Total return: a better use of your permanent endowment

Do you have funds or other assets in your charity which trustees are required to hold permanently and which, while they may be used to produce an income, cannot themselves be spent as income? If so, you have ‘permanent endowment’.

Up until recently, restrictive rules applied to the expenditure of gains from investments forming part of permanent endowment. These rules required that any capital gains (i.e. the growth in the value of the investment itself) should be retained and reinvested as capital (i.e. kept as part of the lump sum invested, rather than spent for the charity’s purposes). Only any income from the fund (for example by way of dividend) could be spent to further the charity’s purposes and support beneficiaries. This caused problems in situations where the income from the investment was in fact very low, while the value of that investment grew quite sharply. This meant that charities had less income to meet the current needs of beneficiaries, while the underlying capital sum continued to grow.

Historically, the only exceptions to this were:

1. Having a specific power in the charity’s governing document for trustees to exercise their judgement when allocating the returns of investment between capital and income; or

2. Obtaining a ‘section 105’ order from the Charity Commission. If the Charity Commission exercised this power it would give trustees power to allocate investment returns in a relatively flexible way. This came closer to a ‘total return’ investment power – namely, a power to allocate capital growth and income as trustees see fit – but there were still some restrictions.

In response to a Law Commission report on this matter, the Trusts (Capital and Income) Act 2013 was passed. This gave the Charity Commission power to make regulations allowing a total return approach to charity funds. Charity trustees can adopt these regulations in place of the restrictions which currently prevent a total return approach.

These regulations have now been published, along with detailed guidance, and are in force from 1 January 2014.

In order to take advantage of the regulations, a charity’s trustees will need to pass a total return resolution under s.104A(2) of the Charities Act 2011. Trustees will need to identify and record, at the time of that resolution, the value of the relevant permanent endowment and the value of any income from that fund which has not yet been applied to anything (the ‘unapplied total return’). The latter is calculated by totting up the total amount or lack of any interest, net rent and other income, dividends, and any capital gains (excluding from this total any investment income which has already been applied for the purposes of the charity). This will then be the ‘unapplied total return’ which trustees may allocate in accordance with the Charity Commission regulations. The remaining funds will be treated as the investment fund to be reinvested. Once these sums are fixed, they cannot subsequently be altered by the charity. Note that if there is more than one permanent endowment fund, the resolution can only apply to one fund at a time.

The unapplied total return may then be allocated between the income fund to further the charity's purposes, and the investment fund invested to produce a return.

The regulations also allow trustees to release some funds from the investment fund to be spent as income on the charity's purposes, provided that not more than 10% of the fund is released, and that this release is later recouped.

These powers will provide greater flexibility for charity trustees, who will now be able to decide how best to allocate income and capital growth in their permanent endowment in order to best benefit their current beneficiaries and the future ongoing charitable enterprise.

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