Introduction–The Charitable Sector and the Evolution of the Endowment Fund

For decades, donors have been able to make gifts to charities where the property gifted is invested, and only the income or growth from those investments are used for the charitable activities. This arrangement is called an endowment fund, and provided the foundation met the disbursement quota from Canada Revenue Agency (CRA) of 3.5% of the foundation's endowment funds[1], there were no regulatory problems with this arrangement.

In the last 30 years, the first evolution in the endowment fund occurred. Donors were permitted to place their name or family name on the fund as a way of immortalizing the gift. The endowment fund changed to the Named Endowment Fund, and an example would be the John Doe Fund.

In the last 20 years, donors began to insist on some degree of control over the use of the funds. Charities acquiesced and the Donor Directed Endowment Fund was born. This type of fund is a named fund where the income is to be used for a specified purpose. An example would be the DeWayne Osborn Fund for the Treatment of Arthritis. By accepting this sort of direction from the donor, a trust was created between the donor and the charity where the organization was bound to take the property gifted, invest it and then use the income for the distinct purposes as have been identified by the donor and documented in the charity's files.

A problem became apparent in situations where the donor's direction was at the time, or eventually became, unduly expensive, too onerous, or even impossible to deliver. Charities were unable to disburse the funds in a manner that was consistent with the donor's direction, which caused disbursement quota problems with CRA. A classic example would be the John Doe Fund for the Eradication of Smallpox. A century ago, Small Pox was a far more prevalent problem than today. It is important to remember that endowment funds last forever; hence care must be exercised when they are established to avoid problems down the road. Unfortunately, the only retroactive solution to this problem was litigation.

The proactive solution to the donor direction "trap" is to include a power-to-alter phrase in the written direction from the donor. This phrase permits the charity to alter the original direction should the use of the funds become unduly difficult or too expensive. Using the previous example, the DeWayne Osborn Fund for the Eradication of Smallpox would include a power-to-alter statement such as: should such eradication become unduly expensive or impossible, then the fund should be directed toward the eradication of similar viruses. The power-to-alter phrase is an essential component of the overall structure of these types of endowment gifts.

While Donor Directed Endowment Funds are still very common in many larger community foundations, smaller charities do not have the resources to properly administer such funds. Therefore community foundations have been receiving

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[1] Less any amounts spent on charitable activities or administration in the fiscal period.

endowment fund gifts with direction to benefit other organizations – a process that is perfectly suited for a public foundation[2].

In the last ten years, another evolution of the endowment fund is beginning to take shape. Donors want some degree of control over how the funds are managed and by whom. These funds have been called Donor Advised Funds or Manager Retention Funds and were made famous by Fidelity in the USA. Fidelity established the Fidelity Charitable Gift Fund and it received Section 501(c)(3) public charity status in October 1991. Since that time, the charity has acquired assets of nearly $3 billion and made grants totaling $4.3 billion. Two key reasons for this explosive growth were: all gifts to the charity were invested in Fidelity products allowing the referring advisor to remain compensated from the assets, and because Fidelity was able to effectively preserve assets under administration (AUM) indefinitely, there was strong head office support of the charity.

Operating a charity that permits donor advised funds requires excellent administration. In order to pay these administrative expenses, it is not atypical for the receiving charity to charge an administrative fee to maintain the endowment account. In Canada, many community foundations that have no other source of funding except the growth from their endowment funds, charge 50 to 150 basis points (1/2 to 1.5%) on AUM to pay for the administration of the endowment fund. A separate management fee is paid to the fund manager. Both of these fees are deducted from the overall return before grants are paid.

With the advent of the donor advised fund, the donor and his or her family can effectively create a private foundation within the framework of a public charity – typically a public foundation. Typically, the donor and/or his or her family are active in making recommendations to the charity as to where to use the income from their fund. The charity may opt not to follow the recommendation.

The terms and conditions of the fund are normally spelled out in a terms of reference document, or deed of gift, that is signed by all parties. The document outlines how the funds will invested, how the decisions as to use of the funds will be made, explain the donor's involvement, include power to alter clauses if applicable, and so on. Typically this is a living document and subject to review on a regular basis (e.g. annually). It is important to note that under the definition of a gift, the donor gives up all rights and entitlements to the property in favour of the charity. Therefore, a donor can only make recommendations and the charity is not obligated to follow them. To legally bind the charity is to violate the basic tenant of a gift and CRA takes a dim view of such activity.

Obviously the charity will make every effort to adhere to the donor's recommendations, which have already been spelled out in the fund's terms of reference documents[3].
In the terms of reference documents, a critical piece is the investment policy statement (IPS). This document details how the funds will be invested and is the first line of accountability to donors. Sample clause would include:

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[2] Public Foundations are mandated to perform their charitable activities primarily through other charities.
[3] It is critical for the charity to incorporate broad uses for the funds to avoid issues later.

- The funds will be generally invested in a 60/40 fixed income to equity manner.
- The maximum allowable fixed income investment shall be 75% of the total fund.
- The equity component shall not exceed 10% in foreign content.
- The fixed income investments will be strictly Canadian.
- The investment managers may exercise full discretion to re-balance the funds to the 60/40 mix if either component varies by more than 15% (e.g. equity rises to 55% when it is to max at 40%).

Unfortunately, it is not unusual for this document (or reference to it) to be forgotten in the mania of soliciting and closing a large a gift!

The IPS should be specific to the charity and not the fund. In other words, it is unwise to have several IPS documents governing endowment funds. The IPS speaks to all of the funds pooled together. In the absence of a power to alter clause or process, charities should be <u>very careful</u> in accepting a gift subject to specific investment directions (e.g. I want my fund to be invested in GIC's only). Very few if any charities with significant endowment funds will invest their funds in such a manner[4].

Lastly, thanks to poor market returns in the late 1990's, many institutions were faced with serious disbursement issues. Why? They had invested excess returns of the past into the capital of the endowment funds – capital that was supposed to be preserved indefinitely. Today it is not uncommon for institutions to allow encroachment on capital as a last resort to meet disbursement quota requirements. Recent legislation (May 2005) permits charities to pool their capital gains and to use the resulting balances to lower their DQ requirements. Please refer the Resources Section for a PowerPoint presentation and comprehensive example of how the new DQ works – including the capital gains pool.

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[4] An obvious threat to such investment is GIC returns are insufficient to meet CRA's disbursement quota.