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Canada
ADVISING FAMILIES ACROSS GENERATIONS

Session 12 – Philosophical Philanthropy
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JUNE 14-15, 2021

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IMPACT INVESTING BY CHARITIES

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A. SETTING THE STAGE

1. What is Impact Investing?

- Many charities, as well as donors, are interested in “impact investing” but are not necessarily sure what it involves or what hurdles may be encountered
- “Impact investing” generally refers to investments made with the intention to achieve a measureable social or environmental impact, as well as a financial return to the investor (e.g. a dual purpose)
- Impact investing is often used interchangeably with “social investing”, “social finance” and “program related investing”
- Social responsible investing (“SRI”) and environmental, social and governance investing (“ESG”) is somewhat different from impact investing in that SRI and ESG investing tend to be more passive strategies for investments in public equities

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2. Different Forms of Impact Investing by Charities

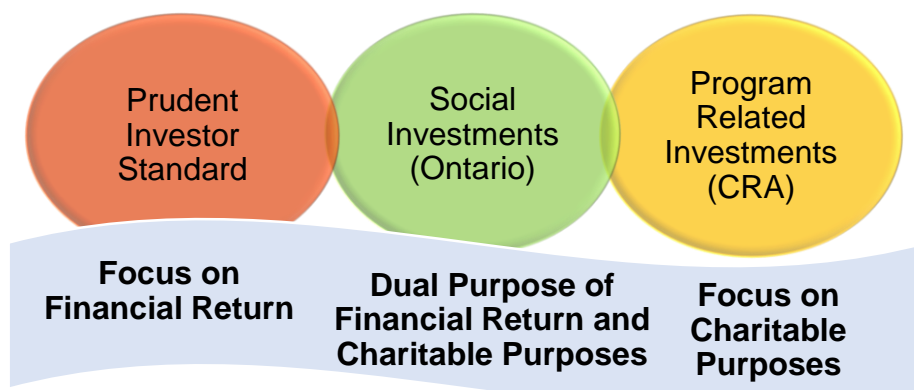
- Charities can become involved in impact investing in one of two ways
 - Demand Side - where the charity seeks out investment capital by issuing debt, e.g. promissory notes or social impact bonds, in order to attract capital to pursue a charitable purpose, including supply side impact investing
 - Supply Side - where the charity uses its charitable resources to make investments in third parties (both charities and non-charities) in order to achieve a charitable purpose
- Individuals may be interested in making either a loan or a donation to a charity in order to create a “charitable impact investment fund”

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- A donation to a charity will result in a donation tax receipt whereas a loan to a charity will not, unless the loan is subsequently forgiven by the holder of the debt
- The focus of this presentation is on supply side impact investing by charities
- Supply side impact investing by a charity with a third party can take the form of:
 - A loan (both secure and unsecure)
 - An equity interest (e.g. shares or partnerships interests)
- While impact investing is an important development, it has limitations which the charity and its advisors need to be aware of

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3. The Impact Investment Spectrum for Charities



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B. THE LEGAL FRAMEWORK FOR IMPACT INVESTING BY CHARITIES

1. Knowing What Investment Power Applies

- Provinces have jurisdiction over charities and charitable property
- Generally, the *Trustee Act* in each province or territory applies (CCQ in Quebec)
- Situations where the provincial *Trustee Acts* may not apply:
 - The letters patent, articles of incorporation or articles of continuance of a charity state that the *Trustee Act* does not apply
 - A different investment power is set out in special legislation creating the charity
 - A special purpose trust in a will or gift agreement establishes a different investment power from that contained in the *Trustee Act*

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2. Prudent Investor Standard

a) Standard of Care

- Ont. *Trustee Act* states that when investing trust property, a trustee must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments
- Most other provinces provide for a similar standard of care

b) Authorized Investments

- Ont. *Trustee Act* states that a “trustee may invest trust property in any form of property in which a prudent investor might invest”
- Investment in mutual funds and pooled funds are permitted
- Similar approach taken in most other provinces

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- c) Mandatory Investment Criteria
 - Ont. *Trustee Act* states that seven mandatory criteria must be considered, among others “that are relevant to the circumstances”
 - Includes “assets special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries”
 - Arguable this criteria provides for some scope to make impact investments as part of an investment strategy to pursue financial returns for the charity
 - Similar approach in most other provinces
- d) Mandatory Diversification Obligation
 - Ont. *Trustee Act* requires that trustees must diversify to an extent appropriate to the requirements of the trust and general economic and investment market conditions
 - Similar provisions in most other provinces

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- e) Delegation of Investment Decision Making
 - Ont. *Trustee Act* permits trustees (e.g. the board of a charity) to delegate investment decision making
 - However, there needs to be an investment policy and agency agreement in place and an investment manager must be selected and monitored in accordance with statutory requirements and reflect the standard of what a prudent investor would do
 - Similar provisions in most other provinces
- f) Prohibition on Sub-delegation
 - Ont. *Trustee Act* provides that a delegated investment manager may not further delegate investment decision making
 - This can prove to be problematic for investment managers who want to invest in mutual funds or pooled funds
 - This prohibition generally does not apply to other provinces

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g) Liability Protection of Trustees

- Ont. *Trustee Act* provides that a trustee will not be liable for losses if the investment decision conformed to an investment plan that a prudent investor would adopt under comparable circumstances
- Similar provisions in most other provinces
- This statutory protection is an important factor for volunteer directors of charities who are inherently risk adverse

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3. “Social Investment” Standard in Ontario

a) Option of “Social Investments” (Dual Purpose) in Ontario

- In 2017 the *Charities Accounting Act* in Ontario (CAA) was amended to permit all charities in Ontario to make “social investments”
- “Social investments” involve applying or using charitable property to both (dual purpose):
 - Directly further the purposes of the charity, and
 - Achieve a “financial return”
- “Financial return” is defined as an outcome that is better, in financial terms than expending all of the property”

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- b) Duties of Trustees in Making “Social Investments”
 - Must ensure that social investment is in the interest of the charity
 - Review the investment periodically after making a social investment
 - Both before and after making a social investment, determine whether advice should be obtained (not clear what type of advice is required)
- c) Limitations on Expenditure of Capital
 - Social investments may not be made in relation to trust property that is subject to a limitation on capital unless trustees expect that the social investment will not contravene that limitation or the terms of the trust to permit such investment
 - Therefore, important to review existing endowment agreements, and endowment templates for future endowment agreements to avoid contravention, as well as possible breach of trust

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- d) No Delegation of Power to Make Social Investments
 - Charities may not delegate decision making power with regard to making social investments
 - Therefore the board of a charity is required to make all decisions concerning social investments
- e) Liability Protection for Trustees
 - Protection of trustees (directors) from liability for losses from social investments is limited to only when trustees “acted honestly and in good faith” in accordance with the duties restrictions and limitations that apply under the CAA and terms of trust

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4. CRA Program Related Investments

- a) What are Program Related Investments (PRIs)?
 - Described in CRA Guidance on Community Economic Development Activities and Charitable Registration <https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/policies-guidance/community-economic-development-activities-charitable-registration-014.html>
 - PRIs are defined by CRA as investments that “directly further” the charitable purposes of the charity
 - A PRI may generate a financial return, though they are not made for that purpose
 - A PRI usually involves the return or potential return of capital but is not a requirement
 - A PRI may also yield revenue, such as interest, but the yield can be below market rates
 - A charity can make a PRI with both “qualified donees”, e.g. other registered charities, or even non qualified donees

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- Common forms of PRIs include loans, loan guarantees, share purchase and lease of building
- PRIs may overlap with social investments in Ontario referenced above
- As such, social investments may require compliance with the CRA requirements of a PRI
 - legal advice should be sought in this regard
- b) Requirements to engage in PRIs
 - Need a policy to describe how PRIs will further the purposes of the charity
 - The charity must maintain “direction and control” over the PRI when engaged in PRIs with non-qualified donees
 - Must ensure that any private benefit is no more than incidental
 - Must prepare and maintain adequate books and records to prove compliance

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- c) Accounting for PRI
 - PRIs are excluded from the asset base for the calculation of the 3.5 disbursement quota (“DQ”)
 - PRIs, though, are not considered by CRA to be charitable expenditures in meeting the 3.5% DQ except with the loss of capital or lost opportunity cost
- d) What Happens if PRI Requirements No Longer Met?
 - If the requirements for a PRI are no longer met then either exit the PCI or the investment would need to meet prudent investor standards of a regular investment
 - In this regard, it is important to make sure that regular investments are not seen as a business of the charity and/or a “collateral unstated non-charitable purpose”

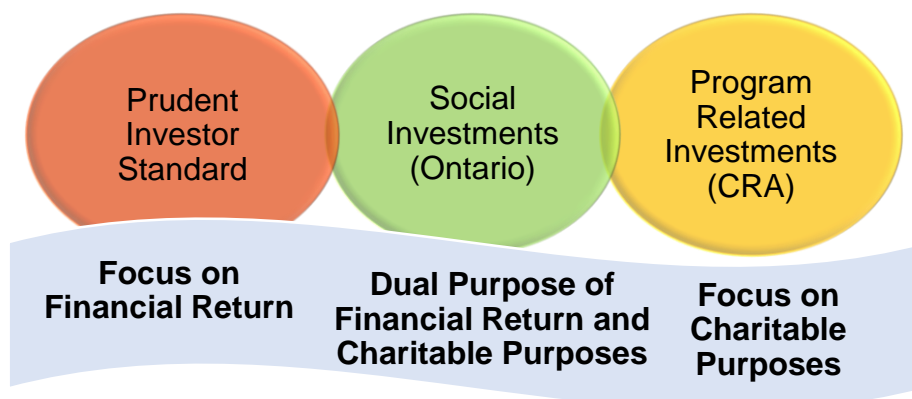
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5. Other Factors to Consider when Engaging in Impact Investing

- a) Under the *Income Tax Act*
 - Restriction on acquisition of control of corporations by public and private foundations
 - Non-qualified investment rules for private foundations
 - Excess business holding regime for private foundations
 - Limitations on registered charities investing in limited partnerships
 - Related business rules compared to the rules for ordinary investments
- b) Under the *Charities Accounting Act* in Ontario (CAA)
 - 20% “substantial interest” threshold permitting the Public Guardian and Trustee to require financial statements and seek court intervention
 - Commingling of restricted funds rules under CAA regulations

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6. Reminder of Impact Investment Spectrum for Charities



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C. RESOURCE MATERIALS

- OBA Institute paper entitled “The Investment Spectrum for Charities, Including Social Investments” dated February 6, 2018, at <https://www.carters.ca/pub/seminar/charity/2018/oba/OBA%20Paper%20Investment%20Spectrum.pdf>
- Handout from Charity & NFP Webinar Series entitled “The Expanding Investment Spectrum for Charities, Including Social Investments” dated March 28, 2018, at <https://www.carters.ca/pub/webinar/2018/Investment-Spectrum-for-Charities.pdf>
- Charity & NFP Law Bulletin No. 426 entitled “Guidance on Social Investments Released by the Ontario PGT” dated August 30, 2018, at <https://www.carters.ca/pub/bulletin/charity/2018/chylb426.pdf>
- Guidance of the Public Guardian and Trustee: Charities and Social Investments dated April 9, 2018 at <https://www.carters.ca/pub/article/charity/2018/PGT-Guidance-with-Cover.pdf>
- Estate Planners Council of London Handout entitled “Investment Challenges and Opportunities for Charities, Including Social Investments and Donor Advised Funds” dated October 21, 2019 at <https://www.carters.ca/pub/seminar/charity/2019/Estate-Planners-Council-of-London-Handout-2019-10-21.pdf>
- Chapter 16, “Provincial Investment Power Issues” in *Corporate and Practice Manual for Charities and Not-For-Profit Corporations* (Thomson Reuters), by R. Jane Burke-Robertson, Terrance S. Carter, Theresa L.M. Man at <https://store.thomsonreuters.ca/en-ca/products/corporate-and-practice-manual-for-charities-and-not-for-profit-corporations-30842800>

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