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Summary

The long history of endowments serves as a testament to their enduring value to charities. In this edition of Gift Planner's Digest, Philip Purcell from the Planned Giving Resource Center for the Central Indiana Community Foundation provides a brief history of endowments, how they are used, terminology, and practical operational issues.

by Philip M. Purcell

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"It takes a noble person to plant a seed for a tree that will one day provide shade to those whom he may never meet."

Unknown Author

History and Magnitude of Endowments

Plato's will left his farm to a nephew with instructions the proceeds be used to support students and faculty at the academy he founded. Ancient Rome developed the "corporation" that led to endowments. In the Middle Ages, wealthy patrons donated land to religious groups that used the rental income for financial support. Countless charitable endowments were established in 18^{th} and 19^{th} century England, and the concept was exported to the U.S. where English trust law governed (i.e., court prescribed list of investments) until *Harvard College v. Armory* in 1830 introduced the Prudent Man Rule.

A number of studies illustrate the magnitude of endowments.

- In a 1998 survey of over 700 colleges and universities, the National Association of College and University Business Officers (NACUBO) estimated total fund values of more than $178 billion.[1]

- In a 1996 survey of 42,000 organizations by the Philanthropic Research Institute, 6,000 held endowments. A broad range of value existed in these funds that were held by a variety of charities.[2]

- Charities held $421.5 billion in total investments (i.e., endowments and other non-operating funds) in 1993, according to tax data from the IRS. Private foundations hold nearly $195 billion.[3]

- The latest estimates of the transfer of wealth hold immense promise for building endowments.[4] 4 Low-range estimate: $41 trillion will transfer from 1998 to 2052, and the actual figure may double or triple that amount. This is significantly greater than the earlier figure of a $10.4 trillion transfer between 1990 and 2044.[5]

Definition of Terms

The use of the term *endowment* has particular legal and accounting consequences. It has often been used synonymously (but incorrectly) with bequests or deferred giving only.

Financial Accounting Definitions: FASB and AICPA

Endowment. An endowment is an established fund of cash, securities, or other assets to provide income for maintenance of a nonprofit organization. The use of the fund may be *permanently restricted, temporarily restricted, or unrestricted.* **Note:** While the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accounts (AICPA) guidelines apply to endowments, applicable state law definitions must be used.

Endowment funds. Endowment funds generally are established by donor-restricted gifts to provide a *permanent endowment*, which is to provide a permanent source of income. The portion of a permanent endowment that must be maintained permanently, not used up, expended, or otherwise exhausted, is classified as *permanently restricted net assets*.

Term endowment. A term endowment provides income for a specified period. The portion of a term endowment that must be maintained for a specified term is classified as *temporarily restricted net assets*. **Note:** Some donors may ask charities to hold term endowment that may then be passed through for current use, or later given by the donor to permanent endowment in whole or part.

Unrestricted net assets. A governing board may earmark a portion of its *unrestricted net assets*as a board-designated endowment (i.e., funds functioning as endowment or quasi-endowment funds) to be invested to provide income for a long, but unspecified, period. A board-designated endowment is not donor restricted, and is classified as unrestricted net assets. The principal of these funds may be spent at any time.

Donor imposed conditions versus restrictions. A condition is a stipulation by the donor that specifies a future event whose occurrence, or failure to occur, may give the donor the right to a return of the donated assets, or a release from the obligation to donate the assets in the first place. Examples may include a donation on the condition that additional funds are raised to meet a particular goal or that a new program is established. A donor restriction stipulates that the donated assets must be maintained permanently, permitting expenditure of only the income or net appreciation of the donated assets. A gift for endowment is a donor restriction.

Spending rate. The portion of total return used for current fiscal needs. It is usually measured in terms of an amount or a specified percentage of a moving average market value. The spending rate emphasizes: 1) the use of a systematic formula to determine the portion of total return that can be used to support fiscal needs of the current period; and 2) the protection of endowment gifts from a loss of purchasing power.

Total return. A measure of investment performance that focuses on the overall return on investments, including interest and dividend income, as well as realized and unrealized gains, and losses on investments. Frequently used in connection with a spending rate formula to determine how much of that return will be used for fiscal needs of the current period.

State Law Definitions: Uniform Management of Institutional Funds Act

The Uniform Management of Institutional Funds Act (UMIFA) has now been adopted in 39 states (Exhibit A). The model legislation may be adopted "as is" or modified by the enacting state. Typically, the governing board of that institution must formally adopt UMIFA by resolution. UMIFA statutes define a number of terms:

Endowment fund. This is defined as an institutional fund not wholly expendable on a current basis under the terms of the donor's gift agreement. An "institution" commonly includes colleges/universities, other organizations that are exempt under IRC § 501(c)(3) with a minimum endowment fund value (e.g., $10 million).

Net appreciation. Net appreciation is the growth in the fair value of the assets of a fund (realized and unrealized) over the historic dollar value of the fund (e.g., the aggregate fair value in dollars of the original endowment gift plus each subsequent donation at the time the donation is made). All net appreciation is available for use unless the donor specifies to the contrary, except in states (e.g., Massachusetts) in which law restricts the expenditure of net appreciation.

Gift instrument. The donor may indicate his/her intention not to expend net appreciation in a gift instrument. A restriction upon the expenditure of net appreciation may not be implied from a designation of a gift as an "endowment," or from a direction to use "only income, interest, dividends, rents, etc.," or to "preserve the principal intact."

If there is no applicable law or explicit/implicit donor-imposed restriction that would require net appreciation to be deemed permanent endowment, then FASB regards net appreciation as temporarily restricted or unrestricted net assets. The net appreciation may be used for the purpose of the fund during the financial statement period and will not be deemed permanently restricted, unlike the fund principal (and subsequent gifts thereto).

Ordinary business care and prudence. In the investment of its endowment funds, the institution must exercise ordinary business care and prudence. This standard requires considering long- and short-term needs of the institution, expected *total return* on investments, general economic conditions, etc. Some statutes describe investments that are explicitly authorized.

Releasing restrictions. Allows a method for releasing restrictions on the use of funds or selection of investments by mutual agreement with the donor in order to avoid the need for court action. Note: Some states have additional statutes and/or case law that define *cy pres* authority for a court of appropriate jurisdiction to change donor restrictions, or even the charitable recipient, pursuant to applicable legal criteria and procedures.

Uses and Types of Endowments

An endowment offers many potential benefits to a charity: operating subsidy for on-going support or for program expansion (e.g., scholarships, faculty chairs, staff positions, maintenance costs for facilities, equipment, supplies, etc.); independence from economic, governmental, and political forces; hedge against inflation and the market; improvement of the balance sheet; replacement for other income sources; leverage for bond-rating capacity, mortgages or loans for new buildings, equipment purchases, etc.; and enhancement of institutional prestige and permanence, encouraging further support by outright and especially planned gifts.

Community foundations offer endowment management for charities and donors. All components funds of a community foundation are subject to the variance power of the foundation board that allows ratification or alteration of grants to assure awards to charitable organizations or for charitable purposes.[6] The types of funds held by a community foundation, as well as many other types of public charities, include unrestricted, restricted, field-of-interest, scholarships, and donor advised funds. Many community foundations, and other charities, maintain one or more supporting organizations.

Unrestricted endowments allow the community foundation, or other charity, to make grants to address current and emerging needs with proactive grant making since donors do not place grant or use restrictions on the fund.

Restricted endowments at a community foundation may be established by donors and/or charities to provide support exclusively for one or more named charities. Restricted endowments at other public charities may be used for charitable programs and services of that charity (e.g., academic departments, hospital service areas, a particular church of a national denomination, etc.) Note: Per FASB Standard 136, funds transferred by a charity to a community foundation are listed on both the charity's and foundation's financial statements (with an offset on the foundation's). Gifts directly to the fund are reflected on the community foundation's statements only.

Field-of-interest funds allow donors to establish endowments to benefit particular charitable interests (e.g., programs for youth, environment, elderly, health, specific academic, service, or program areas, etc.).

Scholarship funds may be used to provide aid to students for different schools, areas of study, etc.

Donor advised funds allow donors to make recommendations to the community foundation board of directors as to the grant recipients from the fund. **Note:** Many charities other than community foundations have, or are considering, donor advised funds. Grants from such funds are often restricted, all or in part, for the particular charity. A number of for-profit financial firms have established very successful "subsidiary" charities, called charitable gift funds, which offer donor advised funds (e.g., Fidelity, Vanguard, Charles Schwab, Eaton Vance).

Supporting organizations are established by donors to support community foundations and other charities for a number of planning reasons: 1) to allow for a separate board to assist grant decision making; 2) to offer a more personalized investment strategy; 3) to manage assets with particular risks (e.g., real estate, closely held stock, etc.); and 4) as an alternative to a private foundation.[7]

In its *Continuing Professional Education and Technical Instruction Program for Exempt Organizations for Fiscal Year 2000*, the IRS lists as a topic under public charity classification and private foundation issues, "*Aggressive* interpretations of provisions applicable to donor advised or directed funds and IRC 509(a)(3) supporting organizations." The IRS is concerned about abuse such as inappropriate donor control over directing grant distributions, investing fund assets, private benefit, etc.

Sources of Endowment

Outright gifts can include pledges, major gifts of cash or other assets, lead trust gifts, transfers from private foundations, etc. Beneficiary designations from bequests, life insurance, charitable remainder trusts, gift annuities, pooled income funds, remainder interests in real estate, etc., are considered planned gifts. Donors may consider funding endowment with both outright and planned gifts.

Investment Issues For Endowments

Management of endowment funds has become more sophisticated. The Prudent Man Rule was introduced in 1830 in *Harvard College v. Armory*. It abolished legal lists of approved investments and established a standard of investment for endowment as a *prudent person*. The Uniform Prudent Investor Act, now adopted in many states, removes the Prudent Man Rule and allows a more sophisticated investment strategy (i.e., modern portfolio theory).[8] In the 1950s, Professor Harry Markowitz introduced his modern portfolio theory (MPT), which emphasized that total return is maximized by asset class allocation (including risk) rather than specific stock selection or market timing.

The Principal and Income Act, adopted in many states, applies to trusts and is sometimes inappropriately applied to endowments. The Principal and Income Act defines income as interest, dividends and rents, etc., and capital gains are deemed principal. In some states, the Principal and Income Act allows *realized* capital gains to be considered "income." The application of this Act and its definitions to endowment investment management resulted in an investment strategy that ignores the maximization of total return in favor of a conservative approach to produce current "income."

UMIFA allows pooling of investments, a prudent or business care standard, and authority to delegate investment authority. It permits a "total return" investment strategy.

Endowment Policies

Endowment management policies should be created to ensure financial integrity. This can be accomplished through the creation of an endowment management team. This team can include:

- **Investment committee** comprised of members of board of trustees; representatives from the business office, treasurer or financial affairs office; development office; and/or qualified volunteers from the community, alumni, etc.

- **Advisors** to assist with establishment of investment policies, spending rate policies, selection of individual investors, market forecasts, etc.

- **Investment firms** to implement investment policies.

- **Separate foundations** (i.e., 501(c)(3) charity) are used by some charities or other organizations (e.g., public universities, health care organizations, social or professional associations, etc.) to manage the endowment. A separate board of trustees, staff, etc. is often used for these foundations. The charity's board must, by resolution, establish its endowment and determine its philosophy (e.g., favor current income, growth for future, or relative annual equality over the long term, etc.).

Investment policies define objectives, asset class allocations (by percentage) with maximums per company and industry, and sets benchmarks for performance to fulfill the endowment's philosophy.[9]

Spending policies should be established for spendable earnings available from income or growth (capital appreciation). Spending may come from all or a percentage of net income (bond income, rents, dividends, royalties, etc.), a fixed percentage of market value of portfolio, or of a moving average of portfolio (e.g., previous three years), or a combination (e.g., lesser of net income and fixed percentage).

A donor and/or charity may choose to allocate unspent earnings to principal, make available some or all earnings for current use, future use, or a combination. A reserve fund may offset fluctuations in principal as market changes occur, providing stable spending levels.

The spending policy must match the investment policy to assure efficient production of available resources and minimize drastic fluctuations in keeping with philosophy as determined by the board.

Fee policies should be set by the percentage of market value or basis points (1% to 2% is common). Some funds may be exempted from fees for policy or marketing reasons (e.g., scholarships). It is recommended that disclosure of fees be provided to all donors.[10]

Charitable remainder trusts and gift annuities may be pooled with an endowment, but separate funds (life income funds) would permit more specialized investment management. Pooled income funds (PIFs) are problematic to pool with the endowment due to valuation and investment restrictions, etc. The Philanthropy Protection Act of 1995 requires written disclosure (prospectus with information on investments, policies, etc.) to donors of life income planned gifts if the donated assets are commingled with other charitable assets such as an endowment.[11]

Gift Policies and Documentation

In addition to the policies outlined above, additional policies will assist donors.

Gift protocol. Which staff may negotiate endowment fund agreements? What information is shared with donors (e.g., investment return, spend rate, fees, etc.)? Who authorizes gift restrictions? Who signs the agreements? Who facilitates the transfer of assets? Who accounts for the gift? Who reviews planned gift documentation? How is the donor recognized? What is the stewardship protocol (e.g., fund reports as to value and use of funds, etc.)?

Minimum funding levels. These vary per institutional needs. In some cases, the principal may equal the amount needed to underwrite the annualized cost of an activity, assuming rates for growth, spending, inflation, costs, etc. Also consider what other charities do, market potential, the integration of outright and planned gifts to reach the minimum, etc.

Allowable restrictions. Some donors may wish to attach restrictions to the use of their funds that are impractical, illegal, or incapable of fulfillment. Encourage "preference" statements, with the right of the charity to change in the future if deemed impractical. A number of IRS and other rulings have permitted scholarship restrictions based on religion, geography, schools, exceptional ability, economic disadvantage, etc.[12] Special consideration and legal counsel review must be made in the case of awards based on race or ethnic/national origin.[13]

Endowment Fund Documentation

While the endowment fund agreement is a formal contract, the charity may assist ease of use by keeping the language as straightforward and simple as possible. Topics to include in a fund document are:[14]

- Full name of all donors (with address), charity (with address), and the name of the fund (e.g., donor, loved ones as a memorial, etc.).

- Assets transferred to the fund (outright gifts) or planned gift arrangements (testamentary transfers). Can be listed in an appendix.

- Allowance of future additions to the fund from any source or donor, subject to charity approval.

- Specified uses of the fund with any allowed donor restrictions (preferences) as to use.
- For competitive awards (scholarships, faculty awards, etc.), a description of review protocol. Donor may be involved in an advisory capacity only. Final approval by charity.
- Spending rate to be applied to the fund (may allow for future modification).
- Investment policy to be applied to the fund (may allow for future modification). Some charities allow donors to suggest investment preferences, subject to charity ratification or change.
- Savings clause to assure that fund parameters may be changed to assure compliance with new laws and to assure donor's charitable tax savings.
- Merger clause to allow the fund to be pooled for investment purposes, and/or to allow grants of an amount sufficient to produce grants for the stated purpose of the fund.
- Amendments subject to mutual agreement.
- Board may approve template or each individual agreement (prior or retroactive). Consider efficiency of process.
- Signatures by all parties. Notarized.

It is always advisable to provide donors with sample language to include with a gift to a pre-existing fund, or to establish a new fund by beneficiary designation of a CRT, gift annuity, PIF, retirement plan, life insurance, etc. If the entire fund is to be funded at death, a fund document may be prepared, signed, and incorporated by reference in the planned gift designation. In the event that the planned gift does not produce the typical minimum amount to set up an endowed fund for the stated purpose, a "merger" clause should allow the fund to be merged with other funds, not only for investment, but also to produce grants of sufficient size (e.g., for scholarships).

Endowment Education

Early in the cultivation process, donors must learn that endowments are intended to last a very long time (*infinity and beyond*). Forever is a very long time, and all parties are best served if the fund parameters allow as much flexibility as possible.

Share drafts of the endowment agreement for review. Carefully explain all provisions. Define all terms. Carefully explain the difficulties associated with restrictions that tie the donor's/charity's hands and prohibit flexibility.

Endowments may be named for donors, loved ones as a memorial, favorite faculty, or program staff, etc. Endowments may be established for scholarships, faculty or staff chairs/positions, program support, building costs, etc. Donors may be matched to purpose(s). Umbrella funds that identify multiple uses of the annual grants (e.g., by certain percentage amounts), and donor advised funds, allow grants for many needs. Many donors appreciate the opportunity endowments provide to allow permanent support for future longevity of the charity and its important programs that they cherish.

Endowment minimums may offer an attractive challenge to some donors who understand the merits of these thresholds. Families, friends, colleagues, business associates, etc. may donate to a fund that honors an individual. Further, such persons, as well as the donor, may serve as fund advisors to a donor advised fund for on-going grant recommendations. While a name on a building may appeal to some, the idea of supporting functioning programs, faculty, students, etc. may also be attractive.

Endowments may be established currently with outright gifts and supplemented by planned gifts. Or donors may set up future funds by planned gifts, and later decide to make current gifts to implement the fund while alive to see the benefits of its use, and to observe its operation. Current gifts to endowment could be pledged from income received from planned gifts.

Pledges may be made to achieve minimum fund levels. Pooled endowments may be used (with the donor's name recognized with all others in the fund pool), until the donor reaches the independent fund minimum, at which time a separate named fund is established.

Current pledges may equal what the spendable amount from a particular purpose endowment (funded at its minimum level) would be to provide current use awards named for the donor. An additional annual amount could be pledged that would be given directly into the endowment fund to begin building it to the minimum threshold.

Conclusion

The long history of endowments serves as a testament to their enduring value to charities. Properly planned and managed, an endowment can be a valuable source of charitable giving that may allow your clients to permanently support their chosen charities.