The Charity Law & Practice Review

PERMANENT ENDOWMENT AND TOTAL RETURN

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The Charity Commission have recently added to the operational guidance on their website a section entitled "Endowed Charities: a total return approach to investment".

In this operational guidance the Charity Commission offer to grant to permanently endowed charities an order authorising them to apply part of the capital growth in their endowments to income purposes, thus enabling such charities to adopt a total return strategy in their investment policy.

Questions might no doubt be asked about the formula which the Charity Commission propose to adopt in such orders to calculate the amount of such capital growth which should be expended; for example, there is no obvious mechanism to ensure that inflation is taken into account in applying the formula. Such issues, however, are outside the scope of this article.

What this article is intending to explore is whether or not the Charity Commission have the power which they claim to use to issue such orders in the first place.

To recap, the problem is as follows. Where, in giving an endowment to a charity, a donor has stipulated that the trustees may spend only the income and not the capital on the charity's objects, then the trustees are holding that endowment on special trusts which enable them only to expend the income. In the past this has not presented any major problem, but with modern investment policies focussing more on the concept of total return (i.e. that investments should be targeted to produce a return regardless of whether that was in the form of income or capital growth), this clearly became more of an issue. When one adds

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to that the loss of the charity's ability to recover the corporation tax credit attributed to dividends paid out to it, thus in effect reducing the value of their investment income by a quarter, the problem became even more acute. The result was that charities with permanent endowment found themselves adopting an investment policy dictated by the constraints of their trust instrument rather than the advice they were receiving as to the appropriate investment policy for them.

This is clearly an undesirable state of affairs and there can be no doubt that the law does need to be changed so that such charities will be in a position to apply part of the capital growth which they receive as income. The Law Commission is currently considering the question as part of its review of the law relating to apportionment and hopefully primary legislation will follow the completion of the Law Commission's review.

The Charity Commission, however, have adopted the view that they need not await such primary legislation. The operational guidance which they have issued also confuses the question still further in two respects.

First, it does not distinguish very clearly between, on the one hand, charities which have an endowment the income from which they use to fund annual grant-making activities, but where they are, if they so wish, free to spend the capital as well as the income in the making of grants and, on the other hand, charities whose endowment is permanent endowment where they are not so free because of the trusts imposed by the donor at the time the endowment was given to the charity. This is clearly an important distinction since charities with an endowment which is not permanent endowment (i.e. not subject to such a restriction) have always been at liberty to adopt a total return policy.

The second confusion contained in the operational guidance is the statement that trustees of charities which have endowments are under a duty to be even-handed in the way they treat current and future beneficiaries. By this the Charity Commission mean that they must be careful to ensure that they do not prejudice the position of future beneficiaries as a result of their treatment of current beneficiaries. This is a fallacy. The rule is certainly true in the case of private trusts where the trustees are under a duty to balance the interests of the income beneficiaries with the interests of the ultimate beneficiaries of the capital. This principle does not, however, apply to charities. If the trustees are not under any trust obligation to retain their capital then, if they see fit, and, in their absolute discretion, they think that it is the best way of furthering the charities' objects to spend all their capital in one year and they are not being capricious, there is no legal reason why they should not do so. The duty of even-handedness applies to charities only as a result of the rules relating to permanent endowment. For the

Charity Commission's guidance to treat the two as separate principles is therefore misleading.

These issues are not, however, fundamental to the question of whether or not the Charity Commission are correct in taking the view that they have the power to make orders authorising trustees to adopt a total return investment policy.

Their proposal is to make such orders under the authority of section 26 of the Charities Act 1993.

Section 26 is the statutory authority that empowers the Commission to sanction, by order, activity by the charity trustees in the administration of the charity which they would otherwise not have the power to carry out. On the face of it, therefore, it would appear that this section would be sufficient authority for the Charity Commission to make the orders they are proposing. The power contained in section 26, however, is limited by the provisions of sub-section (5) of section 26. This states that no order can authorise the doing of any act that is:

- expressly prohibited by Act of Parliament (other than certain disabling Acts); or

- expressly prohibited by the trusts of the charity; or

- to expand or alter the purposes of the charity.

The expenditure of permanent endowment is not expressly prohibited by Act of Parliament nor would it constitute an extension or alteration to the purposes of the charity which are its stated objects. It is submitted, however, that a total return investment policy is "expressly prohibited by the trusts of the charity" when those trusts include the constitution of a permanent endowment.

It is, of course, difficult to construe this phrase in the context of permanent endowment. Some permanent endowment might arise by virtue of the expression in the trust deed of a prohibition ("you shall not spend capital"). On the other hand permanent endowment more often arises by virtue of the trustees being given a power to spend income only.

"Express prohibition" in this context, however, does not need to be an active statement. In considering the term "expressly prohibited" one cannot ignore ellipsis on the part of the trust draftsman. Simply because the trust, as drafted, only states that income only is expendable does not mean that "capital must not be spent as income" is not both necessarily and properly implied, and what is necessarily and properly implied in this context should be taken to be expressed.

One has to look for the overall meaning - a view supported by *Bennion on Statutory Interpretation.* Otherwise, given the means by which a permanent endowment arises, this could create a very arbitrary distinction and one which has never been suggested by commentators on the issues arising in connection with permanent endowment.

Indeed, the Charity Commission fully accept that the power given to them by section 26 is limited to a power to make orders affecting the administration of the charity. They take the view, however, that the orders they are proposing to give are in fact administrative in nature rather than affecting the trusts of the charity.

The reasoning is as follows:

Income and capital are simply expressions which currently are used to distinguish between that part of the charity's assets to which the permanent endowment trusts apply (the capital) and that part of the charity's assets which are distributable in furtherance of the charity's objects (the income). What the Commission have done is to use new terms for income and capital. In their operational guidance they refer to assets "allocated to the trust for application (income)" and assets "allocated to the trusts for investment (capital)". They then say that it is an administrative matter to decide which part of the return which a charity receives annually on its investments should be allocated to which trust. Consequently they feel that it is an administrative matter for them to authorise a charity to allocate to the "trust for application" part of the return more properly allocated to the "trust for investment". Notwithstanding this, they do feel able to say in the operational guidance: "The power does **not** authorise the expenditure of the charity's investment fund." It is rather difficult to see what else a proposed order would be doing.

However it is dressed up, the fact is that once trustees are operating under the power given to them by an order as proposed, part of what they will be spending as income will be capital. That, of course, is precisely what a permanent endowment trust forbids.

This is something which even the court will not do. There are, as far as we are aware, only three authorities which tend to be quoted as support for the proposition that the court has the power to authorise the expenditure of the capital of the permanent endowment fund as income. Each of these is quite particular to its own facts and the latest of them was heard in 1900. The cases are *Andrews v M'Guffog* [1886] 11 AC 313; *Re Willenhall Chapel Estates* [1865] 2 Dr & Sm 467; and *AG v Day* [1900] 1 Ch 31.

In the case of *Andrews v M'Guffog* the relevant charity trustees spent some capital as income in order to build a school to the specification required by the testator which proved to be far more costly than the £500 provided for the purpose. In these circumstances, the House of Lords found it proper to distinguish between the charity intended to be created, and the means by which that purpose was directed to be accomplished. The question of whether recoupment out of future income was necessary was remitted back to the Court of Session.

In the case of *Re Willenhall Chapel Estates*, the Court allowed part of the capital fund set aside to maintain an incumbent to be used to repair the chapel in which he carried out his duties and which also formed part of the property of the charity. The Vice-Chancellor expressly distinguished in his judgment between the normal situation of a charity with "a numerous and indefinite class of objects" where recoupment would be the proper course, and this particular case in which the incumbent was the sole beneficiary of the income and was willing to give that income up.

The last case, *AG v Day*, only seems to be authority for the possibility of the court being able to order costs to be met out of the capital of a permanent endowment fund, where an order to pay out of accumulated income would prejudice the persons entitled to the costs.

If any general principles can be derived from the above cases, they seem to be that the Court does have the capacity to authorise the expenditure of capital out of a permanent endowment fund as income, but that it will only do so in quite particular circumstances (or what the fourth edition of Tudor describes as "a proper case"). At best, the Commission would need to decide how peculiar circumstances needed to be before they could rely upon these authorities, none of which draw a clear line.

It certainly, therefore, is not open to the Charity Commission unilaterally to redefine what constitutes capital and what constitutes income, and inventing new terminology to describe capital and income does not in any way alter that position.

It may be (and undoubtedly is) the case that the law needs to be changed. However, currently the law is very clear as to what is income and what is capital. Where the trusts of a charity preclude the spending of capital (i.e. where there is a permanent endowment) there is little doubt as to which part of the charity's return it is authorised to spend.

Permanent endowment trusts exclude an ability to spend capital.

To use section 26 to authorise the spending of capital is to seek to use section 26 to authorise the alteration of the trusts of the charity. This is expressly beyond the scope of section 26.

What the Charity Commission will be doing in issuing these orders, therefore, is to authorise trustees to act in breach of trust. From the point of view of trustees who do so, section 26(1), which says expressly that anything done under the authority of a section 26 order shall be deemed to be properly done, will protect them from personal liability. (Although there is an argument which suggests that trustees should be chary of relying on this in the case of an order only purporting to be made under section 26 and in fact outside the authority given to the Charity Commission by that section.)

The difficulty about trustees acting in accordance with such an order is that eventually a case will arise when the matter will come before the courts. Unless there has by then been a change in the law the courts might well find that this application of capital was in breach of trust and it will then be necessary for that capital to be replaced. Since the trustees will probably not be called upon to replace it from their own personal assets the only way in which capital can be replaced in these circumstances would be from accumulation of income.

This clearly would have a major impact on the charity's ability then to carry out its objects. Were the Charity Commission right in their belief that there is a duty of even-handedness, a need to apply ongoing income to replace previous income overspent would clearly be a breach of such a duty. The consequences of having to put right such a situation would be complex and contrary to the interests of the charity. It is to be hoped, therefore, that the Charity Commission's announcement will, at the very least, provide a major incentive to the Law Commission to complete its review of the law as fast as it can.