GIFT PLANNING in Canada™

◆ The arts and science of charitable gift planning ◆

Volume 16, Number 2 February 2011

Are Endowments a Folly?

BY MALCOLM D. BURROWS

Recently I received a copy of Seymour Schulich's freewheeling and eccentric "mentoring book" *Get Smarter*. Schulich is one of Canada's great philanthropists, a man who has given away more than $200 million to charity, and has university faculties named for him across the country. He has a gloriously mischievous approach to life and philanthropy. Even though he has chosen to support the most traditional causes - universities and education - he has done so in the most iconoclastic fashion.

Take endowments. Endowments are the backbone of educational fundraising. These permanent investment funds - where the capital is kept intact and only income is paid out annually - have become the measure of prestige, health, and muscle for big educational institutions. They represent continuity, stability, and the accumulated wealth of generations. They are a prime source of bragging rights – a basic element of any college or university with pretensions.

Schulich's take?

"*Universities in the US and Canada have acquired the counterproductive habit of building up huge pools of capital called endowments,*" he writes in Chapter 47 of his book. "*These sacred cows are the height of folly. The universities take a dollar from the donor and dole out five cents annually.*"

"*Now, there is no business in the world that runs on this type of formula. Just imagine asking a hard-nosed entrepreneur to put up $20 when a dollar of capital spending is needed. The universities go one better - they set up committees that cut endowment payments in years where universities' incompetence produces no returns. In effect, universities say to their donors, `Look, we screwed up, so the money you put up to create scholarships for students is now in escrow until we can straighten out the mess the incompetence of our chosen money managers has created.'*"

"*The foolishness of the endowment fund is magnified by the rule that says. `Ninety per cent of your money's purchasing power is eroded every thirty years.' Endowment funds look great superficially but are pools of declining purchasing power.*"

And you know what?

He has a point. (And the book was published in 2007, a year before Harvard and University of Toronto each lost more than 30% of their endowments in the market meltdown of 2008.)

Let me expand a bit on Schulich's points.

1. Endowments use capital inefficiently. Most endowments pay out 4%, which means 96% is not being used to advance the mission. The vast majority of the resources are not used for charitable purposes. One could argue a charity may possess the funds it needs, but the funds are locked in a savings account for perpetuity. This is a point that has been repeatedly stressed by the social finance movement, which has advocated utilizing endowments to advance social purposes.

2. Especially when times are tough, endowment managers and policies are biased towards the preservation

of capital over the advancement of mission. Institutions with large endowments become burdened by history and responsibility. They are profoundly risk-averse. Due to law, policy, and culture the capital in an endowment is often treated with greater sanctity than the charitable mission. Yes, trustees have an obligation to be evenhanded in balancing the interest of current and future beneficiaries, but sometimes it seems like the pile of dough is more important than what can be done with it.

3. Despite the mystique that surrounds the notion of "perpetual" endowments, history is littered with endowments (and trust funds) that erode over time due to a combination of inflation, market volatility, and imperfect management. Perpetuity is a mirage. That is not entirely a question of investment managers failing to do their jobs well, although it is a factor. The underlying issue is that the purchasing power of money erodes over time, although the historically robust markets since the 1980s have obscured this fact.

Schulich is one of those dream donors who makes nightmarish demands that challenge the norms of institutional charity fundraising. *"All my benefactions stipulate 7 to 10 per cent payouts, regardless of any capital impairment. Mr. University, you have a fundraising department. Get them off their asses to make up for any shortfalls you create in my capital account."*

In other words, Schulich likes the idea of a limited-term annuity that uses money efficiently over time. Spend on mission within a generation and spend well, with conviction and savvy. Don't create trust fund institutions that cling to the idea of permanence, stability, and absence of need. The implication is: if a charity is not growing - and fundraising - it is slipping into turpitude and embedded entitlement.

This is a perspective that has a rich intellectual and legal tradition. Mortmain is a medieval English term - it literally means "dead hand" - that describes the prohibition on holding real estate in perpetuity. Edward I passed the Statutes of Mortmain in 1279 and 1290 to prevent the church from holding property in perpetuity. The concern was that important public resources would become non-productive if held by a large institution like the church. Indeed mortmain legislation has been part of the common law of charities right up to the present time. It was only in 2010 that Ontario abolished a mortmain provision which prevented charities from owning real estate not directly connected with their charitable purpose.

The anti-endowment perspective overlooks why charities, particularly well-established institutional entities, foster endowments. Charities with significant annual costs need stability for long-term planning. Salaries and other commitments need to be paid. It would be irresponsible to take on obligations that could not be met due to a poor fundraising year. Charities are also fundamentally better at spending money than raising it – they are not businesses, nor should they be.

Another factor is the source of funding for endowments. Most endowments have been primarily funded by bequests. While Schulich may rail against endowments, he also states that he gives, in part, *"to create a legacy that assures I won't be forgotten."* This desire for a form of immortality easily translates into endowments for many donors. Life savings and values intertwine to become the life savings and values of the charity: it's a heady combination.

Even Schulich can't resist.

One of the bracing things about Schulich is he has the urgency of an entrepreneur and the rationalism of an investor. He is a first-generation wealth creator. He seems to find trust fund brats – either individuals or institutional – to be repugnant. Large institutional charities are not very entrepreneurial. Most leaders in this setting cling to the idea of security and have no clue about how to attract new wealth to fund their enterprise if the old wealth is spent. Over the years I have worked with academics and charity administrators who want to build an endowment large enough to fund their *current* operating needs. Why? So they don't have to fundraise. It's the charity version of the lottery fantasy. Schulich's implication is correct: vital, relevant organizations will always be finding new bucks.

Schulich ends his chapter with a warning: *"My advice to donors and potential benefactors is: fight to keep as much of your money as possible out of endowment funds. It's hard to avoid the tremendous mythology that envelops the university endowment fund. The efficiency with which your donation operates will be increased by the amount you can divert from these unproductive capital parasites."*

Endowments do indeed have a "tremendous mythology" attached to them. The mythology of endowments is what we in the fund development and gift planning world sell to donors. (I've spent a good part of my career promoting and believing in the importance of endowments, so I am implicated.) Endowments are powerful finance tools, and they are also emotional legacy structures due to their perpetual nature. Endowments have been promoted extensively in the last 20 years in Canada. I would even say that the Canadian charitable sector only really discovered endowments in the last 15 years. As I quoted in my article "The End of Endowments?" in *The Philanthropist* (Volume 23, No 1, 2010, www.thephilanthopist.ca) "Benefits Canada reports growth in endowment funds from $14 billion in 1997 to $41 billion in 2007." For a structure that dates from the middle ages, endowments are a remarkably new phenomenon in this country.

Another aspect of the endowment mythology is the prestige factor. In the academic world, all ambitious faculty members want to have their own endowed chair. You would think this is because the chair will provide much greater resources for them to do their work, but the reverse is often true. The chairs just pay salary, which the chairholder is already receiving. The chair endowment may provide a modest annual sum for research, but it is relatively minor compared to what a top researcher can attract in grants. The real appeal for most academics is status within their institution and the larger academic world.

I welcome Seymour Schulich's iconoclasm and vocal skepticism. Endowments are an important funding mechanism within the charitable sector, but we have gone through a period where we have built up the mythology of endowments without adequate critical reflection.

There are other models of funding, such as Schulich's high-payout fund, which are technically known as a quasi-endowments. Capital can also be invested in enterprises that produce both monetary as well as mission return. Can we make better use of our charitable capital? It's a question we should constantly be asking.

*Malcolm Burrows (malcolm.burrows@scotiaprivateclient.com) is Head, Philanthropic Advisory Services at Scotia Private Client Group. He is a member of Gift Planning in Canada's Editorial Advisory Board, and a Friend of CAGP*ACPDP™.*

Creating a Successful Endowment Program

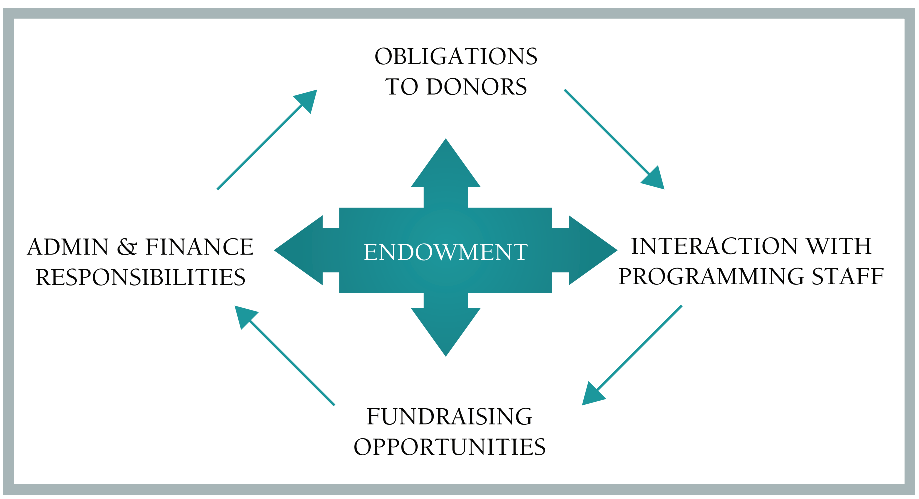
By SUE WIDYARATNE, BBA, CFRE

At one time, only organizations like universities, hospitals, colleges, cultural, and other public institutions established endowments. Now, endowments are becoming more and more common - even small charities are contemplating creating endowments to set in place a sustainable funding mechanism to finance programs well into the future.

Thanks to the changes announced in the 2010 Federal Budget eliminating the 10-year restriction on donated capital to endowments (the 'ten-year rule'), charities can now be more creative and more donor-centered in designing different types of endowments – from permanent funds, to fixed term funds, to flexible in-out funds, or combinations thereof – to satisfy donors' wishes and organizational objectives.

An endowment program includes varying components that must work in harmony to make it successful and sustainable – and communication is key! With the opportunity allowed charities by the changes in the budget, it is now even more imperative for organizations to establish a proper structure to their endowment programs from the get-go.

The main components of an endowment program are as follows. Although the relationship between, and functions within, the components may vary from one organization to another, these are the basic elements that are common among organizations.



Obligations to donors:

It is critical that the donor is aware of the terms of the fund(s) the donor is supporting, whether it is a "named fund" or a general endowment. Therefore, the terms of reference or fund agreements must be prepared and signed off by the appropriate agents. If a donor sets up a named fund, ensure the donor signs the agreement and receives a copy.

Provide appropriate recognition. Because of the intangible nature of endowments, it is difficult to recognize donors in the same way as for a capital campaign. However, a creative a way of recognizing a "named fund" is to create an "endowment gallery" at your organization with displays of plaques containing donor stories.

Prepare and deliver fund reports to donors. This is typically done on an annual basis, or more frequently, depending on the type of fund, and can be delivered personally or at "reporting events". There is nothing more meaningful to a donor than seeing how their contributions have affected the organization they support. It sometimes results in additional donations for your organization. If at all possible, ensure the donors see what they are supporting – a picture is worth a thousand words!

Administrative Responsibilities:

Preparation and regular revision of an endowment policy is another critical aspect, as it outlines the growth and the distribution process of the fund.

Ensure proper coding in the database to link and track the donor with the type of fund associated with that donor.

Ensure drafting of and proper filing of terms of reference for the initiatives supported by the funds, i.e., for a lectureship or fellowship, a particular project, etc.

With the repeal of the 10-year restriction for endowed gifts, it is even more important that your organization review current policies and agreements to determine whether they are still relevant to your organizational objectives. There are a number of issues that need to be addressed for this process, which are not covered in this article.

Financial Responsibilities:

The development of investment policies and proper management of the funds is critical as your organization is accountable to all the stakeholders who have an interest in the growth of the fund.

The disbursement policies should give consideration to preserving the purchasing power of the funds and protecting it against inflation.

Ensure the disbursements from the funds are made according to policy, and according to the designated purposes indicated in the fund agreements. This is typically done on an annual basis unless otherwise stated in the respective agreement.

Ensure regular reporting on the activities of the endowment to management.

Interaction with programming staff:

Since most funds are set up to support the programs and projects managed by the programming staff of your organization, it is critical that the lines of communications are kept open in both directions. These individuals are the sources of information sent to donors about the uses of the funds.

It is important that you create a means of interaction between them and the donors that support their initiatives. It is amazing what a difference this makes to a donor's sense of pride and satisfaction. Sometimes, unexpected friendships also evolve out of these interactions.

Ensure the programming staff is given copies of any terms of reference that are prepared on any initiatives supported by the endowment.

Fundraising opportunities:

If you do all of the above well, and keep the lines of communication among the components open, donors will continue to flow contributions into their funds.

Engage other family members of the "fund holders" by sending them the fund reports, and involving them in any marketing or recognition initiatives that you plan for the endowment. Some of them will also start making regular contributions, as they will now feel an ownership of their respective funds. © Sue Widyaratne

Sue Widyaratne, BBA, CFRE (widya@magma.ca) is Principal, SW Philanthropic Consulting Services (www.swpcs.ca).

An Overlooked Source of Major Donations

BY ADAM APTOWITZER

I have often thought the old maxim of Jean Baptiste Colbert "The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing" applies just as well to soliciting for donations as it does to taxation. And, of course, discussions abound in the sector about how to make donations (especially large ones) as palatable as possible for the donor. So it is with some surprise that we do not often see charities thinking strategically about unlocking the capital value of shares in Canadian businesses.

The key to the strategy involves an understanding of what tax and estate lawyers call an estate freeze. An estate freeze is based on the principle that the Income Tax Act allows the sale (or gift) by Canadians of $750,000 of shares of a Qualified Small Business Corporation (a "QSBC"). This amount is cumulative over the Canadian's lifetime. A QSBC has a technical meaning which we will not canvass here, but is not limited to small businesses, rather it is generally limited to active Canadian businesses (i.e. not passive businesses like royalty or rent collection).

Once the value of a business reaches $750,000, lawyers often recommend exchanging the common shares of the corporation for preferred shares which have a "frozen" value of $750,000. The common shares are then held by another family member and allowed to appreciate until the next $750,000 of value is 'used up' and then the freeze can be done again. The freeze is accomplished by making a condition of the preferred shares that they can be purchased by the corporation for a set amount, in this case $750,000. Because the corporation can force the sale at $750,000 no third party would ever pay more than that for the shares so their value is effectively frozen. As a matter of law, the shares can also be designed so that the shareholder can force the corporation to buy them for that same amount.

Let us assume that an estate freeze has occurred. It is not important who holds the common shares, but in our example the donor holds preferred shares of a QSBC frozen in value at $750,000. Assuming the shareholder has not used the lifetime capital gains exemption before, she can now donate these shares to a charity and receive a $750,000 receipt (noting of course that there are certain hoops to jump through when donating shares of a private corporation to charity) and pay no tax on the donation.

So the donor now has a $750,000 receipt (worth, in Ontario, approximately $345,000) and the charity owns the shares. The charity now has several options. The shares may pay dividends, and for that reason the charity may wish to hold on to the shares. More likely, the charity wants to liquidate these shares (indeed there may be legal reasons why they would have to sell the shares). If the shares are retractable, the charity can force the corporation to purchase them for the full price. On the other hand, it may have to convince the corporation to buy them back all at once or according to some schedule.

Perhaps the most interesting plan may be where the corporation uses the proceeds of life insurance to repurchase the shares. In this scenario, the corporation takes out a life insurance policy, likely on the principal of the business (although as long as the corporation has an insurable interest in the individual this does not have to be the case). When the insured dies, the corporate beneficiary receives the proceeds which are used to buy back the donated shares. Even better is that the corporation has now received a 'bump' to its capital dividend account. This effectively allows the corporation to distribute the amount of the insurance proceeds to the shareholders on a tax free basis. As a result, not only does the charity receive its money but the new shareholders of the corporation receive the same amount paid out from the corporation's revenues (assuming it has them).

While this plan is complicated and therefore requires professional advice, it achieves a trifecta, in that:

a) the donor receives a $750,000 tax receipt;
b) the cash to pay for the donation comes from the donor's corporation; and
c) the charity not only receives the funds but can also receive dividends over many years.

Even with the simplified examples used here the planning is complex, but the potential can be huge as different family members may be able to take advantage of this strategy at the same time. Donors can donate any amount they want, (although some amount may be taxable) and the actual cash comes directly from their corporation. Keep in mind the best time to do a freeze is when the business can legitimately be given a high valuation. This typically occurs while the principal is working (as opposed to retired), which is when people often require large donation tax credits to offset their income.

If your charity or donors need more information about this strategy please feel free to contact the author.

Adam Aptowitzer (adamapt@drache.ca) of Drache Aptowitzer LLP is a charity law lawyer with a national practice based in Ottawa. He has been published in Canadian Taxpayer, Canadian Fundraiser (now Canadian Fundraising & Philanthropy) and the Not-for-Profit News. He has also published a widely distributed study on the regulation of Canadian charities with the C.D. Howe Institute.

As a speaker, he has presented to the National Symposium of Charity Law, the C.D. Howe Institute, the Association of Fundraising Professionals, the Canadian Association of Gift Planners, the Ottawa Estate Planning Council and various large and small Canadian charities. He has also given expert advice on Parliament Hill. Adam is an executive member of the Canadian Bar Association's Charity and Not-for-Profit Law section. Contact him at 613-237-3300 or visit http://www.drache.ca.

Flow-through Shares – A Secure and Ideal Way to Support Favourite Charities

BY FRANK RESTORICK, CFP and BILL HALLETT, PhD, ACFRE

Beware of tax-shelter schemes that could send a tax bill soaring.

The time-honoured expression that says "if it sounds too good to be true, it probably is" definitely applies to investors who want to donate money or shares to charity. Those investors need to be wary of charitable-giving scams that promise receipts far in excess of the actual amount donated to questionable causes or organizations.

Although the Canada Revenue Agency (CRA) has tightened the noose around such schemes, some bogus tax shelter arrangements are still lurking and beckoning to unsuspecting investors who may land up with a sizeable tax bill, after a government audit.

Donate flow-through shares, reduce tax burden

But amidst these murky schemes is a bona fide way of donating shares to charity: one which is fully recognized and accepted by CRA. By contributing flow-through shares to registered charitable organizations, an individual's contribution will not be questioned by the agency's vigilant tax auditors.

So what makes flow-through shares so attractive to savvy investors, who also want to support a charity?

Flow-through shares limited partnerships (LPs) present an exceptionally good strategy for reducing taxes on an investor's long-term financial goals. Canadian tax laws allow mining companies to raise capital by issuing flow-through shares. Simply put, those companies pass on or 'flow' certain exploration expenses through to the investor who can take advantage of a great opportunity to minimize taxes.

Our current tax structure encourages the resources sector to continue exploration and development. At the same time, investors buying these shares in mining or junior energy companies will be rewarded with considerable tax savings. As well, investors do not have to be in the top tax bracket to take advantage of flow-through shares LPs. And they can reduce their tax bill by donating these shares to their favourite charities – which is perfectly legal and above board.

No capital gains taxes on gift of flow-through shares

Flow-through shares LPs provide a significant benefit for an investor who also wants to support a legitimate charity. Donors can write off close to 100 percent for the same year in which they invest in these shares.

To gain the maximum benefit of a tax deduction, investors must hold flow-through shares for 18 to 24 months. With a limited partnership, those units will roll over into a resource-based mutual fund. Investors now have choices. They can sell their shares, switch between mutual funds tax-free, invest in a new limited partnership, or donate their units to charity.

With no capital gains on the gift of shares to a registered charitable organization, flow-through shares represent an ideal and legitimate donation. Investors will also significantly reduce their costs of making that donation. Once they convert the shares to a mutual fund, they receive a gift receipt for the value of the mutual fund units, which they donate "in-kind" to a registered charity of their choice.

Let's look at this simple example of how this works to an investor's advantage. The investor, who we will call Ed, is in the 46 percent income tax bracket. He purchases $10,000 in a flow-through shares limited partnership to reduce his taxes. In the same year that he purchases those shares, Ed will receive a tax credit of about $4,176 (assuming a 90 percent write-off).

Now for the sake of simplicity, let's assume that Ed's investment is still worth $10,000 at the time he rolled it over to a mutual fund. By donating those shares to a local community foundation for youth at risk - his charity of choice - he avoids any capital gains tax and receives a donation credit of $10,000, which will mean tax savings of another $4,600 as Ed is in the 46% tax bracket.

That is a terrific deal for Ed because flow-through shares give him two major tax deductions totaling $9,200. His net out-of-pocket costs are just $800 from his initial investment of $10,000 and his charity is richer by $10,000.

Recoup nearly entire investment

Most Canadians are unfamiliar with flow-through shares and the benefits they offer, not only for reducing their tax bills, but also for supporting charities. With flow-through shares LPs, investors will minimize taxes and still keep much of their hard-earned wealth where it will do the most good – in their own financial nest eggs.

	Flow Through Share Investment	Securities donated in-kind	Cash from securities sold	Cash
Value of donation	$10,000	$10,000	$10,000	$10,000
Adjusted cost base	$0	$5,000	$5,000	$10,000
Taxable capital gain	$0	$0	$2,500	$0
Tax on capital gain	$0	$0	$1,160	$0
Net Out of pocket	$10,000	$8,860	$8,860	$10,000
Flow-through tax savings	$4,600	$0	$0	$0
Donation tax credit	$4,599	$4,599	$4,065	$4,599
After-tax cost of $10,000 donation	($1,225)	($4,241)	($4,775)	($5,401)

While CRA is still cracking down on all kinds of tax shelter schemes, it's comforting to know that flow-through shares provide investors who want to donate to charity with a rock-solid way to support their causes and still cut their tax bill. Like Ed, those wise investors will also recoup virtually their entire investment and can safely donate to their charity of choice for an additional tax credit.

The table above shows the advantages of donating flow-through shares, compared to giving cash and securities, which are also gifts in-kind.

Frank Restorick is a registered investment advisor with Dundee Securities Corporation, a DundeeWealth Inc. Company. For more information, contact Frank at frestorick@dundeewealth.com.

Bill Hallett is an Advanced Certified Fund Raising Executive (ACFRE) with Hallett Horlor Inc. a professional services firm dedicated to helping not-for-profits and charities thrive. For more information, contact Bill at bill@hallettthorlor.com

This article is solely the work of the authors for the information of readers. Although Frank Restorick is a registered Investment Advisor at Dundee Securities Corporation (Dundee Securities), this is not an official publication of Dundee Securities and the author is not a Dundee Securities analyst. The views (including any recommendations) expressed in this article are those of the authors alone, and they have not been approved by, and are not necessarily those of, Dundee Securities.

Important information about flow-through limited partnerships is contained in their relevant Prospectus/Offering Memorandum. Please obtain a copy and read it carefully, including the associated risks and tax consequences, before investing.

THE LAST WORD

Not quite, but it is coming.

Once upon a time in the last century, in a job interview, the interviewers scanned my resume and what could be described in those olden days as a chequered past (stints as: commercial fisherman (twice), subway car cleaner, lab tech in both neuropsychology and low-temperature physics, psychiatric social worker, goat breeder, apiarist, wood-heat contractor, greenhouse builder, Executive Director of a provincial NGO).

One interviewer observed, without prejudice, "Hmmm, a real Renaissance man!"

Another responded, "Or he can't hold a job."

Which may be closer to the truth.

In fact, I have always tried to remain aware of the distinction between 'ten years' experience' and 'one years' experience repeated ten times'. Even gift planners, who unquestionably have the best jobs in the philanthropic sector, live with learning curves that, with time, approach the horizontal.

This is all by way of saying I will be stepping down as Editor of this journal in June, after five and a half years, sixty-six issues, more than a few conferences, and enough email correspondence to fill a terabyte hard drive.

I have made many new friends in the process of building and maintaining what we hope has been a dynamic dialogue on the current and future practice of gift planning. The profession has come a very long way in the past two decades, as has its professional organization CAGP/ACPDP.

I look forward to passing the torch at mid-year.

Janet Gadeski, the new President of Hilborn, will be recruiting my replacement. A description of the opportunity follows this column.

To our many contributors and friends: please keep it coming! This is your opportunity to reveal that new strategy, make the new Editor(s) look good, or excoriate me for any lapses.

The credit for the past five years must go to our authors, with a little help from Strunk & White; the errors and omissions I will claim as my own.

-JWH

Hilborn, the nonprofits' first choice for resources they need to change the world, has an opening for Editor of Gift Planning in Canada. You're a good candidate if you are:

- an experienced, collegial gift planning professional;
- equally comfortable discussing the cultivation and stewardship of planned giving donors/prospects and the technical side of gift planning;
- a capable writer and good at improving the writing of others;
- part of a broad network within the charitable sector;
- able to commit an average of 30 hours a month, and attend 1-3 sector events yearly.

Interviews will be held in Toronto during the second week of April, with the successful candidate to start no later than 1 July 2011. (jgadeski@gmail.com)

GIFT PLANNING *in Canada*™

Editor: John Webster Hochstadt; **Managing Editor:** Lea Clearwater; **Publisher:** Jim Hilborn; **Founder:** G. Roger Schoenhals 1996; **Circulation:** Helen Hanratty; **Design:** Creative by Nature

Subscription Orders & Information: Helen Hanratty, The Hilborn Group Ltd. Box 86, Station C, Toronto, Ontario M6J 3M7 Telephone: (416) 345-9403, Fax: (416) 345-8010, eMail: helen@hilborn.com. **Rates:** One year – $237+HST. Two years – $450+HST. Multiple and bulk rates available. Back newsletter issues @ $5 on request. GST R896266251.

Advertising Sales & List Rentals: Jim Hilborn, Telephone: (416) 345-9403, Fax: (416) 345-8010, eMail: james@hilborn.com.

Gift Planning In Canada®, is published monthly by The Hilborn Group Ltd for Canadian gift planners and nonprofit managers. ISSN 1551-0212.