
**INSTITUTE OF ADVANCED FINANCIAL PLANNERS
IAFP SYMPOSIUM 2009**

“Sharing responsibility for what we cannot control”

London – October 1, 2009

**Effectively Structuring
Endowment Agreements**

By Terrance S. Carter, B.A., LL.B., Trade-mark Agent

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OVERVIEW

- What Is an Endowment?
- What Are the Advantages of an Endowment?
- What Are the Trust Considerations Involving an Endowment?
- What Are the Tax Considerations Involving an Endowment?
- What Are the Options When the 3.5% DQ Cannot Be Met?
- What to Consider in Structuring a Donor Endowment Agreement
- What to Consider in Structuring a Board Endowment Fund

2

- How Should Endowments Be Managed Once Received?
- Preventive Steps to Avoid the Need for Court Direction
- Strategies to Protect Endowments

Note: For background information,

(1) “Donor Restricted Charitable Gifts Revisited: A Practical Overview II” at <http://www.carters.ca/pub/article/charity/2006/tsc0421.pdf>

(2) Charity Law Bulletin #161 entitled “Managing Endowments During Difficult Financial Times” available at <http://www.carters.ca/pub/bulletin/charity/2009/chylb161.pdf>

3

1. WHAT IS AN ENDOWMENT?

- In its simplest form, an endowment is a restricted long term gift to a charity to be invested and used for the its charitable purpose
- Some endowments are directed to be held in perpetuity, while others are directed to be held for a fixed number of years (normally 10 years or more)
- An endowment is either directed to be used for a particular purpose, such as a scholarship, or otherwise used for the general charitable purposes of the charity

4

- Endowments can be subject to a right of encroachment on capital if the donor has built that right into the endowment agreement (subject to tax considerations discussed below)
- The income (e.g. the interest, dividends or realized capital gains) can either be expended in total each year or can be reinvested in part
- The disbursement of income and capital from the endowment by the charity can be left to the discretion of the charity or can be subject to donor advice, e.g. a donor advised fund

5

- An endowment can be created by:
 - An *inter vivos* 10 year gift under the *Income Tax Act* (“ITA”); or
 - A testamentary gift in the form of a bequest or inheritance
- Both 10 year gifts and testamentary gifts are types of enduring property under the ITA to which the 80% DQ does not apply (explained below)
- An endowment can be created by a donor establishing an endowment agreement (donor endowment agreement) or by the board creating an endowment fund (board endowment fund)

6

2. WHAT ARE THE ADVANTAGES OF AN ENDOWMENT?

- An endowment permits the creation of a capital fund on a long term or perpetual basis in order to fund either specific projects or the general operations of a charity
- An endowment provides for long term stability by creating a balance against possible fluctuations in the results of yearly fundraising
- An endowment allows donors to create a fund in the name of the donor or their families in order to have a long term impact on charitable programs

7

- An endowment facilitates the donor acquiring naming rights for a particular project or have naming rights placed on a building for a specific period of time
- An endowment permits the creation of both large segregated endowed funds that are initiated by the donor, as well as smaller contributions to existing board endowment funds that are established by the charity
- If an endowment is operated through a parallel foundation, then the endowment can be protected from creditors of the operating charity (discussed further below)

8

3. WHAT ARE THE TRUST CONSIDERATIONS INVOLVING AN ENDOWMENT?

- An endowment in essence is an explicit or implicit charitable trust for a restricted purpose
 - A restriction to hold monies or property for a specific period of time (or in perpetuity)
 - As well as possibly a restriction to hold monies or property for a specific application (i.e., a scholarship)
- Failure to comply with the terms of an endowment as a charitable trust will result in the board of directors being found in breach of trust and exposed to personal liability

9

- The donor cannot vary the terms of the charitable trust after the endowment has been created, although the donor can retain input through a donor advised provision in the endowment agreement
- The charity has no authority to vary the terms of a charitable trust on its own unless:
 - The document creating the endowment permits the charity to modify the terms of the charitable trust; or
 - The charity applies for a variation of the trust from the court, possibly using section 13.1 of the *Charities Accounting Act* for a simplified procedure

10

- 4. WHAT ARE THE TAX CONSIDERATIONS INVOLVING AN ENDOWMENT?**
- Disbursement Quota (“DQ”)
 - Charitable organizations and foundations (both public and private) must spend each year on its own charitable activities or grants to qualified donees, the sum of:
 - 80% of previous years’ received donations and transfers received from other registered charities, plus
 - 3.5% of investment assets in excess of \$25,000

11

- Enduring Property
 - Enduring property (as explained below) is excluded from the DQ in the year that such property is received and included in the year the funds are spent
 - Enduring property includes
 - An *inter vivos* gift by a donor to a charity that is subject to a trust or direction that the property given or the property substituted for the gift is to be held by the charity or another charity for at least 10 years
 - Bequests or inheritances
 - Life insurance proceeds

12

- RRSP/RRIF funds
- Inter-charity 5 year gifts to charitable organizations
- Transfers of 10 year gifts and bequests or inheritances from another charity
- Therefore 10 year gifts and bequests or inheritances, as forms of enduring property, will be exempt from the 80% DQ
- What are requirements for an endowment to be a 10 year gift?
 - In order for an *inter vivos* endowment to constitute a 10 year gift, the gift creating the endowment must meet the statutory requirements prescribed in the ITA for 10 year gifts

13

- A 10 year gift must be subject to a trust or a direction that the property (or property substituted for the gift) be held for at least 10 years
- The document required to evidence a 10 year gift must
 - be executed by the donor for each gift that is made
 - clearly identify the donee charity, including its official name and registration number

14

- indicate the amount of the gift
- set out the date the gift is made
- set out the name and address of the donor
- set out the serial number of the official receipt issued to the donor for the gift
- The information must be attached to charity's duplicate copy of receipt
- Each 10 year gift must be separately tracked

15

5. WHAT ARE THE OPTIONS WHEN THE 3.5% DQ CANNOT BE MET?

A. Avoid the Restriction of a 10 Year Gift

- Check to see if the 10 year time restriction of a 10 year gift has expired
 - This reflects the importance of separately tracking each 10 year gift
 - Read the terms of the endowment agreement to see when the 10 year time restriction expires
 - If the 10 years (or whatever time restriction imposed by the donor) has expired, then the capital of the 10 year gift can be expended

16

- See if the endowment consists of other types of enduring property
 - Other types of enduring property that do not have a 10 year restriction but still avoid the 80% DQ on enduring property include:
 - Bequests or inheritance
 - Life insurance proceeds
 - RRSPs
 - RRIFs
 - Inter-charity 5 year gifts
 - If the endowment is enduring property but is not a 10 year gift, then it is not subject to a 10 year minimum hold period and the capital can be expended

17

B. Carry DQ Surplus Forward or Back

- Carry any DQ surplus forward or back in the event of a current year DQ shortfall
 - A DQ surplus can be carried forward 5 years or back 1 year
 - If there is a current DQ shortfall, then if there is a DQ surplus accumulated from the previous 5 year, use the earlier DQ surplus to offset DQ shortfall in the current year
 - If it is anticipated that there will be a DQ surplus in the following year, the anticipated DQ surplus next year can be brought back to offset the current year's DQ surplus

18

C. Encroach on the Capital of a 10 Year Gift to Meet the 3.5% DQ

- If the endowment agreement so provides in writing, the charity can encroach on the capital of a 10 year gift up to the 3.5% DQ of a charity even if it has a DQ surplus
- The charity will need to add 80% of the encroachment of capital onto the DQ of the charity, meaning that the charity will end up with a larger DQ deficit

19

- However, the charity can avoid or reduce an 80% DQ inclusion when encroaching on capital, provided that the charity has tracked and applied its “capital gains pool” and such encroachment on capital does not exceed either the 3.5% DQ for the charity or the amount tracked in its capital gains pool
- The capital gains pool is a notional account used to track realized capital gains from all forms of enduring property, not just 10 year gifts, i.e. bequests or inheritances, RRSP, RRIF, life insurance proceeds and inter-charity 5 year gifts

20

- It is therefore advisable for a charity to keep track of its capital gains pool account in completing its annual T3010B
- If the endowment agreement permits a charity to encroach upon a 10 year gift beyond the 3.5% DQ, then the gift in question would not qualify as a 10 year gift, which would mean that 80% of the total gift would need to be added onto the 80% DQ at the time of the gift

21

D. Seek Relief From CRA

- If there is still a DQ deficit after the charity has exhausted all of the above options, the charity may seek relief from DQ requirements in the current year under sub-section 149.1(5) of the ITA
 - A charity can only seek relief at the end of the current taxation year after the current year T3010 has been filed
 - The charity must use all disbursement excesses from previous years before relief will be granted
 - The charity must demonstrate that it is incapable of making up any part of the disbursement shortfall in the following tax year

22

- The charity must be unable to meet the DQ due to unforeseen circumstances that are beyond the charity's control
- Accordingly, all of the charity's information returns must be filed before any requests are considered, and relief will not be granted in advance or anticipation of a shortfall
- CRA will look to see if the charity may have unrestricted funds that it can draw on to meet its DQ
- Need to complete form T2094
- See CRA Policy Commentary CPC-029 for more detail at

<http://www.cra-arc.gc.ca/tx/chrts/plev/cpc/cpc-029-eng.html>

23

6. WHAT TO CONSIDER IN STRUCTURING A DONOR ENDOWMENT AGREEMENT

- Is there to be a minimum amount required to establish a donor endowment agreement?
- Is the fund created by a donor endowment agreement to consist of monies or gifts in kind, e.g. shares?
 - e.g. If it is a gift of shares, then the charity needs to ensure that there is a proper evaluation of the shares done in advance of the gift
 - Gifts of publicly traded shares will be exempt from capital gains tax but not gifts of private shares

24

- Do the proposed anti-tax shelter provisions apply pertaining to the valuation of the gift?
 - e.g. Possible reduction of FMV of the gift in kind (subject to exemptions) to the ACB of the gift if it was acquired within 3 years or within 10 years if it was reasonable to conclude that the donor had an intent to make a gift
 - e.g. Will the proposed expanded definition of “advantage” under the split receipting rules limit the eligible amount of the gift for receipting purposes?

- Is the capital of the fund to be held in perpetuity or alternatively for a period of at least 10 years in order to establish the basis for a 10 year gift?
- During the first 10 years, is the charity to have the ability to encroach on capital in order to meet the charity’s 3.5% DQ?
- If the fund is to be held for at least 10 years, but not in perpetuity:
 - When can the capital be expended after 10 years?
 - What is the capital to be used for at that time? e.g. Are there any restrictions concerning usage of the capital that is to apply?

- For a fund that is to be held in perpetuity, is the charity to be able to encroach on the capital after 10 years and if so, under what circumstances?
 - e.g. Meeting the yearly 3.5% DQ shortfall, and/or
 - e.g. In the event of extenuating circumstances encountered by the charity in the discretion of the board

- Are further contributions of capital to the fund permitted, and if so, are there any limitations to be imposed on the further contributions?
 - e.g. Are there limitations on who can make further contributions?
 - e.g. Are there time or quantum limitations on further contributions?
 - It will be necessary to track further contributions as new 10 gifts for income tax purposes

- What is the purpose of the fund, e.g. is there to be a restriction in relation to the use of the income and/or capital or can the income and/or capital be used for the general charitable purpose of the charity?
- Is the application of the income/capital to be structured as a “donor advised fund” and if so, is it clear that the board of the charity must ultimately exercise its discretion over the expenditure of the income and/or capital as opposed to that of the donor?

- Is the investment policy of the charity to be incorporated by reference into the endowment agreement or is the donor allowed to impose specific investment terms of reference on the gift?
 - Does the prudent investor standard from the *Trustees Act* apply?
 - Does the charity have an investment policy?
 - Does the charity have an agency agreement to delegate investment decision making to an investment manager?
 - Is the donor able to impose restrictions on the type of investment and what happens if the restrictions no longer are prudent in the circumstances?

- Is the charity able to charge a reasonable administrative charge against income of the endowment fund and/or capital?
- Are the details of an administrative charge contained in the endowment agreement or is it to be cross-referenced to the gift policy of the charity?
- Does the charity have a disbursement policy to determine how much income is to be paid out each year from the endowed fund and how much is to be reinvested and under what circumstances there can be an encroachment on capitalized income and capital?

31

- Does the endowment agreement permit a transfer of the endowed fund and change of trustee to another charity, such as a parallel foundation?
- Does the endowment agreement include a *cy prés* type of clause to permit the charity to change the purpose of the gift in the event that the original purpose becomes impossible or impractical?
- Does the endowment agreement include provisions to protect the endowment by requiring it to be transferred to another charity in the event of a pending insolvency, bankruptcy or winding up of the charity?

32

- Does the endowment agreement permit amendments to the administrative terms of the agreement?
- Does the endowment agreement address due diligence concerns under anti-terrorism legislation?
 - e.g. Has the charity conducted appropriate due diligence enquiries of the donor?
 - e.g. Has the charity retained a discretion not to apply the endowed fund to the restricted purpose in the event of anti-terrorism concerns?

33

- Is the donor to be given naming rights? If so:
 - How long do the naming rights extend for?
 - Has the charity retained the right to terminate the naming rights of a donor and under what circumstance?
 - Do the naming rights constitute an “advantage” under the ITA?
- Does the charity wish to reserve the right to refuse or even return a gift and if so under what circumstances?
 - e.g. Criminal conviction?
 - e.g. Immoral conduct?
 - e.g. Concerns about terrorist activities?

34

- If a gift is to be returned, what are the tax implications to both the charity and the donor?
 - A gift over to another charity would be a better option than simply returning the gift to the donor
- Has the donor been advised to seek independent legal and/or tax advice?
- Has the charity ensured that there is no evidence of undue influence involved in the donor making the endowment?
- Has the board of a charity authorized the signing of the endowment agreement and who has signing authority on behalf of the charity?

35

- 7. WHAT TO CONSIDER IN STRUCTURING A BOARD ENDOWMENT FUND**
- When creating the terms of a board endowment fund, the board of the charity should adopt a board resolution to authorize the same
 - There should be a board resolution to authorize each separate board endowment fund
 - The substantive terms of a board endowment should generally be similar to the terms of a donor endowment agreement as described above

36

- **Examples of board endowed funds could include:**
 - A perpetual endowment fund
 - A building fund
 - A debt reduction fund
 - A specific project fund
 - A scholarship fund

37

- **Have the terms of the board endowment fund been adequately communicated to the donor in writing or is it available on the charity's website?**
- **There should be some form of an endowment fund contribution agreement in order that the donor can evidence in writing that the gift meets the requirements of a 10 year gift under the *Income Tax Act*?**

38

8. HOW SHOULD ENDOWMENTS BE MANAGED ONCE RECEIVED?

- **Identify the nature of the endowed gift to determine if it is actually an enforceable donor restricted gift or a "precatory trust" that is not enforceable**
- **Review and approve donor restrictions before receiving the gift, as there is no obligation to accept a gift**
- **Need to track every 10 year gift separately, as well as all the contributions to a 10 year gift**

39

- **Effective ongoing management of endowed gift includes**
 - Depositing the endowed gift into the bank account of the named charity
 - Invest the endowed fund in accordance with applicable investment powers
 - Do not borrow against the endowed gift
 - Commingle endowed gifts only in accordance with the regulations in the *Charities Accounting Act* (Ontario) and not with any general funds of the charity
 - Always comply with the terms of the applicable restrictions

- 9. PREVENTATIVE STEPS TO AVOID THE NEED FOR COURT DIRECTION**
- Public fundraising appeals should state that any surplus funds resulting from a campaign for endowed funds will be used for the general charitable purposes of the charity
 - Ensure that an endowed gift includes a *cy prés* clause that will allow the charity to vary the purpose of the gift if the original purpose becomes impossible or impractical
 - Recommended that documentation creating endowed gift include the words “in trust” in accordance with recent case law

- 10. STRATEGIES TO PROTECT ENDOWMENTS**
- Increased exposure to claims arising from the *Christian Brothers* decisions
 - Background of *Christian Brother* decisions
 - Endowed gifts will now be at risk to creditors of the charity
 - Claims against operating charities that hold large endowed funds may increase
 - The ability of donors to create enforceable restricted gifts may be in question if not properly structured
 - Donors may become more reluctant to give large gifts directly to an operating charity if preventative steps are not taken

- Considerations in developing a strategy in response
 - Possibly establish and/or utilize an arms-length parallel foundation to receive endowed gifts
 - Possibly utilize a community foundation or trust company to receive endowed gifts
 - Possibly structure a gift as a determinable gift with a gift over to another charity in the event of an actual or pending insolvency or bankruptcy of the charity

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