Foundations & Endowment Funds

So, you are thinking about establishing a Foundation or an Endowment Fund. This article takes a look at some of the reasons why, what these terms mean, what's involved in establishing and operating, some pros and cons, and some other things to think about.

You may be an existing charity looking to do more and wanting to enhance the longer term financial and operational sustainability of your good organisation. Alternatively, you may be a philanthropic individual wanting to establish a more formalised legacy for your charitable giving. Either way, establishing a Foundation or an Endowment Fund are popular strategies.

However as with any new endeavour, and especially one that will likely involve ongoing compliance obligations, and may even involve establishing a separate legal entity, we suggest it is important to firstly pause and:

1. be very clear of your objectives

2. understand and consider the main options and implications; and then

3. develop your strategy and act.

With reference back to an earlier article https://www.rsm.global/newzealand/news/please-dont-set-new-nfp-entity New Zealand already has an extraordinarily high number of not-for-profit and charitable entities. Especially when considered in light of our relatively small population. Hence, it is imperative that any decision is a considered and well-thought through strategy, rather than just **"a good idea at the time**", or reacting to the causal, and possibly well-intentioned but sometimes ill-informed, suggestions of others.

What’s the difference between a Foundation and an Endowment Fund?

In our experience, the words are often (incorrectly) used interchangeably. Yet there are some important differences. Hence it is important to understand these to ensure the correct vehicle is used and to avoid any unintended consequences.

A Foundation (also sometimes called a **charitable foundation**) is a term generally used to describe a separate legal entity with a principal purpose to typically donate funds and support other charitable/not-for-profit organisations. Alternatively, it may exist to provide the source of funding for its own charitable purposes. While not-for-profit in nature a foundation is usually concerned to maximise the revenue generated from its capital while also balancing adherence to a specified risk appetite to ensure protection of the underlying capital invested.

The legal structure of most foundations in New Zealand is that they are incorporated as charitable trusts under the Charitable Trusts Act 1957. This of itself does not mean they are charitable though as under New Zealand law an entity is now required to register with DIA Charities Services under the Charities Act 2005 in order to be granted registered charitable status. Being recognised as a registered charity provides it with benefits of income tax exempt status as well as a degree of public credibility.

An Endowment Fund is an investment fund established by a foundation or registered charity whereby capital is set aside to support the organisation or a specific project or purpose. Most endowment funds are structured so the principal amount invested remains intact, while the investment income is available for the purpose that the fund was established for.

An endowment fund could technically be established by a profit seeking corporate but as such it would not have any tax advantages and hence would be unlikely to attract any significant gifts or other support.

The main difference from a foundation is that an endowment fund is <u>not</u> a separate legal entity. But rather, it is an internal fund of an existing entity i.e. a fund established within an existing legal entity, usually a registered charity. You can think of an endowment fund as a bank account within an organisation established for a specified purpose.

Endowment funds may be restricted or unrestricted with the restriction specified by the original donor of the funds. The funds of the unrestricted variety may be used in any way the recipient organisation chooses whereas restricted endowment funds may have limitations put in place over them by the original donor. A common example is a university scholarship where the funds are to provide income to fund scholarships in a specified area of study.

A highly variable feature of endowment funds is the level of formality applied to them. This can range from very little to highly detailed internal rules and requirements specifying in great detail the fund’s purpose and how it will be operated and reported.

Foundations – Pros and Cons

Pros

- A separate legal entity – this can assist with ring-fencing funds from potential attack as opposed to those funds being just seen as part of the funds of the larger operating charity.
- Provides a greater degree of protection and certainty that the capital won't be redirected due to any short-term whims or cash-flow needs of the beneficiary charity.
- Separate charitable registration is possible and hence can assist in making it very clear to donors what any donated funds are for and are to be applied to.

Cons

- A separate legal entity – hence has a legal life of its own and all of the establishment requirements, ongoing administration, compliance and governance that goes with that – effort and cost. This will include amongst other costs; separate financial statements, audit if it is large enough, and Charities Services filing compliance.
- Separate governance can occasionally prove problematic due to the governing body sometimes diverging from original establishment intentions. Especially challenging if the foundation deviates from supporting the organisation it was originally established by and intended to support.
- Depending upon how the Foundation is established and operates then it still may be considered under accounting rules to be a controlled entity of the beneficiary charity. As such its financial statements would need to be consolidated into the financial statements of the beneficiary charity. This can prove problematic when a Foundation is established with an intention of specifically separating the optics of the main charity's funding.

Endowment Funds – Pros and Cons

Pros

- Not a separate legal entity – this saves on unnecessary costs or duplication of costs
- Flexible as generally just a decision of the governing body to ring-fence part of their funds for a specific purpose and use. Formality of this can vary but is ultimately under the governing body control and as such they can generally change as they see fit.
- Part of the host entity's charitable registration. Hence the host can still potentially fundraise in the name of the endowment fund and for its specific purpose as long as they still clearly disclose the registered charity details. Donors still get the benefits of donating to a charitable entity and should be able to receive a charitable deduction.
- Can be a good way to highlight, profile, and ring-fence, a fundraising project of an entity.
- Doesn't need to produce separate financial statements by law as is just part of the host entity's operations.

Cons

- Not a separate legal entity – hence if the charitable entity is attacked then the endowment funds may be legally exposed as part of the entity's overall available funds.
- As it is in effect just a bank account of the charity then there is the danger that its funds may be diverted by the governing body for short-term needs. i.e. is within their decision-making ability to change.
- May be more difficult for the charitable entity to demonstrate to third parties why it needs more funds if its endowment fund is a part of its overall financial statements and this gives it the appearance of having significant available funds.
- Can be viewed by some as less likely to attract significant gifts than a separately governed legal entity such as a foundation – however this is debatable and can be a function of quality of communication only.

Community Foundations – another sensible alternative?

Recent years has seen a rise in the establishment, promotion, and growing support of community foundations in New Zealand. These have proven themselves a successful model overseas and with good reason. In essence, they are a charitable fund aggregator that utilise economies of scale to provide a cost-efficient investment, administration and funding vehicle.

As we have noted above, to establish a separate foundation as a separate legal entity and registered charity involves a reasonable amount of skill, effort and ongoing compliance and governance. The basic philosophy behind the community foundation movement is that a motivated donor can instead donate to a specialist organisation like a community foundation which is itself a registered charity, specifying wishes of what their donation should be used for. As the community foundation is managing a number of funds they can get synergies and better returns from their scale and skills and the donor benefits from this. Most community foundations also allow a range of flexibility depending upon the donor’s wishes. For example, some donors may wish to establish a fund within the community foundation in their name, whereas others may be happy to add to an existing special purpose fund that appeals to them. Some donors may be quite specific with where/to whom they wish to donate. Others may wish to only donate income from their original donation, whereas others may wish to donate a mix of capital and income, or for this to change over time.

There are a growing number of these now established in New Zealand such as the Acorn Foundation, the Auckland Foundation, the Nikau Foundation to name a few. The growing maturity of this sector is such that there is now a Community Foundations of New Zealand organisation established and you can visit their website for more information; www.nzcommunityfoundations.org.nz

For individuals and families, donating via a community foundation can be a very sensible choice given the value of a specialist structure and professional best practice skills in managing them. This is a choice that can ensure both effectiveness and efficiency of donating.

Alternatively, a small charity without the capacity and scale to efficiently and effectively operate either a separate foundation or endowment fund of its own may potentially want to consider establishing a fund within a community foundation for ongoing support.

Summary

As can be seen above there are advantages and disadvantages to any choice of action regarding establishing foundations or endowment funds. The key is to be very clear on what your aims are, be aware of the main implications and then to seek appropriate legal and accounting advice to ensure your choice meets your aims.

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