7 - Updated Legal Opinion

Since the Guidebook for Foundations and our primer on the Legal Implications of Impact Investing was released two years ago, there have been a few developments in the legal arena which impact how foundations can think about making impact investments. For the purposes of our comments, an impact investment is in the middle of the spectrum of investments – it is not a traditional investment and is not a grant.

There are two broad sources of legal rules that are relevant to foundations making impact investments: provincial trust law and federal tax law.

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In the words of Susan Manwaring and Sarah Fitzpatrick, Miller Thomson

Update to the legal opinion provided by Miller Thomson on page 21 of the of Impact Investing Guidebook for Foundations.

(a) Developments in Provincial Law

The general rule is that foundations are required under provincial law to meet a "prudent investor standard" when investing charitable property. Each province has its own legislation but generally the rules are similar. The prudent investor standard requires a charity to invest, with a view to generating a reasonable financial return on investment, while balancing appropriately against risk of loss. The standard is applied to the investment portfolio as a whole, not to individual investments. As such, there are no significant legal implications for foundations when they shift their impact investing approach from a "carve-off" strategy to a "total portfolio" approach. The same considerations continue to apply. Is the portfolio balanced? Is the portfolio diversified? Does the portfolio appropriately balance risk and expected return?

Since 2017, Ontario has become the first province to introduce specific rules aimed at facilitating impact investments. Under the Charities Accounting Act, a charity can make a social investment without having to consider whether the investment meets the prudent investor standard. A "social investment" is the use of charitable property in order to (a) directly further the purposes of the charity, and (b) achieve a financial return. The concept of "financial return" is defined broadly, referring to an outcome in respect of the property that is better in financial terms than expending all the property. In other words, an investment that generates any financial return to the charity, no matter how small, will be a "financial return".

Provided certain requirements are met (e.g., being satisfied that the investment is in its best interests and considering whether it needs to seek advice), a foundation is permitted to make a social investment, unless the charitable property used to make the investment is subject to a restriction on capital. If restricted, a foundation can still use the charitable property if the foundation expects that that the social investment will not contravene those restrictions.

The Charities Accounting Act amendments provide comfort to charities who are subject to Ontario jurisdiction that they can make social investments without needing to consider whether such investments fit within the traditional prudent investor standard.

(b) Tax Compliance Issues for a Total Portfolio Approach

The Income Tax Act (Canada) (the "ITA") regulates the status of foundations as registered charities. This regulation includes rules with respect to how foundations can use their property. Foundations that are registered charities can only make investments on 'below market' terms where: (i) the investee is a qualified donee (which includes other registered charities), or (ii) the investment is structured as a 'program-related investment' (PRI). A charity cannot make a below market investment in a non-qualified donee that is not structured as a PRI.

As discussed in the 2017 primer, while the Canada Revenue Agency ("CRA") does not explicitly define market rate investment, its published guidance suggests it uses the rate of expected return from T-bills or GICs as a benchmark.

If a foundation is applying impact investing across all of its asset classes, the T-bill or GIC rates of return may not be an appropriate indicator of a market rate investment for all of its asset classes. CRA uses T-bills and GICs as comparators for investments that are loans or share purchases. CRA's guidance suggests that if the investment is a lease, the benchmark would be the fair market value of the lease (the dollar value the foundation would get in an open and unrestricted market from a tenant). As such, the market rate of return that the impact investment is assessed against depends on the type of investment being made.

Conclusion

The most significant legal update for impact investing has been the creation of the Ontario social investment rules. While foundations that are regulated in other jurisdictions do not yet have similar rules aimed at facilitating social investment, they continue to have considerable scope for making impact investments under provincial and tax law.