

# Managing Endowments in Difficult Economic Times

17th Annual CAGP Conference  
May 12-14, 2010

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## Introduction

- The current economic downturn has resulted in lower returns from investments and sharp decline in value of capital.
- For charities this means that charitable programmes they have been funding are at risk.
- Charities are turning to their endowment funds to determine
  - whether and to what extent they can encroach on capital to fund commitments and to meet disbursement quota obligations.
  - whether they can or should change their investment strategy.

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## Introduction (Cont'd)

- The answer to these questions requires a review of the regulatory framework pertaining to endowment funds and restricted funds.
- The rules derive from the Federal Income Tax Act (Canada) and Provincially from the common law relating to trusts and statutes such as the Trustee Act, The Charitable Gifts Act and the Charities Accounting Act.

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## Income Tax Act

- Federal Budget 2010 – DQ Changes

### Pre Budget DQ Rules

- All registered charities required to expend on own charitable activities or on distribution to qualified donees an amount equal to:
  - 80% of donations received in previous year
  - 80% of gifts from other registered charities (100% for private foundations)
  - 3.5% of value of property not used in charitable activities of administration (for amounts over \$25,000)
- Failure to meet DQ is grounds for revocation

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## Pre-Budget Rules (Cont'd)

- Exceptions to 80% charitable expenditure rule
  - Enduring property
    - Endowments subject to 10 year hold
    - Bequests
    - Proceeds of life insurance
    - RRSP's, RRIF's and TFSA's
  - Specified gifts – certain inter charity transfers
  - Capital Gains Pool

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## Capital Gains Pool

- A charity is permitted to reduce its DQ for amounts encroached up to 3.5% of investment assets if it has a capital gains pool
- Capital gains pool is a notional account. It is the total of all capital gains realized from the disposition of enduring property since March 22, 2004 less enduring property gifted and prior permitted encroachments
- Capital gains pool can record capital gains not just relating to capital gains realized on 10 year gifts but on capital gains realized on all enduring property

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### Problems with Pre-Budget DQ

- Hard to characterize expenses
  - Administration
  - Charitable activities
  - Fundraising
- Complicated and hard to understand enduring property rules, capital gains pool concept
- 80% - 3.5% spending – 10 year hold
  - Arbitrary expenditure requirements
  - Not sensitive to the operational needs of charities
  - Not effective in preventing and addressing abusive practices
  - Not sensitive to prevailing market conditions

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### Problems with Pre-Budget DQ (Cont'd)

- Administrative Costs
  - Rigid
  - Confusion as to whether encroachments to cover administration and investment management fees out of capital of enduring property tainted the enduring property
  - Did not recognize charities are different

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### Federal Budget 2010 DQ Changes

- 80% charitable expenditure requirement
  - Repealed
- 3.5% disbursement requirement
  - Remains – for amounts in excess of \$100,000
- Concepts of enduring property, specified gift and capital gains pool
  - Eliminated

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## DQ Changes (Cont'd)

- Anti Avoidance Provision
  - For non-arms-length inter-charity gifts –recipient charity must expend 100% of the gift in the year or in the following year
  - Possible penalty of 110% of amount of gift not expended and/or possible revocation
  - Can be avoided if make designated gift and not count toward satisfying DQ requirements of donor charity.
  - If charity engages in transaction a purpose of which is to delay unduly or avoid application of DQ – possible revocation
  - Fundraising Guidance – proposal to use as regulatory tool

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## Implications

- Easing of administrative burden of compliance with 80% DQ requirement
- Lessens need for restrictive endowment conditions to meet enduring property definition
- Fundraising Guidance – uncertainty
- Existing endowments
  - No tax consequences for breach?
  - Still draft legislation
  - No CRA policy yet
- Future Endowments

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## Does The Federal Budget Solve All Existing Issues

- Notwithstanding the significant changes brought about by the Federal Budget, in addressing challenges of difficult economic times, reduced portfolio values, lower returns, charities must still deal with existing endowments.
- It will still be necessary to consider to what extent the charity will be able to access capital of an endowment fund and address other restrictions.
- This will require a continued review of the regulatory framework (other than the Income Tax Act) and relevant documents.

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## Endowments

- Can be created by a donor either during lifetime (usually evidenced by a donor agreement setting out the terms of the gift) or on death (documented in a will)
- Can be internally created by the Board of a charity
- Involves the setting aside of capital (either cash or assets that are converted into cash and reinvested) either in perpetuity or for a term of years which capital is invested to earn income
- Income can be expended on charitable programmes or can be accumulated (subject to applicable provincial statutes)
- Generally the terms of the endowment do not allow for expenditure of the capital either for a term of years or in perpetuity

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## Restricted Funds

- Endowments are a form of restricted funds
- Terms of restricted funds can require expenditure of the income and capital over a period of time
- Constraints can relate to restrictions on use or restriction as to a specific purpose (scholarship/research in a particular dept for example; real estate to be held for a particular use)
- Written agreement not needed for a court to determine whether donor intended restricted charitable gift. Will consider other written or oral evidence to determine intent such as correspondence, memo of discussions, fundraising material of charity

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## Unrestricted Gifts

- Gift at law to be applied towards the general charitable purposes of a charity. Not subject to any restrictions by the donor.
- Board may apply towards certain of its charitable objectives and also redirect the use.

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### Precatory Gifts/Donor Advised Funds

- Non binding requests by donor. No enforceable restrictions although moral obligation on charity receiving the gift to consider the expressed preference, desire, request of donor.
- Donor Advised Fund is a form of precatory gift.
- Too much control retained by donor may cause donation to not qualify as a gift thereby disqualifying it for charitable receipt under ITA.

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### Meaning of Income and Capital

- Many endowment agreements provide for distribution of income but no right to encroach on the capital.
- Generally no right to vary the agreement retained by the donor.
- Even if capital not to be retained in perpetuity, because of the ITA rules prior to the 2010 Federal Budget many gifts structured as gifts given subject to trust or direction that capital or property substituted therefore be retained for at least 10 years. This removed the gift from the requirement that 80% of the receipted gift had to be expended in the subsequent year.

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### Meaning of Income and Capital

- It is therefore important to understand these terms in considering existing endowment agreements.
- Income and capital are colloquially regarded as mutually exclusive terms.
- The former denotes earnings, revenues or returns.
- The latter refers to the assets or property that is employed or invested to generate such returns.
- Analogy frequently employed is that of tree and the fruit borne by it.

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## Meaning of Income and Capital

- Consistent with this view, capital gains presumptively regarded as distinct from income; even where accretions of capital are realized they retain their character as capital and are not treated as equivalent to interest income, dividend income, rents etc.
- It should be noted that depending on the context, capital gains may attract certain income like consequences such as being subject to tax. This is an example where trust law and tax laws may diverge.

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## Encroachment On Capital

- Starting point for charities under existing DQ regime : If the income is insufficient is encroachment permitted to meet the DQ or for programming needs?
- Under pre 2010 Budget could only encroach on 10 year gifts if donor agreement permitted and to the extent of capital gains pool.
- Much confusion over capital gains pool, how to count for administrative expenses etc led to CRA Views April 22, 2009 series of questions and answers. Many charities likely offside and still confusion.
- While the 2010 Budget has eliminated the confusion the question of what constitutes income and capital is still relevant in determining what a charity can expend both to meet the new DQ and to meet programming needs in these hard economic times.

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## Encroachment on Capital

- Must review:
  - A. Documents
  - B. Regulatory context:
    - Federal:
      - Income Tax Act (Canada)
    - Provincial:
      - Jurisdiction over Charitable property and common law
    - Trust law

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## Documents

- Donor agreements/directions
- Constatng Documents –Letters Patent/Special Act/By laws
- Internal policies of charity relating to spending, distribution of funds, investment policies
- External publications used for fundraising or reporting or other communications

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## Issues/Questions

- Must review terms of Gifts
- What restrictions –
  - On investment?
  - On expenditure of income? capital?
  - For what purpose?
  - When?
- Who imposed the restrictions-
  - Donor?
  - Board of charity?
- If can expend income but not capital
  - What does income mean?
  - What does capital mean?

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## Caveat

- Not all "enduring property" has restrictions on distribution of capital. For example direct designations of RRSP, RRIF, Life Insurance proceeds, certain gifts by will
- Charities need to review sources and terms if any of such gifts

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### Relevant Considerations for Existing Endowments

- Do terms of the gift permit encroachment on capital?
- Is capital to be held for a term of years or in perpetuity?
- Are 10 year gift restrictions still relevant?
- Are restrictions internal or external?
- Common law/trust law issues
- Donor relations/public reputation

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### Endowments

- If holding period or other restriction is set by donor at time of gift: trust law considerations
- If holding period or other restriction set by the Board: may be able to be changed by the board

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### Investment Decision Making During Difficult Financial Times

- Recession has resulted in significant losses in investment portfolios
- This has caused Boards to review their investment strategies and consider how best to invest in volatile market
- As with the review of whether a charity can encroach on capital of an endowment, this review has also led some charities to the realization that their investment powers are somehow restricted and to consider whether and to what extent they can be varied.

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## Restrictions On Investment Powers

- Statutory
- In Ontario Charities Accounting Act provides that charitable corporations are deemed to be trustees of their charitable property and that they must comply with the investment decision making requirements of the Trustee Act
- Trustee Act will not apply where Letters Patent or Special Act or Trust Agreement establishing a charity state that it will not apply or the terms of a will or gift agreement provide for a different investment power

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## Trustee Act

- Where the Trustee Act applies it establishes a "prudent investor" standard  
"A trustee may invest trust property in any form of property in which a prudent investor might invest"
- Trustee Act sets out 7 mandatory criteria to be considered in making investment decisions
- Delegation permitted but need investment policy
- Commingling of trust funds permitted but donor agreement should expressly provide for it

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## Restrictions on Investment Powers

- Restrictions can be imposed by donor in donor agreement or by terms of will.
- Restrictions can appear in the constating documents of the charity (Letters Patent, Trust Agreement, Special Act).
- Restrictions can be internally imposed.

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## Can Endowment Agreement Restrictions Be Amended

- Endowment agreement should be reviewed to determine whether agreement reserves right for charity to vary terms of agreement.
- If no such right, neither charity nor donor able to permit encroachment on capital.
- Although document is referred to as agreement, the relationship is not contractual because no consideration passing to donor. If it did, it would not be a gift for ITA purposes. Thus donor can't enforce the direction re capital nor can charity and donor agree to variation of the arrangement.
- It is important to note that because the gift is to a charity, a third party, the public interest, is involved. Thus there are public supervisory mechanisms which include the inherent supervisory jurisdiction of the courts, Attorney General and, at least in Ontario, the powers assigned to the PGT which enforce the charitable interests and ensure the application of the terms of the agreement.

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## Is the Endowment a Trust

- Trusts
  - intention of settlor
  - property or subject matter
  - beneficiaries-objects
- A gift given subject to trust or direction that it is to be held for 10 years
- What is a direction? Not a term of art and does not have any fixed legal meaning. In context of charitable gifts, term used in manner that it is synonymous with trust obligations or trust terms. (see Stillman)
- See also CRA Doc # 2008-0031495 where CRA describes enduring property as a trust at law
- So even if not called a trust – arrangement will almost invariably establish a trust like arrangement.

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## If Gift is a Trust

- Trust terms must be complied with and any failure to do so constitutes breach of trust.
- Donor (settlor) is without authority to vary terms of trust unless power expressly reserved at time trust is settled.
- Thus charity cannot encroach on capital if terms of trust do not permit encroachment.

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### How Can Endowment Agreements be Varied

- Variation by court order
- In Ontario s. 13 Charities Accounting Act (Ontario) provides a summary process
- Re Killam Estate (1999) 38 ETR (2d)142
- Stillman Case (2003) 68, OR (3d) 777 (SCJ)

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### Killam/Stillman

- In both cases testamentary trusts had been established for charitable purposes and the trustees had been directed to maintain a capital fund in perpetuity with only the income to be used to fund charitable activities. The testator had also imposed investment restrictions.
- In each case, application brought because income generated by the trust's capital assets was insufficient to meet the charity's DQ or at least its disbursement objectives.

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### Killam/Stillman

- In both cases the court approved the "total return" concept of investing which seeks to maximize the total of capital gains plus income of trust funds over the long term so that more funds are available for annual spending over an extended period than would be the case if the goal were to maximize income in the restricted sense (ie excluding capital gains)
- Court found that this approach protected the corpus of the Trust from the effects of inflation
- However, approach gave rise to income shortfall so needed further authority from court to make distributions in excess of the income
- Terms of charitable trusts were varied to permit total return investment policy and capital encroachment based on % of value of the assets

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## Killam/Stillman

- Court invoked its inherent jurisdiction to approve arrangements whereby the administrative provisions of charitable trusts, which are perpetual in nature, are adapted to suit changing circumstances so as to accomplish the donor's charitable intent more effectively as economic times change.
- Court in both cases accepted that this power extended to vary the terms of the trust to encroach on and distribute capital where the testator or settlor had directed the perpetual maintenance of a capital fund.

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## Stillman

- Caveat noted by Court in Stillman. Court will not allow settlor's directions to be superseded simply on the grounds of "expediency" Rather any variation should be made under the court's well- recognized and more clearly defined cy-pres jurisdiction.
- Generally this jurisdiction is usually exercised to remedy problems in the identification of charitable objects (ex where it is impossible to give effect to a testamentary gift because the charity has ceased to exist)
- However threshold for exercising this power is "impracticability"-not total impossibility but more than just expediency or convenience
- So court will not intervene if there is simply an inability to meet DQ Applicant must demonstrate broader inability to make distributions to achieve charitable intentions of testatrix

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## Role of Public Guardian and Trustee

- In Ontario, PGT has authority to regulate charities
- Must be served if court application
- Parens patriae role filled by Attorney General in other provinces
- Expedited process in Ontario through s. 13 Charities Accounting Act. But PGT will not agree to variation beyond the parameters of the Stillman decision.

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### Internally Restricted Funds

- Board can create a fund to which the donors contribute
- Board can set aside unrestricted funds and make them applicable to a particular purpose
- If wish to amend or vary the terms: What can be done? Consider donor expectations and donor relations.
- Need to review terms and see whether flexibility may have been built in. Need to review Board resolutions.
- Also need to check investment and distribution policies of charity

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### Restrictions Found In Constatng Documents

- If constating document is a trust whether inter vivos or testamentary, check to see whether power to vary and if so the scope of the power and the process for variation.
- If constating document is letters patent, follow procedure for amending letters patent in the applicable corporate statute. In Ontario PGT may require that donations received while restrictions in Letters Patent continue to have those restrictions apply to existing endowments.

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### Protecting Endowments from Creditors

- Charitable organizations have become more aware of the risks to their endowments over the years.
- Christian Brothers cases clarified that segregated funds are not immune from negligence claims.
- Many charities have considered transferring endowment funds to parallel foundation.
- Check endowment agreements to determine if restrictions or conditions on transfer.
- ITA permits transfer of funds inter charity.

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## Structuring New Endowments

- Lessons learned from recent years of tough economic times.
- Difficulties in meeting DQ obligations and programming needs.
- Reduced level of donations and government funding.
- Great flexibility created by 2010 Federal Budget provisions eliminating complex DQ formula and replacing it with simple distribution requirement of 3.5 %.
- Need to apply those lessons to structuring new endowment agreements and take advantage of the new flexibilities created.

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## Future Gifts

- Review existing gift agreements and remove all language relating to 10 year gifts, enduring property, capital gains pool. New agreements do not need to refer to these concepts.
- Remove references to income and capital. If donor insists on perpetual gift of capital or if donor agreement provides for a hold period, remove capital and income distinction and replace with total return investment and payout strategies or if donor insists on retaining concept of income and capital define what is meant by income and capital. For example can "Income" include realized capital gains?
- Encourage flexibility to deal with unknown circumstances in the future. Include a variance clause in donor agreements and donor directions.

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## Gifts in Perpetuity

- No requirement under ITA
- Donor education
- Education at board level of charity. Board needs to determine strategy for terms of gifts including hold periods.
  - Board should consider flexibility
  - Reduction of administrative costs

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## Other Documentation

- Review internal policies and procedures-investment policies; distribution policies
- Consider simplifying donor agreements by providing for "donor advice" on granting and refer to investment and distribution policies of the charity as amended from time to time
- Review fundraising materials and other communications including website, donor reports, and align with new flexibility

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