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Legal Issues in Managing Endowment Funds

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OVERVIEW OF TOPICS

- Introduction
- What is an Endowment?
- Managing the Acceptance of New Endowment Funds
- Issues in Developing an Endowment Policy
- Specific Issues involving Existing Endowments

A. INTRODUCTION

- There is a significant amount of confusion with regard to the management of endowment funds
- This in part is because there is not a clear understanding of what is meant by an endowment and what are the legal obligations associated with an endowment
- This presentation addresses the issues in the management of endowment funds by explaining:
 - what endowments are
 - what are the legal issues that need to be considered in managing endowments
 - what are the practical issues that also need to be addressed

B. WHAT IS AN ENDOWMENT?

1. Initial Comments

- Use of the term “endowment” when drafting restricted charitable purpose trusts needs to be carefully considered
- “Endowment” is not a well understood *legal* term
- It generally describes the holding of the capital of a gift on a permanent basis in order to generate income for a charitable purpose
- In *Arthritis Society v Vancouver Foundation* (BC), the BC Supreme Court held that “the most common definition of the term ‘endowment’ is the provision of a fund which is intended to generate fixed revenue for the support of a charity”

- The court also cited with approval the definition of endowment from Black's Law Dictionary that it is "the bestowing money as a permanent fund, the income of which is to be used in the administration of a proposed work"
- However, the word "endowment" has also been used to refer to trusts where the capital was to be retained for "10 years or more" for purposes of avoiding the 80% disbursement quota under the *Income Tax Act* ("ITA") prior to the 2010 amendments to the ITA
- Many donors and charities may not actually want to set up a permanent endowment fund when drafting a gift agreement or a will
- As a result, the actual words used in drafting a restricted gift must carefully reflect what the donor actually wants in order to avoid creating an "endowment" when it is not actually intended

2. The Difference Between a Restricted and Unrestricted Charitable Gifts

- An endowment is type of restricted charitable gift
- As such, it is important to briefly understand the basic difference between a restricted and an unrestricted charitable gift

a) Unrestricted Charitable Gift

- An unrestricted charitable gift is a gift at law to be applied towards a charitable purpose of a charity that is not subject to any restrictions imposed either directly or indirectly by the donor
- The board of a charity may therefore apply an unrestricted gift to its charitable purposes in whatever manner it deems appropriate

- This means that the board of a charity may use the gift as it wishes in its discretion, provided that such use does not extend beyond its charitable purposes
- This could involve:
 - Disbursing all or a portion of the gift, or
 - Investing the gift over the short term or long term and using the income to pursue any one of the authorized charitable purposes within the constating documents of the charity
- A board that designates an unrestricted charitable gift for a specific charitable purpose may subsequently apply the funds to a different charitable purpose within the charitable objects of the charity



b) Restricted Charitable Gift

- A restricted charitable gift in general means a gift given to a charitable purpose that is subject to restrictions, limitations, conditions, terms of reference, directions, or other restricting factors
- These limitations are imposed by the donor and constrain how the charity may use the gift
- While an unrestricted charitable gift is beneficially owned by the charity, a restricted charitable gift when structured as a restricted charitable purpose trust is held by the charity in trust for the purpose and is not actually owned beneficially by the charity
- For trust law purposes, each restricted charitable purpose trust is a separate trust

- However, for administrative purposes under the ITA, as long as the trustee is the registered charity, a restricted charitable purpose trust is not required to be registered by CRA as a separate registered charity, although it could be if there was a practical reason to do so
- As is explained later in this presentation, the board and management of a charity that receives a restricted charitable gift, including an endowment, need to be aware of:
 - The nature of the donor restriction
 - The legal implications of the restriction
 - The importance of complying with the restriction

3. Different Types of Restricted Charitable Gifts in General

- a) Restricted charitable purpose trusts
 - Long term gifts, including endowments
 - Restricted use gifts
 - Restricted charitable trust property
 - Implied special purpose charitable trust funds
- b) Conditional gifts
- c) Precatory trusts and donor advised funds
- d) Gifts subject to donor direction under the *Charities Accounting Act* (Ontario)
 - For more information, see *Drafting Issues for Restricted Gift Agreements Including Endowments* (2014) http://sectorsource.ca/sites/default/files/Restricted_Gifts.pdf



4. The Specifics of Restricted Charitable Purpose Trusts

- A restricted charitable purpose trust is a gift held by a charity in trust for a specific charitable purpose that falls within the parameters of the general charitable purpose of the charity as set out in its constating documents (letters patent or articles of incorporation)
- A charity, though, cannot hold property as a restricted charitable purpose trust where such purpose is outside the scope of the charity's corporate objects or purposes
- A charity can only use the gift to accomplish the specific charitable purpose established by the donor, otherwise there would be a breach of trust

- Common types of restricted charitable purpose trusts include:
 - Endowments
 - Long term funds
 - Scholarship funds
 - Building funds
 - Research funds
- For more information, see article on *Considerations When Drafting Restricted Charitable Purpose Trusts* (2012) http://www.carters.ca/pub/article/charity/2011/ETPJ30-4_Carter.pdf
(2010) <http://www.carters.ca/pub/article/charity/2010/tsc1001.pdf>
and *Donor-Restricted Charitable Gifts: A Practical Overview Revisited II* (2006)
<http://www.carters.ca/pub/article/charity/2006/tsc0421.pdf>



- A restricted charitable purpose trust is established when the donor has expressed an intention that the property be held for a specific charitable purpose
- There are conflicting approaches concerning the type of evidence necessary to establish that the donor intended to create a special purpose charitable trust
- In *Re Christian Brothers of Ireland in Canada (Ont)*, Blair J. held that a high, formal standard of “in trust” is required, which would necessitate that it be in writing



- In *Rowland v. Vancouver College* (BC), Levine J. determined that the requirements for a restricted charitable purpose trust are less formal and could involve consideration of all relevant circumstances involved in making the gift
- In *Re The Land Conservancy of British Columbia* (BC), Fitzpatrick J. followed the less formal requirement and considered the “surrounding circumstances” when a will or gift is made
- The dichotomy between the two approaches remains unresolved



a) Time Restricted Gifts Including Endowments

- Time restrictions involve the length of time that a restricted gift must be held, usually creating a type of long-term gift
- The income (and the capital where encroachment on capital is authorized) are used either for a specific application, like a scholarship, or for the general charitable purposes of the charity
- They may be directed to be held permanently as an endowment or for a fixed number of years
- The donor may give the charity a right to encroach on the capital during the restricted period or not
- Once the restricted period has expired, if applicable, the charity can distribute the entire capital of the gift

- An endowment is the extreme form of a time restricted gift
 - The donor requires that the capital of the gift be held in perpetuity and invested to produce income
 - Since charitable purpose trusts are exempt from the rule against indestructible or perpetual trusts, a charity may accept gifts where the capital is held in trust on a perpetual basis
 - As well, the charity is not able to vary the trust at common law to collapse the endowment
- This method of raising funds is not available to non-profit organizations under subsection 149.1(I) of the ITA, since non-profit organizations do not constitute charitable purpose trusts at law
- Time restricted gifts that are created by the donor are usually initiated through a testamentary gift (will) or an *inter vivos* gift agreement

- The following are a few examples of actual testamentary and *inter vivos* agreement wording establishing endowments:
 - 1) “*We hereby donate to the [Charity] as trustee for an endowment in perpetuity the [XYZ Award].*”
 - 2) “*To pay one such share to the [Charity] for the purpose of founding a scholarship in memory of [individual], the approximate net income therefrom to be paid yearly to a student who meets the following criteria.*”
 - 3) “*To pay the sum of \$25,000.00 to the [Charity] for the purpose of establishing an endowed scholarship.*”
 - 4) “*This is to confirm the submission of \$6175.12 of capital for the [ABC Award] in perpetuity to be awarded in the spring of each year.*”

- 5) *“The gift is an endowed donation to [Charity] and will be held by the Charity in perpetuity.”*
- 6) *“The [Charity] hereby acknowledges receipt of the capital sum and agrees to hold the same in a separate investment account and to invest the capital sum and to pay the income derived therefrom to the [Charity] in one annual instalment on or about [date] in each year.”*
- 7) *“I direct that the amount payable to the [Charity] shall be used by the Charity to provide a permanent scholarship to be awarded in my name.”*

b) Restricted-Use Gifts

- Restricted-use gifts oblige the charity to apply the capital and income according to particular purpose or purposes as stipulated
- Unless the gift also has a time restriction, the gift is generally applied as soon as is practical
- Use restrictions often require the gift be applied to:
 - A particular capital project (e.g. a building program)
 - An operational use (e.g. a relief effort in a foreign country)
- In either situation, the use restrictions must be within the parameters of the charitable purpose set out in the charity's constating documents

- Donors may also restrict how the charity is to accomplish the charitable purpose of the gift - For example:

D
is for donor.

- Donors can restrict who may benefit from the gift i.e. children, provided that such beneficiary group is not too small, e.g. children who live on one street
 - As well, the board must ensure the restrictions are not repugnant or contrary to public policy, such as discrimination against a disadvantaged group
- Donors often include a use restriction along with a time restriction as well, e.g. a million dollar gift to be held in perpetuity with the income to be used for research into a particular disease

C. MANAGING THE ACCEPTANCE OF NEW ENDOWMENT FUNDS

1. Need to ask how was the endowment created?

- There are three ways in which an endowment can be created:
 - By the donor,
 - By the board, or
 - By a combination of the two
- Donor initiated endowments can arise out of
 - *Inter vivos* gift agreement
 - Testamentary provisions
 - It is important that the charity, if possible, make template endowment wording available to donors and their legal counsel for testamentary gifts to avoid inadequate drafting of the endowment

- Board initiated
 - Board authorizes the establishment of the endowment fund and asks donors for contribution, e.g. “Please send your contributions to the Millennium Endowment Fund”
 - When the board of a charity creates a time restricted gift, it usually advises potential donors of the terms of restriction and then invites donors to contribute
 - This creates a binding restriction on the board of the charity, so it is important to have the wording carefully documented in order to avoid misunderstanding concerning donor expectations
 - A board initiated endowment fund may sometimes be tied into a matching gift program, e.g. when the government offers a matching gift program where every dollar paid for an endowment is doubled



2. Initial Issues to Address Before Accepting an Endowment Fund

- Whenever a charity receives an endowment (whether *inter vivos* or testamentary), the charity must carefully review the terms of the restricted gift creating the endowment
- The starting point is that a charity is not under an obligation to accept a gift, but if it does, then it must comply with terms of the restrictions otherwise, at present and in the future, the board could face exposure to liability
- Is the charity administratively capable of handling an endowment fund?
- Is the gift a restricted gift, and if it is, is it an endowment or a restricted use gift or a combination of the two?

- First, the charity must ensure that the restrictions in use that are placed on the gift are actually of a charitable nature
 - Restrictions that are not charitable (e.g. a fund to support a political party) render the entire restricted charitable purpose trust invalid
- Next, the charity must ensure that the restrictions in use are within the charitable purposes of the charity
 - If a restriction has no relation to the nature and work of the charity, it is a good indication that the charity may not be able to accept the gift



- Then, the charity must determine whether the restrictions are both possible and practicable
 - It is pointless to accept an endowment with a restriction in use that make the trust impossible or impractical to administer
 - Determining this at the outset may avoid wasting valuable time and money in managing an unworkable endowment
- Lastly, the charity must determine whether the restrictions in use are, in fact, acceptable to the charity and the charity can continue to comply with the restrictions
- If any of these questions are answered in the negative, the charity may not want to accept the endowment and as well no charitable tax receipt would be issued

- If the endowment is subject to restrictions in use that the charity wishes to accept but are either impossible or impractical, the charity will need to apply to a court to have the court exercise its *cy-près* scheme-making power to vary the terms of the restriction “as near as possible” to the original restrictions imposed by the donor
- Once a charity accepts an endowment, the board must ensure that the funds will be managed in accordance with the applicable restriction either directly or through a committee of the board in conjunction with staff
- Failure to monitor compliance with donor restrictions can lead to allegations of breach of trust by the donor, board member or other stakeholders

3. Depositing Initial Gifts

- Frequently, a charity with a parallel foundation, like a hospital or educational institution, will want to deposit a gift made out to the charity directly into the bank account of the parallel foundation
- Since a donor restricted gift is given to a specific charity, it must be deposited into the bank account of the named charity
- Otherwise, failure to deposit funds into the bank account of the named charity will leave the board of directors potentially exposed to allegations of breach of trust



D. ISSUES IN DEVELOPING AN ENDOWMENT POLICY

- Charities that hold endowments should either have a separate policy on the management of endowments or include the terms of such a policy within the terms of its gift acceptance policy
- The following is a list of issues that should be considered in developing an endowment policy:
 1. **Thresholds in Managing Endowment Funds**
- Charities should consider whether to require a minimum amount in order to accept an endowed gift
- In determining this threshold, a charity should consider:
 - The cost of administering the endowment fund
 - Whether further contributions of capital to the endowment are to be permitted and from whom

2. Assets Forming the Endowment

- The charity must consider what assets an endowment can consist of
- For example,
 - Monies
 - Gifts in kind, such as shares or artwork to be sold as the proceeds held in the fund
- The charity must handle various types of property differently, e.g.,
 - Gifts of shares need to be properly valued before the gift is made for receipting purposes
 - Gifts of publicly traded shares are exempt from capital gains tax, but not gifts of private shares



- Whether cash or a gift in kind, the donor and the charity will need to consider whether the split receipting and anti-tax shelter provisions of the ITA could affect the fair market value of the gift for receipting purposes
- Split receipting and anti-tax shelter provisions can affect fair market value through:
 - Deduction of any “advantage” from the fair market value of the gift, or
 - Reduction of the fair market value of a gift in kind through the “grind down” deeming provision in the ITA applicable to specific types of gifts in kind in certain situations

3. Naming Rights

- Some donors may wish to build naming rights into the terms of their endowment
- If so, the charity must determine:
 - How long the naming rights will last
 - Whether to reserve the right to terminate the naming rights of a donor
- The donor and the charity should also consider under what circumstances naming rights could constitute an “advantage” under the ITA, preventing the donor from obtaining a tax receipt for the full value of the gift



- CRA has generally held that individual naming rights alone do not constitute an advantage
- For a business, if the naming rights amount to sponsorship that promotes the business' brand or products, the naming rights could constitute an advantage that may need to be deducted from the fair market value of the endowment
- But the business may be able to deduct the value of such advantage as a business expense and would therefore be in the same tax position as if it had received a charitable receipt

4. Investing Endowment Funds

a) Determining Which Investment Power Applies

- Need to look at letters patent, supplementary letters patent, or articles of incorporation of the charity to determine if an investment power has been identified
- If the letters patent or supplementary letters patent are silent, then by default, the *Trustee Act* (Ontario) of the particular province will apply

b) Requirements for a General Investment Policy

- The charity should have a general investment policy
- General Investment Policy needs to reflect the requirement of the charity under the *Trustee Act* as opposed to what a financial institution may propose

- Need to explain the applicable law concerning investing charitable property as a reference point for board and committee members
- *e.g.* in Ontario:
 - Prudent investor standard
 - The ability to invest in mutual funds
 - The seven mandatory investment criteria
 - The need to diversify investments
 - The requirements for commingling of restricted funds
- Since each fund, *i.e.* an endowment fund, will require a different investment approach, there will need to be specific investment policies for each fund that builds on the general investment policy



c) Requirements for Delegation of Investment Decision Making

- At common law, cannot delegate investment decision making
- The *Trustee Act* permits delegation of investment decision making to an agent in accordance with the terms of the Act
- Therefore, need to be familiar with the terms of the *Trustee Act*
- For example, the *Trustee Act* permits delegation of investment decision making under certain limited terms
 - Requires an “agency agreement” in order to appoint an investment manager

- Requires an investment policy in order to reference investment requirements under the *Trustee Act*
- The choice of investment manager needs to be carefully considered and monitored “with prudence”
- The investment manager remains responsible for the funds invested, and as such the general investment policy should require the investment manager to indemnify the charity, not the opposite as is often done in investment policies from financial institutions
- Most charities with endowments are not familiar with the requirements that the *Trustee Act* imposes in order to delegate or comply with the same

5. Commingling Endowment Funds

- At common law, restricted charitable gifts, such as endowments, have to be kept in separate bank accounts from other restricted trust funds, as well as separate from the general bank account
- However, Regulations under the *Charities Accounting Act* permit commingling of restricted charitable purpose trust funds if certain requirements are met, including:
 - Combining the funds must advance the administration and management of each fund,
 - All gains/losses/income/expenses must be allocated rateably to each fund on a fair and reasonable basis and in accordance with GAAP
 - Specific records must be maintained under subsection 3(5) of the Regulations

- Regardless, a charity in Ontario still cannot commingle restricted charitable purpose trust funds with general funds
- Such form of unauthorized commingling might occur where there are internally restricted endowments commingled with externally restricted endowments for investment purposes
- This is often reflected in audited financial statements that normally lump both externally restricted and internally restricted endowments together
- Commingling restricted charitable purpose trust funds in contravention of the Regulations in the *Charities Accounting Act* could expose the directors to allegations of breach of trust and resulting personal liability

6. Borrowing from Endowment Funds

- A charity must never borrow against endowment funds or other restricted funds, whether it be to further other charitable purposes of the charity or to under-write the general operations of the charity, even if the restricted funds are repaid at a later time with interest
- To do so would constitute a breach of trust
- Similar prohibitions would apply in using endowment funds or any other restricted funds as collateral security for loans made by a charity



7. Disbursement from Endowment Funds

- Need to ask whether the donor imposed any restrictions on how the income from an endowment fund is to be distributed
 - Has it been made mandatory to disburse all income each year?
 - e.g. “all income each year must be expended on funding the youth scholarship”
 - Or is the charity given a discretion on how much it can disburse from income?
- Has the donor imposed a restriction that a portion of the income must be retained to keep pace with inflation?

- At common law, no encroachment of capital is permitted unless the donor has given the authority to do so
- What constitutes capital that cannot be disbursed?
 - At trust law, capital gains forms part of capital, not income
 - Therefore, unless the gift agreement defines income as including capital gains, to expend realized capital gains would constitute breach of trust
 - This means that a total return strategy to invest and disburse income (*i.e.* to look at the best total return, without distinguishing between capital and income) is not permissible without authorization by the donor when the gift is established or by court order



- In *Re Killam Estate* (Nova Scotia), the court authorized a total return strategy based on the inherent jurisdiction of the court over the administration of charitable trusts
- In *Re Stillman Estate* (Ontario), the court restricted the authority of the court to authorize a total return strategy to the *cy-pres* jurisdiction of the court in the situation where there is either an impossibility or an impracticality
- *Stillman* generally reflects the approach taken by the Ontario Public Guardian and Trustee, so court authorization for a total return strategy in Ontario will be limited to when there is either an impossibility or an impracticality

- *Stillman* was recently followed in *Fenton Estate (Re)* (BC)
- What would constitute an impracticality for purposes of a *cy-près* court application involving a total return strategy?
 - inability to meet the 3.5% disbursement quota for the charity under the ITA
 - for larger institutions, query whether it might be possible to argue that it would be impractical to not apply a total return strategy to the collective endowment funds of the charity if it would be an excessively costly administrative burden for the institution to administer those endowment funds different from other investments done on a total return basis

- Court authorization in Ontario may be possible on a consent basis through the Public Guardian and Trustee under s. 13 of the *Charities Accounting Act*, or alternatively by an order in open court
- In order to avoid the necessity of having to obtain court authorization, it would be better for the charity to obtain authority from the donor to adopt a total return strategy by either:
 - Including specific authorization in the gift agreement, or
 - the terms of the will, or
 - Incorporating such authority by reference into the gift agreement

8. Administration Fee

- Another issue to consider is whether the charity might want to charge a reasonable administration fee against the income of the endowment fund
- If so, the charity should:
 - Disclose reference to the administration fee in the gift agreement, or
 - Require the gift agreement to cross-reference the charity's gift acceptance policy, which would set out administration fee particulars



9. Variation of Trust

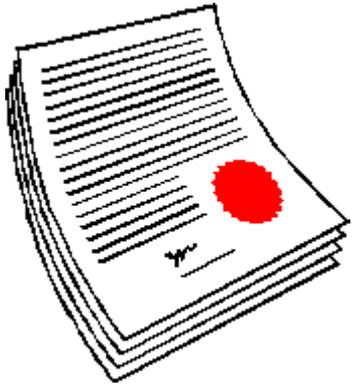
- A donor cannot retain the right to vary the terms of an endowment after it has been created
- However, the donor can retain the ability to provide non-binding input through the inclusion of a donor advised option in the gift agreement
- As well, the charity cannot vary the terms of an endowment fund on its own unless the gift document so provides this power to the charity
- As such, need to look to see if the gift agreement includes a provision giving the charity authority to vary the terms of the endowment agreement, such as encroachment as capital or variation of use restrictions

E. SPECIFIC ISSUES INVOLVING EXISTING ENDOWMENTS

1. Taking Inventory

- It is essential that the board of a charity maintain an up-to-date inventory of all endowments and other restricted funds, to be updated on a regular basis
- However, it is often difficult to locate original documentation that established the endowment
- This is because documentation may have been lost, was inadequate or is confusing
- The charity must therefore go back to original source documents where possible to see what the terms of the endowment and other restrictions were
 - Source documents could include:
 - Endowment agreements

- Terms of wills
- Notes in audited financial statements
- Government contracts for matching funds
- Board resolutions creating the endowment fund or attempting to change the fund
- Donor letters or agreements attempting to change the terms of the endowment
- Family members attempting to change the terms of the endowment
- Notes to file about the endowment made by previous staff of the charity



2. Identify Areas of Deficiencies

- Need to identify when terms of the endowment have not been complied with by the charity
- Non-compliance can occur in any area, but tends to be principally where the charity has followed a total return strategy when there is no authority in the endowment agreement to do so or in a policy incorporated by reference into the gift agreement
- Non-compliance with terms of an endowment agreement can lead to exposure to liability for members of the board of directors, both past and present
- Where there has been evidence of non-compliance, it may be necessary to obtain a relieving court order on a consent basis from the Public Guardian and Trustee

3. Transfer of Endowment Funds

- If an endowment fund(s) is to be transferred to another charity, such as a parallel foundation, then it is important to determine what procedures should be followed
- Firstly, the charity needs to create an inventory of its endowments
- Secondly, it must determine what authority speaks to the issue of transferring the endowment funds
 - Possible in the endowment agreement if it addresses the issue of transfer of funds
 - Possible in the gift acceptance policy if the terms of that policy are incorporated by reference into the gift agreement
 - Or in accordance with section 3 of the *Trustee Act*

- The transfer of funds from one charity as trustee to another charity as subsequent trustee can be done in one of the following ways:
 - Deed of appointment under section 3 of the *Trustee Act*, whereby the subsequent trustee agrees to receive a transfer of endowment funds and comply with the terms of the endowment
 - Alternatively, the charity may want to obtain a consent court order for the transfer of funds (e.g. for a consent order of the Public Guardian and Trustee under s.13 of the *Charities Accounting Act*)



- Where the recipient charity is not arm's length to the donor charity, then there will need to be consideration given to possibly electing to identify the gift as a “designated gift” for purposes of avoiding the 100% disbursement requirement that would otherwise apply
- If donor charity elects the gift to be a “designated gift” in its T3010
 - No 100% expenditure requirement on recipient charity applies
 - However, donor charity cannot use the gift to meet its own 3.5% disbursement quota

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