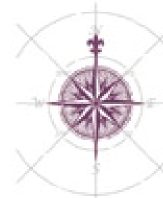

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The Endowment Tax

University donors may be unwittingly giving to more than they intend.

WHEN AMERICANS MAKE large gifts to higher education, as many do each year, they usually have a specific purpose in mind—along with ideas about what they do not want to support. What they don't realize is that if they structure their gift as an endowment, the college, over time, will be able to spend far more of their money on projects and activities unrelated to their goal than on the activity they wish to finance. Think of it as an "endowment tax."

The numbers are huge. In 2006, Americans donated $14.1 billion to colleges and universities. Every day, gifts are announced: $2 million to the University of Arizona to create a professional master's program in the Department of Mining and Geological Engineering; $10 million to endow scholarships at Nashville's Belmont University; $1 million to Claremont Graduate University in California to establish a new fellowship program for female MBA students; $7.7 million to Wayne State University in Detroit to create the A. Paul and Carol C. Schaap Endowed Distinguished Graduate Stipend Fund and to expand and rename the chemistry building. And the list goes on.

What donors often don't realize is that what they want to do with their money and what the college wants may be different. Most college fundraisers play by the rules. But the rules in many respects are stacked against the donor.

Understand: The development office's mandate is to raise as much money as possible with as few restrictions as possible. Fundraisers hit pay dirt when they secure gifts to finance items that the college is going to do anyway or that the administration wants to do but hasn't found funding for.

From the institutions' perspective, the advantages of unrestricted gifts are obvious. But the appeal to donors of unrestricted gifts—especially donors who want their money used to advance a specific educational goal—is far less clear. That's why many donors make restricted gifts.

But even restricted gifts, unknown to most donors, usually provide the recipient institutions with more money for other projects than they do for the programs being financed. Consider what would happen over time to a $1 million endowment gift to establish and maintain the "Fransen Chair in the Study of Israeli Democracy."

> AFTER 75 YEARS, RESTRICTIONS WILL PROBABLY BE FORGOTTEN AND THE MONEY REPURPOSED.

According to a report published in January by Commonfund, a nonprofit investment manager, university endowments during the fiscal year ending June 30, 2007, earned an average return of 16.9 percent. For illustration purposes, however, let's assume my gift earns a more modest annual return of 9 percent. Universities vary in the amount of money they disburse each year from endowment accounts into the endowed program. Typically, the payout is in the 4 to 5 percent range. We'll split the difference and assume a 4.5 percent payout rate.

Now fast-forward 75 years. Let's assume, for argument's sake, that the university faithfully adheres for decades to my wishes (a questionable proposition, judging by the number of donor-intent lawsuits making their way through the courts) and uses the gift only for its intended purpose. After 75 years and innumerable development-office staff changes, whatever restrictions I put on my gift will probably be forgotten and the money repurposed, possibly even to something I might oppose: a course, for example, called "Israel: Bellwether or Bully?"

After 75 years, the endowment fund established with my $1 million gift—even after its annual payouts—would be worth approximately $26 million. Assuming a long-term inflation rate of 3 percent, that $26 million would be worth approximately $2.83 million in today's dollars.

Thus, my $1 million gift for a restricted purpose, after 75 years, will have morphed into an additional $2.83 million (current dollars) bonanza that the college can use however it likes. For every dollar that went to support the designated program, the university will have gained nearly $3 for other things. Put another way, my restricted gift will have been assessed a nearly 75 percent endowment tax.

The alternative to an endowment is a donation that spends down over time. By building an amortization schedule into a gift—so the value decreases each year—donors can make sure their money supports programs they believe in during the entire life of the gift.

Frederic J. Fransen is the executive director of the Center for Excellence in Higher Education, a national organization based in Indianapolis that helps donors improve higher education through philanthropy.

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