may be no penalties if the use is non-fraudulent. However, it may be argued that use of two EINs for one corporation in this manner is in fact fraudulent. It is being used to demonstrate a degree of legal separation that de facto does not exist.