Using Accounting and Market Data with the Total Return Strategy to Manage a Foundation's Investment Portfolio: A Case Study of a Canadian Charitable Foundation

Daphne Rixon
Saint Mary's University

Judy Rois
Trinity College, University of Toronto

Alex Faseruk
Memorial University

This paper examines the impact on charitable organizations of excluding capital gains when defining investment income in wills and bequests. Two problems have been created: (1) insufficient funds available from interest and dividends to provide meaningful grants: and, (2) inability to meet the 3.5% disbursement quota required by the Income Tax Act. To address these problems, some charities have implemented a Total Return Strategy (TRS) that includes realized capital gains in calculating funds available for disbursement. This study adds to the literature, since there is a paucity of research on the implications of using TRS as a method to resolve funding and tax challenges facing charities.

INTRODUCTION

The Anglican Foundation of Canada (AFC) was created by a motion of the General Synod of the Anglican Church of Canada (ACC) in 1957 to encourage and support ministry within this denomination. Following an initial donation of $25,000, the AFC functioned as a member-based charitable organization that has, for almost 60 years, invited individuals, parishes, dioceses and various other church organizations to make annual contributions or bequests so that the AFC can finance applicants who are engaged in active ministry, which will serve and benefit the ACC or its ecumenical partners. At General Synod in 1957, the resolution was that every parish would contribute $50 each year to the AFC in order to build up a fund for mission and ministry across the ACC. The AFC's ability to support ministry is further funded by bequests, memorials/special gifts, donor-designated trusts, life insurance, gift annuities, repayment of low cost loans, and investment income. As a registered charity with trust agreements, the AFC is required to simultaneously distribute a portion of the income from the trusts that it administers and potentially reinvest a portion of that income back into selected trusts (plowback specified in some trust agreements), and preserve capital, that is to say not distribute capital from those endowed trusts. As a registered charity, the AFC must adhere to income tax considerations, administration of trust agreements, and be bound by trust legislation. The AFC also receives unrestricted donations, contributions and membership payments, which are not restricted by various trust agreements for distribution, but must nonetheless adhere to tax considerations.

In terms of governance, the AFC has a Board of Directors (the Board) chaired by the Primate (presiding bishop) of the ACC. The Board has members that are either elected or appointed by the Primate. These board members can either be clergy or lay representatives drawn from all across Canada. The Board meets twice a year to review applications, award grants, bursaries and loans, while continually designing new initiatives to enhance cash flow and distribute much needed money to deserving organizations. Following that initial endowment of $25,000 and nascent member donations in 1957, the AFC has distributed grants and low cost loans totalling more than $28 million CAD with a current investment base of more than $13 million CAD. However, in addition to the various requirements placed on charities for the distribution of cash, as previously outlined, most notably tax and trust considerations, the registered charity is also constrained by the investment performance of its portfolio. In eras of solid stock market performance and buoyant interest rates, the AFC often had a large amount of funds available for distribution. Litner (1956) demonstrated that distributions take place on a lag basis.

With the economic recession of 2008 and chronically low interest rates, the performance of the investment portfolio has compromised the ability of registered charities to distribute cash. These problems are also exacerbated by falling membership, erratic bequests, and rising costs. Although the stock market recorded substantial gains since the end of the last recession, the increase in the value of the portfolio has come through capital appreciation in the value of the underlying assets, which must be divested for the gains to be realized. These divestitures might not always be consistent with the definitions of income outlined in various trust agreements. The Board, through its Treasurer, Finance and Investment committees, have not been willing to approve distributions that may impair capital and potentially compromise the financial integrity of the various administered trusts until an enhanced definition of income was approved by the Board. On a go forward basis, distributions are to be based on a formula that recognizes the constrained optimization nature of distributions, which will meet the needs of the grant applications, adhere to the conditions of the trust, address tax/legal considerations, and maintain the financial integrity of the trusts within the AFC.

This paper examines the impact on charitable organizations of simply using a narrow definition of investment income and preservation of capital restrictions in wills and bequests. Charitable organizations are beneficiaries of bequests and donations that are often accompanied by highly specific terms and conditions, such as those clauses that support the preservation of capital. To ensure preservation of capital, wills often define distributable income as comprised of interest and dividends, but that definition excludes realized, or for that matter unrealized, capital gains. Two problems have been created: (1) insufficient funds available from interest and dividends to provide meaningful grants: and, (2) inability to meet the 3.5% disbursement quota as required in Canada under the terms of the Income Tax Act.

It is important to conduct this study since charities continually struggle to generate sufficient funds to support the purpose for which the funds were donated, while other charities are experiencing difficulty in meeting the 3.5% disbursement quota. Moreover, charitable organizations are currently experiencing declining annual unrestricted donations and more than ever need to maximize funds available for distribution from bequests and restricted donations. Some charities and trusts have applied to the courts for approval to implement a Total Return Strategy (TRS) that includes realized capital gains in calculating funds available for disbursement. This study adds to the literature, since there is a paucity of research on the implications of using TRS, which includes realized capital gains, as a method to resolve funding and tax challenges facing charities.

FOCAL ORGANIZATION

This research is based on a case study of the AFC. As outlined, the AFC was created in 1957 to encourage and support ministry among Anglicans within Canada. The General Synod of the ACC is the chief governing and legislative body. It has met since 1893, currently on a triennial basis, with standing committees to govern the church in between the meetings of General Synod. It consists of lay and ordained, elected and appointed representatives from all across Canada. General Synod rotates meetings every three years in various Canadian cities. In Canada, a foundation is one type of registered charitable organization identified under the Income Tax Act. Foundations represent approximately 12% of registered charities in Canada. The AFC is a public foundation with its stated purpose to raise and distribute funds related to charitable purposes of Anglican ministry in Canada.

The AFC manages trusts valued at approximately $13.3 million CAD (mid 2014) and operates as an independent unit within the ACC. Its mandate is to administer restricted and non-restricted bequests. It has provided loans to parishes for a variety of capital projects and awarded grants in accordance with the terms of these bequests and from funds generated through income on investments. The AFC manages and distributes funds from 45 restricted bequests in accordance with terms set out by the various donors. Of these 45 trusts, seven have trust advisory committees. Funds from the former involving small amounts of less than $5,000 CAD may be disbursed by the recommendation of the Executive Director and confirmed by two members of the AFC Board. Funds from the latter may be disbursed upon motion by the trust advisory committee members followed by ratification of the AFC Board. The reason that seven trusts have advisory committees is that the original documentation of the Trust stipulated an advisory committee. The Executive Director is a member of all Advisory Committees. Some of these trusts have capital endowments which are very low and largely are economically non-productive. In the future, the Board may seek to combine trusts or wind some up if the donor's trust can be altered to allow for this. Still other trusts allow wide latitude in the distribution of funds with some of them being in a capital surplus position.

The funds of the AFC are administered by an Investment Committee, which is a committee established by the Board. In addition to Board members, it also includes investment professionals who donate their time. The Investment Committee oversees the management of the investments on behalf of Board. It proposes guidelines to the Board for the investment and management of the investment process (AFC – Investment Policy Statement), which is subject to continual review, usually done on an annual basis. The Board, on the advice of the Investment Committee, appoints external investment managers. The managers' role is to administer the assets of the Fund, directly through the use of portfolio sub-managers with expertise in specific asset classes (e.g. global equities) appointed by the Manager, to achieve the Fund's investment objectives.

METHDOLOGY

The paper provides a case study of the recent investment policies of AFC and its investment performance. The case study employs a documentary review of the AFC's investment policy, investment reports, financial statements, minutes of Board and Investment Committee meetings. In addition, to gain a more in-depth understanding of the AFC's investments and trusts, interviews were held with the Executive Director, Finance Committee Chair, Investment Committee Chair, and the Foundation's external auditor. The study documents the issues encountered by the AFC in its efforts to stabilize annual disbursements, while preserving capital and adhering to the terms of the restricted donations and bequests.

Yin (1994) defines case studies as a multi-faceted research strategy based on an in-depth examination of one organization, situation or community. According to Singleton and Straits (2002), face-to-face interviews are beneficial in examining complex issues because they facilitate probing for additional information, yield a better response rate, provide flexibility over question content and enable clarification of questions and terminology. Case studies were described by Hill (1993) as holistic investigations which generate both quantitative and qualitative data from archival material, interviews, surveys and observations (Hill, 1993). While the benefit of case studies is their greater realism, the disadvantages of this approach including time to conduct and transcribe interviews, findings cannot be generalized and validity can be compromised by lack of rigorous control (Bennett, 1991; Hill, 1993). Although all the disadvantages cannot be mitigated, a documentary case study is the most appropriate instrument for this research due to the complex nature of the research questions and the need to solicit in-depth feedback from a small number of respondents.

CURRENT SITUATION

The current challenge created by the AFCs investment policy came to a head in 2013. At that time, as depicted in Table 1, total investment income (including realized and unrealized gains) amounted to \$1,439,283. Yet, the distributable funds, calculated as interest and dividends, resulted in only \$333,002 available to support the AFCs various causes.

The trusts managed by committees expressed surprise and concern about the low level of distributable funds available despite the investment portfolio earning over 11%. On the surface, it appears there was over \$1.0 million in investment income that was not available for distribution. This situation occurred due to the fact that the calculation of distributable income excluded realized capital gains. Moreover, with the enhanced mark-to-market requirements by the adoption of International Financial Reporting Standards (IFRS), the trusts appeared that significantly higher amounts were available for distribution than realistically available as they are unrealized capital gains.

TABLE 1
DISTRIBUTABLE FUNDS AVAILABLE 2013 COMPARED TO ACTUAL RETURNS

Balance January 1	**$12,379,609**
Funds Invested	929,802
Funds Withdrawn- income	(516,563)
Funds Withdrawn- capital	$(921,619)
Net Capital Change	**$(508,3800**
Investment income earned	404,708
Fees and expenses	(71,705)
Realized profit (loss)	426,276
Change in unrealized appreciation/depreciation	680,005
Net Income (Loss)	**$1,439,283**
Balance at December 31, 2013	$13,310,512
Investment Return	
Average investment for period	$12,845,060
Net income	1,439,283
Rate of return earned on investments	**11.20%**
Distributable income available	
Capital gain (loss)	$1,106,280
Distributable income	333,002
Rate of return earned based on distributable funds	**2.59%**

FINDINGS: DISCUSSION AND ANALYSIS

During the May 2014 meeting of the AFC Board, the impact of low distributable income was discussed and it was suggested the Investment Committee explore the feasibility of designing a formula to calculate distributable funds. Such an approach would enable the AFC to include realized capital gains in the calculation of distributable funds. The Investment Committee investigated the potential of utilizing the TRS as a means to increase funds available for disbursement and to also reduce the wide fluctuations in funds available from year-to-year through its averaging basis of the preceding three years, i.e. income smoothing.

From an analysis of comparable charitable organizations in Canada, the Investment Committee determined the typical cash withdrawal rate on similar Canadian investment funds are in the range of 3.5% - 4.5%. In addition to determining the average total rate of return, the AFC also had to consider that most bequests and endowments stipulated the preservation of capital, which meant realized capital gains had to be excluded from the calculation of distributable funds. Moreover Bowen, Burgstahler and Daly (1987) demonstrated that there is an informational content associated with actual cash flow as opposed to accrual based methodologies.

The Investment Committee examined recent court decisions that allowed charities to utilize the TRS in calculating distributable funds. While these cases were brought about by the charities not generating sufficient distributable income to meet the 3.5% disbursement quota required by the Income Tax Act, the Court rulings are still relevant for the AFC. Three of these court decisions are described in the following sections.

Killam Estates ((1999) 185 NSR (2d) 201). The terms of this trust specified an annual distribution of 5% of the market value of the funds. The only way this could be accomplished was to distribute a portion of capital gains. The Court ruled the charity had the inherent scheme-making jurisdiction over the administration of the Trust and thus ruled that a Total Return Strategy that necessitated distribution of capital gains could be implemented, even though this was contrary to the specifications of the Will (Carters, 2014, No. 333, pp. 1 – 4).

Stillman Estate: ((2003, 5 ETR (3d) 260). The provisions of this Will called for a 4.5% disbursement quota from income only. The Court permitted the trustees to distribute capital through a Total Return Strategy even though it violated the terms of the Will. It should be noted that in the Stillman case, the Court used a more conservative cy-près scheme-making rather than the inherent scheme-making. Cy-près allows the court to modify the terms of a charitable trust and create a scheme for a chartable purpose in situations where the original purpose is impossible or impractical to obtain (Carters, 2014, No. 333, pp. 1 – 4.)

Fenton Estate (2014 BCSC39). The trust did not generate sufficient to meet the 3.5% disbursement quota as required by the Income Tax Act. Failure to disburse the minimum 3.5% could result in loss of charitable status. The Fenton case also employed the cy-près scheme-making jurisdiction to permit use of the Total Return Strategy which permitted the distribution of capital gains (Carters, 2014, No. 333, pp. 1 – 4).

Based on these Court cases along with the AFC's auditor's general knowledge of recent practices of other Canadian NFPs application of the TRS, the Investment Committee revised the investment policy to permit the use of this strategy. The Board of Directors voted in favour of the following amendment regarding calculation of disbursable funds:

> The available disbursements from the Funds will be expressed in dollars and the amount will be 3.5% of the average unit market value over three years applied to the number of units held by each fund at the beginning of the fiscal year, less any new contributions of principal during the prior fiscal year.

The Investment Committee decided to adopt a conservative approach with the selection of 3.5% disbursement rate and application of a three-year average of the market value. Both components should mitigate against market fluctuations and provide the trust funds with a more predictable level of annual funding. The application of the new versus old distribution methodologies is illustrated in Table 2 which uses the investment results for the six month period January – June, 2014 to extrapolate for a 12-month period.

TABLE 2
DISTRIBUTABLE INCOME USING TOTAL RETURN STRATEGY
FOR THE 6 MONTHS ENDING JUNE 30, 2014

Capital gains (realized)	$116,046
Capital gains (unrealized)	459,474
Interest and dividends	210,337
Fees	(54,171)
Net income	**$731,687**
Distributable funds based on interest and dividends less fees - 6 months	**156,167**
Distributable funds based on interest and dividends less fees Annualized	**312,333**
Return - old method	**2.23%**
Capital gains (realized)	$116,046
Capital gains (unrealized)	459,474
Interest and dividends	210,337
Fees	(54,171)
Net income	**731,687**
Distributable funds based on Total Return Strategy 3.5%	**436,837**
Return Using Total Return Strategy	**3.50%**
Average Endowment market value for past 3 years	**$12,481,063**

As depicted in Table 2, the TRS is very effective in helping the AFC fulfil its mandate of administering trusts and bequests in a manner that honoured the intentions of the donors. When the TRS is applied to the projected three-year average market value of $12,481,063, the total distributable income increased from $312,333 to $436,837. While this TRS formula increased distributable funds by more than $100,000, it is significantly less that the total investment income of $731,687. The excess funds are, in effect, used to smooth income in years when the actual income is lower than 3.5% of the three-year average.

When many of the bequests were made to the AFC and other charities, donors often specified that the capital be preserved by calculating distributable funds as comprised only of interest and dividends. At the time the wills were completed, the donors may not have considered the possibility their funds would earn relatively low levels of interest and dividends and significantly higher levels of capital gains. Similarly, depending on the date of the will, the 3.5% disbursement quota may not have been reflected in the Income Tax Act at that time.

The situation encountered by the AFC and other charities points to the importance of NFP organizations making donors and their legal advisors aware of the potential negative impact of narrowly defining distributable income. Clearly, the courts have recognized this situation and have supported the concept of a TRS that, although contradicts the Will, does actually enable the trustees to adhere to the true intentions of the donor and also comply with the Income Tax Act as it relates to the 3.5% quota.

This case study also highlights the importance of making charities aware of the option to employ the TRS. It is likely that many small charities are not aware of this alternative. Therefore, more needs to be done to disseminate this information.

CONCLUSIONS

The purpose of this paper was to examine how charities can respond to wide fluctuations in investment income and the inherent impact this has on their ability to administer trust in an efficient and effective manner. The paper provides a case study of the experience of the AFC and how it relied on recent case law to adopt the TRS. The paper adds to the literature on the application of the Total Return Strategy to charities and how this approach can help them achieve their mandate and administer trusts to achieve the donors' intentions and comply with the Income Tax Act.

The case study illustrates the folly associated with a narrow definition of investment income and the inadvertent consequences of having preservation of capital clauses in many wills. This exploratory study is based on one organization. Since this case study was based on one organization, it cannot be generalized to all NFP trusts. However, the study raises an important issue of how changing market conditions can have a detrimental impact on the intentions on donors. A fruitful are of future research would be to examine a large number of Canadian charities to identify the extent to which their disbursements are constrained by a narrow definition of investment income and also to explore whether they have should adopt the Total Return Strategy to alleviate disbursement shortfalls.

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