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## **MANAGING ENDOWMENTS DURING DIFFICULT FINANCIAL TIMES**

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### **A. INTRODUCTION**

Many charities, and in particular foundations, that have established endowment funds are currently concerned about the impact caused by the recent downturn of the economy with regards to their reduced ability to meet their disbursement quota requirements under the *Income Tax Act* (Canada) (the “Act”). This *Charity Law Bulletin* provides some general thoughts with regards to what can be done when a charity has insufficient income from an endowment fund to meet its disbursement quota under the Act.

### **B. WHAT IS AN ENDOWMENT FUND?**

In order to effectively address this issue, it is first important to understand what is meant by an endowment fund and what are some of the basic tax rules under the Act that apply to them.

At its very simplest, an endowment is a long term gift to a charity, normally to be held for at least ten years, that is either set aside for a particular purpose, such as a scholarship, or for the general charitable purposes of the charity. Some endowments are directed to be held in perpetuity, while others are to be held for a fixed number of years. Endowments could be subject to a possible right of encroachment on the capital during the endowment period if the donor has built that right within the wording of the endowment agreement. Once the endowment period has expired (except where the donor directs that the endowment be held in perpetuity) the entire endowment can be disbursed by the charity.

An endowment must meet the requirements of a “ten year gift” under the Act. A ten year gift is a gift established in writing by a donor pursuant to a trust or direction whereby the capital is to be held for a period of at least ten years. As such, the capital of an endowment must be held for the term of the endowment designated by the donor, which could be as short as ten years, or as long as in perpetuity.

Furthermore, a ten year gift is a type of “enduring property” defined under the Act. An enduring property is exempt from the 80% disbursement quota (which requires that 80% of a charity’s received gifts in a fiscal year be expended on charitable programs of the charity in the following fiscal year). However, the endowment is still subject to a 3.5% disbursement quota, which generally requires that 3.5% of the endowment fund be expended on charitable programs in each fiscal year. In good financial times, a charity will normally be able to meet its 3.5% disbursement quota out of the investment income earned on the endowment funds. Where the income earned is insufficient, it is possible to encroach upon the capital of the endowment fund in order to meet the 3.5% disbursement quota of the charity, provided that the terms of the endowment agreement permit such encroachment. Such an encroachment would require the charity to add a corresponding amount to the calculation of its 80% disbursement quota. This could result in the charity continuing to be in a disbursement quota shortfall if it has not kept track of its realized capital gains by utilizing a notional pool referred to under the Act as a “capital gains pool.”

### **C. WHAT TO DO WITH ENDOWMENTS DURING A FALLING MARKET**

When the market is rising, charities that have endowments normally will have little difficulty in meeting their 3.5% disbursement quota. However, in a falling market, a charity may experience difficulty in doing so, either because there is not sufficient income being earned or, alternatively, there was insufficient realized capital gains in the past to build up the capital gains pool that otherwise could be utilized to off-set the 80% disbursement quota that resulted from an encroachment of an endowment.

Where a charity is facing difficulty in meeting its 3.5% disbursement quota, the question arises concerning what the charity can do. To answer this question, it is important to review the endowment fund agreements of a charity, as well as the applicable sections of the Act, as follows.

1. The first thing to do is to carefully read the endowment agreement in question. Where the endowment is not required to be held in perpetuity, it may be that the period of time that the original capital of the

endowment was to be held has expired. In this situation, even though the endowment may continue to be recorded in the financial statements of the charity as an endowment (with the assumption that the capital cannot be encroached upon), the reality is that the capital could in fact be disbursed, including being utilized to meet the 3.5% disbursement quota.

2. Some endowments are created by testamentary gifts through wills. Where an endowment has been created by a will, there is no requirement that the gift must be held for a period of at least ten years. However, any restrictions contained in the will concerning how long the gift is to be held for must be complied with. As such it is essential to review the terms of the will to see where it specifies a length of time that the endowment has to be held. In situations where there is no clear statement in the will concerning how long the endowment is to be held and the only terminology used in the will is “endowment,” then legal advice should be sought to determine whether the testator had intended to establish a perpetual endowment. If so, any encroachment upon the capital will require court authorization.
3. A third option would be to determine if there is a balance in the capital gains pool arising from previous realized capital gains referred to above that could be utilized to meet the 3.5% disbursement quota.
4. Finally, if none of the options referred to above are available, then the Act does permit the Charities Directorate of the Canada Revenue Agency to grant a reduction in the disbursement quota for a particular fiscal year if an application is made in writing.

What is also important to keep in mind is that meeting the 3.5% disbursement quota with regards to an endowment is not simply a matter of compliance with the provisions of the Act. It is also necessary to review the terms of the endowment agreement to ensure that any encroachment upon the capital of the endowment does not constitute a breach of trust with regards to terms of reference imposed by the donor at the time of the establishment of the endowment. As such, it is important to seek legal advice before proceeding with options 1 and 2 referred to above in order to avoid the possibility of breach of trust occurring.

#### D. CONCLUDING COMMENTS

Difficult financial times have created unique challenges concerning the management of endowment funds for charities in Canada. Although the statutory requirements under the Act remain the same in bad and good financial times, charities do have options available to them in order to meet their disbursement quota requirements when facing difficult financial times.