Legal Implications of Impact Investing – By Miller Thomson LLP

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We see many foundations that are unclear about the legal implications of impact investing. Some of the questions we hear most often are:

- *"Is impact investing consistent with our board's fiduciary duties?"*
- *"Does impact investing meet the prudent investor standard?"*
- *"Will impact investing affect our status as a registered charity?"*

A number of myths have led foundations to believe that they either cannot do any impact investing, or they face great legal risk in doing so.

We will address these questions and myths in this section. The bottom line: the legal environment in which charities and foundations conduct impact investing is not nearly as restrictive as is often believed. Charities have considerable scope to invest for impact as a way of furthering their charitable mandate.

The term 'impact investing' is used in reference to a spectrum of investments. At one end of this spectrum are 'mission' investments, which are likely to be traditional investments in a stock market or another market, but are invested to target an issue that can be tied to the charity's mission. Impact investments then move along a spectrum where the financial returns reduce and the risk increases. At the far end of the spectrum is a 'grant' to a charitable project; this would generally not be considered an investment, although some grants are referenced as such.

For the purposes of this discussion our comments are directed at investments in the middle of the spectrum. These are not considered traditional investments, but they are not grants. In the middle of the spectrum we discuss investments that can continue to fit as 'assets under investment', albeit sometimes with a higher impact, risk or lower possible return. We also discuss program related investments — i.e., those that are closer to a grant than a prudent investment.

A foundation's board has a fiduciary obligation to act in the best interests of the charity at all times when making decisions regarding the investment of charitable property. This includes ensuring that the foundation complies with its legal obligations under the *Income Tax Act* and provincial law. Within these rules, and considering any donor-imposed restrictions that may apply to any of the foundation's property, the board can decide how to best use the foundation's property to further its mission.

A decision to invest a portion of the foundation's portfolio for impact is entirely consistent with the board's fiduciary duties to the charity. An investment that has the potential to further the foundation's purposes directly constitutes one of many ways that the board can deploy its assets. If after considering different options, conducting appropriate due diligence on any prospective impact investment, and addressing any associated risks, the board concludes that an impact investment will be an effective means of achieving the foundation's purposes, the board will have met its fiduciary duty in proceeding with the investment.

What legal rules apply to impact investing?

Foundations (assuming that they are registered charities) are subject to two broad sources of legal rules that are relevant to impact investing:

- Provincial trust law, which prescribes a ‘prudent investor standard’ that applies generally to the investment of charitable funds; and

- Federal tax law, which applies to registered charities and sets rules around when charities can grant and invest funds in other entities — in particular when those entities are not ‘qualified donees’ under the *Income Tax Act* (ITA).

(a) Provincial Law

Under the *Trustee Act* in most Canadian provinces, or the *Civil Code of Quebec*, charities are generally required to meet a ‘prudent investor standard’ in investing charitable property. In Ontario, for example, the *Trustee Act* provides that a trustee, when investing trust property, must “exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments.” Provincial trust law in other provinces imposes a similar standard.

This standard is generally interpreted as requiring a charity to invest, with a view to generating a reasonable financial return on investment, while balancing appropriately against risk of loss. Some statutes prescribe specific factors that must be considered in making investments.

This standard does not prevent a foundation from including impact investments as part of an overall investment portfolio. It is important to remember that the prudent investor standard is applied to the portfolio as a whole and does not look at individual investments in isolation. This is consistent with the ‘portfolio theory’ of investment, which is based on the assumption that a diversified portfolio carries less risk than an undiversified portfolio, and that there will be different investments within a portfolio with different balances of risk and expected return. It is possible to devote a portion of a balanced portfolio to impact investments that are anticipated to generate a lower financial return or carry greater risk than other more conventional investments. Also, many impact investments generate financial returns that are comparable to or better than traditional investments. Impact investing does not always involve sacrificing financial returns in favour of social impact.

Impact investments that are expected to generate lower financial returns and/or involve greater risk are consistent with a broader understanding of prudent investing in a balanced portfolio. A foundation can take account of the fact that an investment will further its charitable purposes directly and choose to invest on this basis, even if it may lower the financial return generated by the overall portfolio. While the board of a foundation must consider the foundation’s need for ongoing financial returns from its investments, this does not prevent the board from accepting some trade-offs in favour of investments that will directly further a charitable purpose.

There are a few factors under provincial law to bear in mind when making impact investments:

- *Donor restrictions on funds*. Foundations should keep in mind any donor restrictions that may apply to funds that are being used for impact investing. These restrictions may impose limits on the types of investment that can be made. They may also direct the foundation to hold and preserve the funds on a long-term or permanent basis, which may affect the amount of financial risk that the foundation accepts from impact investments within an overall portfolio.

- *Governing documents*. Foundations should also review their governing documents (i.e., letters patent, articles of incorporation, trust deed) to determine whether they contain any provisions that add further restrictions or flexibility with respect to investments. In some cases, it may be appropriate to update the provisions in the founding document to ensure that they accommodate impact investing. In many cases, the existing powers will provide considerable scope to invest for impact.

- *Corporate legislation.* Foundations that are incorporated should also review their governing corporate legislation for any provisions affecting the foundation's investment powers. While corporate legislation is often silent with respect to investments, foundations should nonetheless confirm whether anything in their incorporating statute speaks to the issue and is relevant to a proposed impact investment.

Provincial trust law generally provides foundations with considerable scope to consider impact investments as part of the overall makeup of a balanced portfolio. Provided that the portfolio as a whole is appropriately balanced and diversified to meet the foundation's current and future financial needs, foundations can include impact investments that carry greater risk or lower prospective return within that portfolio.

(b) Tax compliance issues

Foundations are also subject to rules under the ITA related to their status as registered charities. To maintain their status as a registered charity and the benefits that come with it, including the ability to issue official donation receipts, charities must abide by the rules in the ITA.

(i) Structure of investments — Qualified donees vs. Non-qualified donees

The ITA makes a distinction between 'qualified donees' and 'non-qualified donees' that is very important when analysing a charity's ability to make an impact investment. The category of 'qualified donee' includes: other Canadian registered charities, RCAAAs, Canadian federal, provincial and territorial governments, registered Canadian municipalities, as well as certain bodies outside Canada that are registered with the Canada Revenue Agency (CRA). A registered charity is only permitted to make a gift to an entity that is a qualified donee. Making a gift to a non-qualified donee is grounds for penalties under the ITA, potentially including revocation of charitable registration.

When reviewing impact investments, the CRA has stated that a charity can only make investments on 'below market' terms under two circumstances: (i) where the investee is a qualified donee, or (ii) where the investment is structured as a 'program-related investment' (PRI). The CRA has taken the position that a below market investment in a non-qualified donee that is not structured as a PRI may amount to a full or partial *de facto* gift to a non-qualified donee.

This means that the identity of the investee is relevant when assessing tax compliance issues associated with an investment. Where the investee is a qualified donee, the charity can invest on any terms that it sees fit, including by accepting lower rates of return and/or greater risk. Where the investee is not a qualified donee, the charity must be ready to satisfy the CRA that the investment constitutes either a market rate investment or a PRI.

Where the investment is 'market rate' (a concept discussed below) a charity can make the investment and be comfortable that the investment will not be viewed as a full or partial gift to a non-qualified donee. Where the investment is to be made on below-market terms and does not fit within the prudent portfolio, the investment must be structured as a PRI. This means the investment must be made pursuant to an agreement that sets out specific instructions for how the investment is to be used by the investee on charitable activities, and which provides for ongoing direction and control by the charity over the use of the investment (including ongoing reporting and accountability from the investee). As such, the PRI approach is more administratively onerous than a typical investment.

This leads to a natural question: *what is a 'market rate' investment?* The CRA does not define this explicitly, but some information can be gleaned from its published guidance. The CRA appears to focus on the rate of expected return from an investment using T-bills or GICs as a benchmark. Where an expected rate of return from an investment is equal to or greater than current rates available from T-bills or GICs, it appears that the CRA will accept this as a 'market rate' investment. This gives charities considerable scope under the ITA to make impact investments — which often have rates of return that are equal to or greater than prevailing T-bill or GIC rates — without needing to structure the investment as a PRI.

(ii) Disbursement quota

Under the ITA, registered charities are required to meet an annual disbursement quota (DQ). This is a minimum amount that a charity must spend each year on charitable activities or gifts to qualified donees. For public and private foundations, the ITA provides for a DQ calculated as 3.5% of the average value of the charity's property that is not used directly in charitable activities or administration during the preceding 24 months, to the extent that such property exceeds $25,000. For charitable organizations, the definition is the same but the threshold amount is $100,000.

The average value of a foundation's endowment funds and investment portfolio are included in the calculation of the DQ. Making an investment is not a disbursement and thus, although the charity may regard the investment as furthering its mission, the amount invested for impact cannot be included when satisfying the disbursement quota except if the investment is a PRI. Even when the investment is a PRI, the CRA is only prepared to recognize the 'opportunity cost' of a below-market investment structured as a PRI, or the full value of a PRI loan that has been written off as uncollectible as an expenditure on charitable activities. The opportunity cost is calculated as the difference between the amount the charity could have earned from investing in T-bills or GICs and the amount that the charity actually earned from the investment.

When making impact investment decisions, foundations should consider their DQ obligations and the need for income to satisfy this requirement. They need to be sure impact investments that will generate lower current income will not result in the foundation having insufficient funds with which to meet its annual DQ requirement.

(iii) Other compliance issues

Certain types of investments may engage other rules in the ITA, and foundations should be aware of them. This includes the following rules:

- Public foundations are prohibited from acquiring control of a corporation. As such, if an investment will result in the foundation acquiring for consideration greater than 50% of the voting shares of the corporation, it may be considered offside.

- Private foundations are subject to the so-called 'excess corporate holdings regime'. This is a divestment and reporting regime that applies to certain threshold holdings of any single class of shares in a particular corporation by a private foundation. Where a foundation holds in excess of 2% of the issued and outstanding shares of a particular class, it will be subject to monitoring requirements under the ITA. Where the foundation holds in excess of 20% of the shares of a particular class of a corporation, it will be required to divest itself of the shares within a set timeframe.

Charities are also subject to restrictions on business activities that are sometimes implicated by certain investments. Private foundations cannot carry out any type of business activity, while public foundations and charitable organizations can only carry out 'related businesses'. While holding and investing endowed or other funds does not generally result in a charity being considered to be carrying on a business activity, certain types of investments may have this effect. In particular, investments in limited partnerships have traditionally resulted in the investor charity being deemed to carry on the business of the limited partnership. This is due to a feature of the law of partnerships in which each partner (including limited partners investing passively) is considered to be carrying on the partnership business. As such, charities have generally avoided investments in limited partnerships.

The ITA was recently amended to include a relieving measure for charities investing through limited partnerships. The relieving measure is as follows:

> For investments in limited partnerships that are made or acquired after April 20, 2015, a registered charity will not be considered to be carrying on a business solely because it holds an interest in a partnership, as long as it meets <u>all of the following conditions</u>:
>
> - The liability of a charity as a member of a partnership is limited under any law governing the arrangement in respect of the partnership;
> - The charity, together with all non-arm's length entities, holds 20% or less of the fair market value of all interests in the limited partnership; and
> - The charity deals at arm's length with each general partner of the limited partnership.

Provided that a foundation abides by these restrictions, and is not otherwise involved in the activities of the partnership, it can invest in a limited partnership without being deemed to carry out the business of the partnership.

Conclusion

We hope that this summary has helped to clear up some of the myths associated with impact investing and its legal implications. While there are certainly issues of which foundations need to be aware, these are all manageable and should not prevent charities and foundations from putting their investment assets to work in achieving their mission beyond simply generating financial returns.