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# Endowment Spending Policy: *Special Situations*

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**Endowment Spending Policy: Special Situations**

Our previous white paper on *Endowment Fund Spending Policy and Practice* that was published in May 2013 is an excellent guide for the established endowment. However, it has come to our attention that endowments that are experiencing significant growth may have special situations that call for a temporary change to the calculation methods employed.

In this white paper we will demonstrate one calculation method that may be employed in a situation where an endowment has received a significant gift that has increased the size of the endowment all at once (vs. continual endowment growth over time). Our demonstration uses an endowment that had a market value of approximately $1 million over the past three years (the organization employs a 12-quarter average market value to calculate annual appropriations for spending) and the organization has received a $4 million gift during the last quarter of the 12-quarter measurement period. The ramifications of this gift are obviously more significant to a smaller endowment than they would be to a larger one. The $4 million gift increased the size of our example endowment 400% while a $4 million gift to a $100 million endowment would only increase that endowment 4% and that larger endowment may be justified in employing different spending appropriation calculations than the one demonstrated in this white paper.

The remainder of this white paper will refer to the attached Excel Work Sheet at the end of this document.

Column B represents the 12 measurement quarters. Quarter 1 is the most recent quarter and quarter 12 is the quarter from almost 3 years earlier.

In Column C we have the calculation of the appropriation spending for the year prior to the receipt of the $4 million gift. The appropriated spending amount is $44,962 using a spending policy rate of 4.6% applied to the 12-quarter average market values of the endowment fund.

In Column E we have demonstrated one option for calculating the appropriation spending amount for the following year – the year in which the $4 million gift was received during the last measurement quarter of the 12-quarter period – *i.e*. quarter #1. The quarterly endowment market values for quarters 1 – 8 have been carried forward from the previous year and represent quarters 5 – 12 of the current calculation period. The market values for quarters 2, 3 and 4 represent the quarter endowment market values obtained from the current year investment statements. The $2,042,936 market value for quarter #1 represents the actual market value at the end of this quarter but only considering ¼ of the impact of the $4 million gift received during that quarter. (For ease of calculation, we assumed that the $4 million gift had no earnings growth during the quarter. In Column L we will demonstrate another way of addressing this gift.)

While the $4 million gift should impact the appropriated spending amount, since the spending policy is an annual amount (i.e. 4.6% is an annual percentage rate), it would be inappropriate to use a quarter-1 market value of $5,042,936 when $4 million of that balance was received during the last quarter. The 4.6% annual spending rate should not be applied to the $4 million gift until that gift has been in the endowment for a complete year.

Using this methodology, the appropriated spending amount for this year is $50,061. As you can see, the $4 million gift even though it was received during the last quarter of the 12-quarter measurement period has had little impact on the organization's appropriated spending amount. The appropriated spending amount increase only slightly over the $44,962 of the prior year. Because the organization uses the 12-quarter measurement period, it will take 3 years for the $4 million gift to completely impact the endowment spending.

Consider an organization that has no existing endowment. If it were to receive a $4 million gift to start an endowment would it be logical for that organization to average that $4 million over 12-quarters, nine of which would be zero? No; I think that the average person would believe it would be appropriate to use the average endowment over 4 quarters for the first year; use a measurement period of 8 quarters at the end of the second year and 12 quarters at the end of the third year and thereafter.

In Columns G and H we have demonstrated a method whereby the appropriated spending amount from the original endowment continues to be calculated using the 12-quarter measurement period, but the new $4 million gift is used to calculate an appropriated spending amount like that described in the immediately preceding paragraph. In Column H, ¼ of the $4 million gift received in that quarter is used to calculate $46,000 of appropriated spending. This is 4.6% of a $4 million gift that was only available to the organization for ¼ of the measurement period.

Using this stratified calculation method, the organization has calculated an appropriated spending amount of $92,228. This is significantly more than the $50,061 calculated in Column E and more properly reflects the impact of the receipt of a $4 million endowment gift.

One year later the endowment spending appropriation calculation gets a bit more complicated. The $4 million gift has been comingled and invested along with the original $1+ million endowment in order to maximize investment diversification and investment return. (The original endowment and the $4 million new gift should never be kept separate just to facilitate the endowment spending calculation. )

Columns J through M calculate the endowment spending appropriation one year after the $4 million gift has been received. Column J represents the quarterly market values for the 12-quarter measurement period. Quarters 5 - 12 contain the market values carried forward from quarters 1 - 8 of the previous year. Quarters 1 – 4 contain the quarterly market values of the most recent year.

In Columns K and L we have to split the comingled market values in Column J into two components – the original endowment and the portion of the endowment applicable to the $4 million gift. In Lines 26 and 27 we calculated the percentage of the comingled endowment immediately after receiving the $4 million gift. At that time the $4 million gift represented 79.32% of the new, larger endowment and the original gift represented 20.68% to total 100% of the new, larger endowment balance.

Columns K and L (starting at Line 16) represent the separation of the current endowment balance (contained in Column J) into the original endowment (Column K) and the new $4 million gift (Column L). These figures have been calculated using the percentages from Line 27.

Column M is needed because the $4 million gift has to be reduced to its quarterly impact for the first 3 quarters of its existence. You can see this impact in Column M on Lines 16-18.

The 12-quarter average market value of the original endowment is $1,088,641 and the 5-quarter average market value of the $4 million gift is $3,314,486. The annual 4.6% spending policy rate is applied to each of these figures and the total appropriated spending for the organization is $202,544. This is more than double the $92,228 appropriated spending amount of the previous year and the $4 million gift is having a greater impact on the endowment appropriated spending amount.

In Columns O through R we have extended our calculation out one more year. The calculation is the same as we have already demonstrated. The appropriated endowment spending continues to increase significantly over the prior year. It will continue to increase until the $4 million gift is 3 years old, at which time the appropriated endowment spending will only increase based on the earnings of the endowment.

If you have any questions or difficulty implementing an endowment spending policy that has been impacted by your special circumstances, please contact any member of our Not-for-Profit Services Group.

| | A | B | C | D | E | F | G | H | I | J | K | L | M | N | O | P | Q | R |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | **Endowment Spending Policy** | | | | | | | | | | | | | | | | | |
| 2 | **Special Situations** | | | | | | | | | | | | | | | | | |
| 3 | **KLR Example** | | | | | | | | | | | | | | | | | |
| 4 | | | | | | | | | | **Actual** | | | | | **Actual** | | | |
| 5 | | | **Endowment** | | **Optional** | | | | | **Endowment** | **Split the Endowment** | | | | **Endowment** | **Split the Endowment** | | |
| 6 | | | **Market** | | **Calculation** | | **Optional Calculation** | | | **Market** | **Into Two Portions** | | | | **Market** | **Into Two Portions** | | |
| 7 | | **Quarter** | **Value** | | **Method #1** | | **Method #2** | | | **Value** | | | | | **Value** | | | |
| 8 | | | | | | | | | | | | | | | | | | |
| 9 | | 12 | 940,125 | | 966,915 | | 966,915 | | | 994,469 | 994,469 | | | | 1,022,403 | 1,022,403 | | |
| 10 | | 11 | 946,752 | | 973,731 | | 973,731 | | | 1,001,480 | 1,001,480 | | | | 1,029,202 | 1,029,202 | | |
| 11 | | 10 | 953,426 | | 980,595 | | 980,595 | | | 1,008,539 | 1,008,539 | | | | 1,036,046 | 1,036,046 | | |
| 12 | | 9 | 960,147 | | 987,508 | | 987,508 | | | 1,015,649 | 1,015,649 | | | | 5,042,936 | 1,042,936 | 4,000,000 | 1,000,000 |
| 13 | | 8 | 966,915 | | 994,469 | | 994,469 | | | 1,022,403 | 1,022,403 | | | | 5,378,291 | 1,112,291 | 4,266,000 | 2,133,000 |
| 14 | | 7 | 973,731 | | 1,001,480 | | 1,001,480 | | | 1,029,202 | 1,029,202 | | | | 5,735,948 | 1,186,259 | 4,549,689 | 3,412,267 |
| 15 | | 6 | 980,595 | | 1,008,539 | | 1,008,539 | | | 1,036,046 | 1,036,046 | | | | 6,117,388 | 1,265,145 | 4,852,243 | 4,852,243 |
| 16 | | 5 | 987,508 | | 1,015,649 | | 1,015,649 | | | 5,042,936 | 1,042,936 | 4,000,000 | 1,000,000 | | 6,524,194 | 1,349,277 | 5,174,917 | 5,174,917 |
| 17 | | 4 | 994,469 | | 1,022,403 | | 1,022,403 | | | 5,378,291 | 1,112,291 | 4,266,000 | 2,133,000 | | 6,958,053 | 1,439,004 | 5,519,050 | 5,519,050 |
| 18 | | 3 | 1,001,480 | | 1,029,202 | | 1,029,202 | | | 5,735,948 | 1,186,259 | 4,549,689 | 3,412,267 | | 7,420,764 | 1,534,698 | 5,886,066 | 5,886,066 |
| 19 | | 2 | 1,008,539 | | 1,036,046 | | 1,036,046 | | | 6,117,388 | 1,265,145 | 4,852,243 | 4,852,243 | | 7,914,245 | 1,636,755 | 6,277,490 | 6,277,490 |
| 20 | | 1 | 1,015,649 | | 2,042,936 | A | 1,042,936 | 1,000,000 | B | 6,524,194 | 1,349,277 | 5,174,917 | 5,174,917 | | 8,440,542 | 1,745,599 | 6,694,943 | 6,694,943 |
| 21 | | | | | | | | | | | | | | | | | | |
| 22 | 12-Quarter Average | | 977,445 | | 1,088,290 | | 1,004,956 | 1,000,000 | | 2,992,212 | 1,088,641 | | 3,314,486 | | | 1,283,301 | | 4,549,997 |
| 23 | | | | | | | | | | | | | | | | | | |
| 24 | 4.6% Spending Rate | | 44,962 | | 50,061 | | 46,228 | 46,000 | | 137,642 | 50,078 | | 152,466 | | | 59,032 | | 209,300 |
| 25 | 4.6% Spending Rate | | | | | | | 92,228 | | | | | 202,544 | | | | | 268,332 |
| 26 | | | | | | | | | | | 1,042,936 | 4,000,000 | | | | | | |
| 27 | **Notes:** | | | | | | | | | | 20.68% | 79.32% | | | | | | |
| 28 | A | A $4 million donation was received during the quarter. $1 million was added to the quarterly market value. | | | | | | | | | | | | | | | | |
| 29 | B | A $4 million donation received in the last quarter is counted at 1/4 of its value for the first four quarters | | | | | | | | | | | | | | | | |
| 30 | | The total market value of the endowment at the end of this quarter is $5,042,936 | | | | | | | | | | | | | | | | |
| 31 | Column J | This represents the original endowment comingled with the $4 million givt received at the end of the previous year. | | | | | | | | | | | | | | | | |

## ABOUT OUR FIRM

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*Please note that this whitepaper is a general summary of the law and omits many important details, footnotes and caveats. It is no substitute for informed advice from a tax professional based on your particular circumstances.