EXPENDITURE PROPERLY CHARGEABLE AGAINST THE PERMANENT ENDOWMENT OF A CHARITY: A REVIEW OF THE CHARITY COMMISSION'S PRACTICE

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There is an apparent contradiction between the Charity Commission's *Statement of Recommended Practice (2005)* ('the SORP') and the Commission's guidance note *CC38 – Expenditure and Replacement of Permanent Endowment*. In a nutshell, the SORP states that certain costs "should be" charged to capital, whereas CC38 says that, generally, such treatment is not allowed. So which is correct? The purpose of this article is to clarify the Commission's views on the application of permanent endowment, with regard to both improvement costs of land and management costs.

Costs of improvement to land

The SORP, at Appendix 3 paragraph 3(c), says this in relation to expenditure of permanent endowment:

> "*Any expenses incurred in the administration, or protection of endowment investments should be charged to capital. For example, the fees of someone who manages the investments in a permanently endowed fund, or the cost of improvements to land held as an endowment investment.*"

Contrast that with CC38 (which is concerned "mainly with expenditure on repairing, improving or extending buildings belonging to a charity") in which the Commission say that they are prepared to make an Order to authorise expenditure

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of permanent endowment for essential work, but that – unless the trustees are able to convince the Commission that there are good reasons why the permanent endowment has to be spent but cannot be replaced – the Order will require the expenditure to be recouped out of future income.

So, on the one hand, improvement costs should be charged to capital (the SORP), and on the other, the Commission will usually require such expenditure to be recouped from income (CC 38). The solution to this dichotomy is that CC 38 is concerned exclusively with expenditure on functional land (land occupied or used for the purposes of a charity). The Commission have accepted that CC 38 is not clear, in that respect; indeed, the guidance note might be said to be misleading, since it defines permanent endowment as "e.g. land, buildings, investments or cash" and makes no reference to functional land.

The Commission therefore applies different criteria in determining whether improvement costs to land can be met out of permanent endowment, depending upon whether the land in question is investment land or functional land.

Investment Land

The Commission's approach has changed somewhat over the past twenty years. Until quite recently it adopted the approach set out in a Board Minute of 11th November 1986 in which, for the first time, it agreed to countenance expenditure on investment property, without recoupment. Minute 2.9 was as follows:

> "*It was agreed that where expenditure on investment property was being incurred by a well-endowed charity which used land as part of its investment portfolio, items of capital expenditure on buildings should be considered in relation to the overall management of the charity's investment portfolio whether land or investments or both.*
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> *The Commissioners saw no reason in principle why capital gained in one area should not be used to erect or improve buildings on investment land belonging to a charity if overall there was demonstrably no capital loss to the charity. In agreeing to dispense with recoupment it would be for the trustees to put a case to the Commissioners showing that there would be no overall loss suffered by the charity*".

The Minute was somewhat delphic. In particular, it was unclear how one was to set about determining whether an investment portfolio had increased in value by the required amount. Did one simply compare current value with historic cost which, for long-held investment land, may be very low indeed? That question now becomes academic, since the Commission's policy has recently moved on.

The Commission have explained that the use of permanent endowment in the improvement or development of investment property is now regarded generally as a change of investment, rather than as expenditure. Whether such a change of investment is justifiable will depend on the circumstances of the charity's investment portfolio as a whole, and specifically on whether the relevant duties with regard to investment by trustees, at common law and in the Trustee Act 2000, have been properly discharged. Trustees therefore need to show that the change of investment is justified in accordance with the usual trustee investment duties, which, of course, include the duty to maintain overall fairness between the present and future beneficiaries. The Commission regards as an important factor in this justification the relationship between the enhancement in the capital/income values of the building which is being improved, and the capital/income values of the investment(s) which is/are being realised to fund the improvement.

Private trust law, on what works constitute repairs chargeable to income or to capital, is not regarded by the Commission as the prime determinant in this context. Of overriding importance is the evaluation of the likely investment return from the application of funds. Indeed, in some cases the Commission are prepared to permit expenditure from permanent endowment on work which would be regarded, for private law purposes, as expenditure chargeable against income. For instance, the financing of repairs would not usually be justifiable as an investment of capital although there may be circumstances in which the Commission might be prepared to consider this – eg where the work enhances the capital value and investment return.

Functional Land

The Commission's views, with regard to improvements to functional land, are contained in a *Board Minute of 1987*, and this continues to apply.[2] As will be seen, the circumstances in which the Commission will permit expenditure without recoupment are somewhat limited.

In the Minute the Commission explain why different approaches are adopted in the treatment of improvement costs of investment land and functional land, emphasising that work on improvements to functional land "may not" increase the value if sold. In correspondence with the author, the Commission have elaborated on this, noting that expenditure of investment capital on functional land cannot be regarded as a change of investment. Investment is not the purpose, and the fact that the improved functional land and buildings might ultimately be sold at a profit does not change this. Such expenditure is regarded as an application directly for the purposes of the charity, and essentially anticipates future income available for

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2 The Minute is set out in full (with the Commission's consent) in the Appendix to this article.

spending on the furtherance of the charity's purposes. Such expenditure must therefore normally be replaced out of future income. The Commission are however prepared to make an exception in the case of funds used in the purchase of freehold land, on the basis that that can always be expected to retain its real value.

The Commission's view is not wholly convincing. Although functional land is non-income producing, it is possible to categorise it as an investment, conferring a form of income benefit on the charity. As the charity enjoys rent-free accommodation, its income available for charitable purposes is accordingly greater than would be the case if it did not own the functional land. Whilst funds expended on improvement costs cease to be available to generate investment income, they will enhance the opportunity cost of the building. The Commission's view focuses only upon one-half of the equation – the loss of future income – and ignores the other – the increased income enjoyed by virtue of rent-free accommodation.

Management Costs

The Commission applies private trust law, in determining whether management costs can be charged against capital. In *Carver v Duncan* [1985] 2 All ER 645, the House of Lords held that "The general rule is that income must bear all ordinary outgoings of a recurrent nature, such as rates and taxes, and interest on charges and incumbrances. Capital must bear all costs, charges and expenses incurred for the benefit of the whole estate". And the SORP, at Appendix 3, paragraph 3(c) echoes *Carver v Duncan*:

> "*Any expenses incurred in the administration, or protection of endowment investments should be charged to capital*".

Whilst the rule in *Carver v Duncan* is easily stated, its application is not free from difficulty. Many types of expenditure might seem to satisfy the criteria of being both ordinary outgoings (income) and for the benefit of the whole estate (capital). What, for example, is the status of an annual fee paid to investment advisors? In *Carver v Duncan* it was held that such expenditure is not an "ordinary outgoing" and therefore should be charged against capital. In so deciding, the House of Lords seemed to be following *In Re Bennett* [1896] 1 Ch 778, where it was held that "By an 'outgoing' is generally meant some payment which must be made to secure the income of the property". In *Re Bennett* capital was ordered to pay the expenses of the yearly audit.

In practice, many trustees intuitively charge most management costs against income, since they have the feel of being revenue outgoings. However, as will be clear from the above, many such costs are of a capital nature[3].

The Charities Bill

The Charities Bill includes provisions (clause 42 in the Bill as amended in Committee in the House of Lords on 12 July 2005), substantially broadening the scope of the existing power, contained in section 75 Charities Act 1993, to spend capital of an endowment fund. In particular, new section 75A will introduce a power capable of being exercised by trustees of larger unincorporated charities (charities with a gross income exceeding £1,000 and an endowment fund with a market value exceeding £10,000). The principal conditions to be satisfied, before trustees will be capable of exercising the power, are that:

- The trustees must satisfy themselves that "the purposes set out in the trusts to which the fund is subject could be carried out more effectively if the capital of the fund, or the relevant portion of the capital, could be expended as well as income accruing to it, rather than just such income", and

- The Commission must be satisfied that this will accord with the spirit of the gift of the capital to the charity. In reaching a decision the Commission will need also to take into account a statement from the trustees, providing reasons for the expenditure of capital, and also any evidence available as to the wishes of the donor, and any changes in circumstances relating to the charity since the making of the gift.

Trustees may take the view that section 75A, when enacted, will render academic questions of whether expenditure should be paid out of capital. That view would seem misguided, for two reasons. Firstly, trustees have a duty properly to allocate expenditure between capital and income. Secondly, where trustees incur expenditure properly chargeable against capital, it would seem somewhat incongruous for them also to invoke the section 75A procedure, seeking the Commission's concurrence to the proposed allocation.

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3 For a discussion on the allocation of general costs incident to administration, see *Underhill & Hayton: Law of Trust and Trustees* (15th Edition Butterworths) at p. 544.

Conclusion

It is hoped that this article will help to lift some of the apparent obscurity concerning the Commission's practice regarding the application of permanent endowment. And further clarification can be expected, as an Operational Guidance note is presently being drafted by the Commission, on the use of permanent endowment, which they hope will be available very shortly. In this context the Commission has said that it wishes its practice and policy on the use of permanent endowment to be as open and transparent as possible, and they welcome discussion on these and their legal basis.

Finally, my thanks to the legal department at the Commission for their helpful input to this article.

Appendix: Charity Commission Board Minutes of 1987

"33. **Recoupment policy: improvements to functional land**

33.1 At their meeting of 11 November 1986 the Commissioners reaffirmed their basic policy that before any expenditure of permanent endowment can be sanctioned, some provision for its recoupment out of future income must be made. Where, however, expenditure on investment property was being incurred by a well endowed charity which held land as part of its investment portfolio, such expenditure should be considered in relation to the overall management of the charity's investment portfolio and that expenditure could be offset by capital appreciation on other property forming part of the charity's portfolio, thus dispensing with the need for recoupment in each individual case of expenditure. The Commissioners also agreed that policy on recoupment in respect of functional property should be developed in light of experience.

33.2 With a view to developing such a policy a case had been referred to the Commissioners where the cost of improvements to functional land had been defrayed out of permanent endowment funds and it was suggested that recoupment might not be necessary. The Commissioners confirmed their view that there is a distinction between new building and improvements to buildings on land held as permanent endowment to produce an income and such building work on land appropriated for use in specie in carrying out the purposes of the charity. In the former case the building work would only be in the interests of the charity if it increased the value of the property as an investment, either by way of capital appreciation or increased income. But where the land is used for the purposes of the charity justifiable building work may not increase the value which would be realised if the premises were sold, or at least by an amount approaching the total cost incurred. Work which could properly be regarded as representing improvements for one purpose might not be an improvement for some other use of the building which might be permitted under the planning laws and might even lead to a diminution of the value of the property. It did not therefore follow that the expenditure of funds on new building or improvement work in relation to functional land would lead to a proportionate, or even any, increase in capital value.

33.3 The Commissioners were now asked whether in cases where capital expenditure to maintain a charity's functional property is essential if the charity is to survive and the charity has insufficient resources to fund it either by expenditure with recoupment or by raising a loan, the Commissioners would be prepared to sanction the expenditure of capital on these terms with a view to preserving the charity.

33.4 *Re Willenhall Chapel* [1865] 2 DR and SM467 and *Andrews v MacGuffog* [1886] 11

Appeal cases 313 indicated that there is no absolute and invariable rule that recoupment must always be a precondition to the expenditure of capital. Nevertheless the cases showed clearly that while the courts have power to permit the expenditure of capital without recoupment they would be prepared to do so only in very exceptional circumstances and that normally they would require such sums to be replaced.

Nevertheless, the court did not appear to exclude the possibility that if the expenditure of capital without recoupment was the only way in which a trust could be executed, then such expenditure might be sanctioned. Accordingly, it seemed that the courts would take the view that, if an expenditure of capital without recoupment was the only way in which the charity could be preserved according to its existing trusts, then this might in exceptional cases be permitted.

33.5 *The Commissioners agreed* that if no other funds could be found for the maintenance and preservation of its land and building recoupment of the permanent endowment expended to ensure the continuation of the charity's ability to pursue its purposes through the use of its functional property, need not be necessary provided that

a) there was clear evidence (and not merely an optimistic hope) that there was a need for the property to be retained on its existing trusts, in other words that the charity met and fulfilled the definite need;

b) trustees had clearly demonstrated that other forms of funding, for instance by a loan, were not feasible;

c) the trustees had demonstrated that recoupment (whether by setting aside other investments or by accumulating income) was not viable;

d) that expenditure would be on work of long lasting rather than transitory benefit and was essential to the continued use of the property;

e) the buildings had a long life expectancy, say in excess of 100 years; and

f) trustees could demonstrate that they would make *certain* provision out of future income for the future repairs and maintenance of the property.

33.6 The Commissioners did not expect that many charities would be able to satisfy all these conditions and in some cases relaxation of the fourth and fifth criteria might be necessary. Any cases where authority to expend permanent endowment is sought and the criteria laid down apply should until further notice be referred to the Board."