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ENDOWED CHARITIES: A TOTAL RETURN APPROACH TO INVESTMENT?

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In June 2001 the Charity Commission published on its website guidance about the policy which it will follow when receiving requests from trustees of endowed charities for authority to adopt a total return approach to investment.

The Commission's understanding is that, under the general law, the trustees of endowed charities are subject to the same trust law rules concerning the analysis of investment returns between income and capital as are the trustees of private trusts in which there are distinct income and capital interests.

Under these rules, rents, interest payments, and cash dividends, for example, are invariably categorised as "income". These would, in the case of a private trust, belong to the life-tenant, and in the case of a charity they are subject to a trust for application for its purposes. Gains on the disposal or revaluation of assets, and payments in a corporate liquidation, for example, are invariably categorised as "capital". These are subject to a trust for investment, in which, in the case of a private trust, the remainderman would have an interest. The corresponding future interest in the case of a charity is the interest of the future beneficiaries of the trust for application for the purposes of the charity.

The Commission's proposals for providing a more flexible framework for the allocation of investment returns of endowed charities are, of course, based on the premise that the trust law rules do, in fact, apply to endowed charities. Although the decided cases in which the trust law rules have evolved all concern private trusts, there seemed no reason why different rules should apply to the allocation of investment returns belonging to endowed charities. As mentioned above, there are distinct present and future interests in both types of trust. This has certainly been held to be the position in some cases in the USA.

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The trust law rules are, of course, intended to ensure a fair balance between income and capital interests. But they have come in for considerable judicial and academic criticism in recent years for their inflexibility, and in particular for their inability to accommodate recent tax-driven changes in the structure of corporate investment returns. Far from supporting the aim of achieving even-handedness between present and future interests in a trust, the trust law rules are often now seen as standing in the way of it. Many trustees of endowed charities complain that they are forced into making sub-optimal investment decisions simply in order to obtain, in accordance with the trust law rules, the balance of income and capital investment returns which meets the present and future needs of the particular charity.

A more flexible system for the analysis of investment returns between capital and income has been on the law reform agenda for many years. But no reform has, in fact, taken place. This does not, of course, prevent those setting up new endowed charities from prescribing a more flexible framework. Should existing endowed charities have to wait for law reform?

Some commentators appear to have taken the view that the adoption of the Commission's policy would involve authorising charity trustees to re-allocate property which is subject to a trust for investment to a trust for application, and/or to re-allocate property which is subject to a trust for application to a trust for investment. They have questioned whether it is, in fact, within the powers of the Court and the Commission to do this.

The basis of these doubts does not seem entirely clear. For example, in *Re J W Laing Trust* [1984] Ch 143, the judge set aside a direction of the settlor which required the distribution of the funds belonging to the charity within a particular time. Effectively he re-allocated property which was, under the trusts of the charity, subject to a binding trust for application for its purposes. He did so, of course, on the basis of the view that it was expedient in the interests of that charity, but there was no underlying *vires* objection.

But, in any case, this is not the real issue. The real issue is the logically anterior one about the basis upon which investment returns are to be analysed between capital and income interests in the first place.

There seems to be no English authority on the point, but there are decided cases in the USA where charities have been authorised by the courts to allocate to "income" investment returns which would otherwise be categorised as "capital". The issue has arisen in the USA in the context of the pressure exerted on the trustees of endowed charities by USA tax law each year to apply for the purposes of the charity a specified proportion of the value of the assets subject to the trust for investment. What happens if there is insufficient "income" to enable this to happen?

One example is *Davison v Duke University* (1973) 194 (2nd Series) South Eastern Reporter 761, a decision of the North Carolina Supreme Court. In that case the Court authorised the trustees of an endowed charity to treat some trust assets which, according to the standard rules for analysing investment returns between capital and income, would be regarded as being subject to the trust for investment, as if they were income applicable for the purposes of the charity. The limit of the trustees' discretion was defined by the Court by reference to the need to avoid the tax hit. Whilst this particular issue does not, of course, arise in the UK, the case shows the Court's willingness to modify the normal allocation rules in a case where those rules would have worked to the charity's disadvantage.

This strongly suggests that there is no underlying *vires* objection to the Court and the Commission giving the trustees of endowed charities the authority to adopt a different system for the analysis of investment returns from that prescribed by the rules of trust law. The Court and the Commission have the *power*: the condition for *exercising* the power is that the greater flexibility in the allocation of investment returns should be perceived to be expedient in the interests of the charity.

The way in which the Commission proposes to use its statutory powers in the total return context has been described in detail in the published guidance. But, in essence, what it will be authorising the trustees of endowed charities to do is to substitute for the system directed by the rules of trust law a discretionary power of allocating investment returns between the trust for investment and the trust for application. The discretion will, however, be regulated by an overriding duty of care modelled on that in the Trustee Act 2000, coupled with duties to balance present and future interests in the charity, to take appropriate professional advice when exercising the power, to make appropriate accounting disclosures and so on. There is no suggestion that the concept of an endowed charity is being undermined.

Normally, the Commission will be relying on section 26 Charities Act 1993 to confer the authority on trustees. This enables it to sanction any action, whether or not it would otherwise be within the powers exercisable by the charity trustees in the administration of the charity, if it appears that the action is expedient in the interests of the charity.

The power in section 26 cannot be used to authorise any act expressly prohibited by Act of Parliament or by the trusts of the charity. But the trust law rules from which departure is being authorised have evolved from decided cases: they have not been given legislative expression in any Act of Parliament. Nor is there anything in those decided cases which suggests that the trust law rules operate otherwise than by default: it follows that only in the rare case where the rules are explicitly written into the trusts of the charity can they be said to amount to an "express prohibition" against the adoption of some different system for analysing investment returns between the trust for investment and the trust for application.

Neither can the power in section 26 be used to extend or alter the "purposes" of the charity. What is meant by "purposes" in this context? The provision which has become section 26 of the 1993 Act is in substance a re-enactment of section 23 Charities Act 1960. It was new at that time, although it was intended to replace a range of more specific Commission authorisation provisions which had appeared in earlier legislation.

Early drafts of the 1960 bill contained a specific reference to the charity's objects in the prohibitory provision which, as enacted, simply refers to an alteration or extension of the charity's purposes. It is not entirely clear why this reference was dropped. But in view of the way in which the legislation distinguishes between "purposes" and "administration" - for example in the definition of "trusts" in section 97(1) of the 1993 Act - it seems that it was dropped because it was considered to be tautologous. At any rate, there was an amendment proposed at Commons Committee stage which would have had the effect of re-introducing a specific reference to objects in the prohibitory provision. This was resisted by the government, on the basis that it would duplicate the provision which prohibited the use of the power to authorise transactions which involved an alteration or extension of the charity's "purposes".

All this suggests that "purposes" has a meaning which is akin to "objects". The machinery for determining the analysis of the investment returns of a charity between income and capital does not seem to be an aspect of its objects, and this perception is supported by the case of *Re J W Laing Trust* (supra). If the release of resources subject to a trust for application from that trust does not involve an alteration to the "purposes" of the charity - as the judge decided in the *Laing* case - then a fortiori authorising a more flexible system of analysing investment returns between the trust for investment and the trust for application does not involve such an extension or alteration.

The Commission will not pressurise the trustees of endowed charities to apply for authority to adopt the total return approach to investment. Nor will it lose sight of the requirement to satisfy itself that it is expedient in the interests of the charity that its trustees should have this authority. But, in the Commission's view, there is no underlying *vires* objection to the use of the power in section 26 in the manner described above. Any applications for authority will be treated on their own merits.