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CHARITY LAW BULLETIN NO. 333

FEBRUARY 27, 2014

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BC SUPREME COURT AUTHORIZES TOTAL RETURN INVESTMENT STRATEGY

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A. INTRODUCTION

On January 13, 2014, the British Columbia Supreme Court in the *Fenton Estate* decision (2014 BCSC 39) considered an application to authorize a "total return investment strategy" (i.e. to allow capital gains to be distributed as a supplement to income) in order to meet the 3.5% disbursement quota of a charity under the *Income Tax Act*. This Charity Law Bulletin provides a brief overview of the decision and in particular the Court's reasoning concerning why the implementation of a total return investment strategy was justified in order to allow the trustee to encroach on a portion of the capital gains of the charitable trust even though to do so was not permitted under the terms of the will creating the trust.

B. THE FENTON ESTATE CASE

In his will, the deceased Anthony Michael Jewell Fenton directed his executor to establish a private charitable trust, the Tony and Mignon Fenton Trust (the "Trust"), which was to hold the gifted capital in trust in perpetuity. Any net annual income derived from the Trust was to be distributed to organizations or individuals that supported infirm elderly in need of home care in Oak Bay, British Columbia. Further, the will directed the trustee to reinvest a portion of the Trust's income to protect the capital from inflation. However, the will restricted the trustee to distributing only net annual income (i.e. "interest, dividends,

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rents, royalties and the like"), and as such, the Trust was precluded from encroaching on and distributing any capital.

The problem surrounding the Trust arose because the disbursement quota for registered charities under the *Income Tax Act* requires that a charity disburse 3.5% of the average fair market value of its investment property in the preceding 24-month period. Failure to disburse this minimum amount could result in loss of charitable status. This became an issue for the Trust, as historically low rates of returns on investments did not allow the Trust to generate sufficient annual income to meet the 3.5% disbursement quota, let alone be able to reinvest a portion of income to protect the capital from inflation as directed by the terms of the will. The will prevented the trustee from encroaching on capital because the capital of the Trust was required to be held in trust "in perpetuity". Concerning what constituted the capital of the Trust, the Court was clear that capital gains were considered to be part of the original capital, not income:

> "I view a gain on, or appreciation of, capital to become part of capital by definition, as opposed to an addition to capital from interest or income earned on it. For the purposes of this petition, I consider a power to distribute some part of capital gains as an encroachment on capital..."

The trustee consequently applied to the British Columbia Supreme Court for relief by requesting that the Court authorize a total return investment strategy.

C. THE TOTAL RETURN INVESTMENT STRATEGY

In general, a total return investment strategy provides an approach for the administration of a charitable trust that permits the trustee to seek the best returns of income and capital gains without making any distinction between them. In this case, the use of a total return investment strategy would provide a degree of flexibility that would allow the trustee to encroach on capital gains in any year that it is necessary, notwithstanding that to do so was prohibited under the will, by adding capital gains to income in order to meet the 3.5% disbursement quota and thereby avoid jeopardizing the Trust's charitable status.

In considering whether to authorize a total return investment strategy in this case, the Court considered its use in previous cases. Specifically, it examined the application of a total return investment strategy in two similar cases, *Re Killam Estate* ((1999), 185 NSR (2d) 201) and *Re Stillman Estate* ((2003), 5 ETR (3d) 260).

Re Killam Estate concerned a will that set up charitable trusts aimed at the betterment of higher education. The will restricted income to being spent only to further those objects. To protect the trust from the effects of inflation, the trustees sought judicial approval of a total return investment strategy to allow them to distribute portions of realized capital gains to meet the annual distribution goal of 5% of the market value of the funds. The Court stated that it had the inherent scheme-making jurisdiction over administration of the trust to implement a total return investment strategy and thereby permit the trustees to distribute capital gains despite this being "contrary to the expressed, unequivocal direction" expressed in the will.

The facts in *Re Stillman Estate* were similar to those in *Fenton Estate*. In *Re Stillman Estate*, the trustees were directed under the will to distribute income to charitable beneficiaries in perpetuity, but had no power to encroach on capital. The trust was unable to meet the disbursement quota (at that time 4.5%) from income alone. The trustees consequently sought judicial authorization to utilize a total return investment strategy. The Court permitted the trustees to distribute capital gains through a total return investment strategy despite the will containing directions to the contrary. However, in *Re Stillman Estate*, the Court did not do so pursuant to the Court's inherent scheme-making jurisdiction of the court over administrative matters, but instead relied upon the Court's narrower and more conservative *cy près* scheme-making jurisdiction. *Cy près* jurisdiction allows the court to vary the terms of a charitable trust and create a scheme for a charitable purpose trust where its purpose has become impossible or impracticable to attain.

D. CONCLUSION

In the *Fenton Estate* decision, the Court followed the more conservative decision in *Re Stillman Estate*, granting an order permitting the use of the total return investment strategy based upon the Court's *cy près* scheme-making jurisdiction in order to allow the trustee to add a portion of realized capital gains to income as necessary to meet the 3.5% disbursement quota. Whether the authority to establish a total return investment strategy is based upon the inherent scheme-making jurisdiction of the court over administration or upon the court's more limited *cy près* jurisdiction is less important than the willingness of the court to grant an order permitting a total return investment strategy that permits encroachment on capital gains

where necessary in order to meet the disbursement quota of a charity. As such, this case will no doubt serve as a useful precedent for other charities facing similar situations.