WeirFoulds LLP

Low Interest Rates Threatening an Income Trust? There is a Solution.

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A trustee appointed under a Will must follow strictly the directions given in the Will. However, where the administration of a trust has become impractical by virtue of superseding events, the courts in Ontario can allow an exception to this rule.

One such superseding event is low interest rates. It is an appropriate example given the prevailing environment.

Endowments for charities are often set up by a Will that stipulates the residue of an estate is to be set aside and invested, and the income used in perpetuity for a particular charitable purpose. But where little income is being generated, the charity suffers and the deceased's intentions will be thwarted. The courts of Ontario have permitted a trustee of a perpetual trust and its beneficiary charities to ignore a donor's express stipulation in a traditional income endowment, and to adopt the more modern investment model known as "total return".

Traditional Income Endowments

A trustee of a perpetual endowment for a charity has two primary goals: first, to maximize annual distributions to the charity so that it can carry out its charitable work; and second, to preserve the purchasing power of the assets of the trust so that the distributions can continue in perpetuity. Naturally, for either goal to be achieved, the assets of the trust must be invested.

The assets of a trust can be invested either in instruments that may increase in value, such as shares (equities), or instruments that mainly produce income, such as bonds. Historically, the law and the practice have been that if the perpetual endowment stipulates that the assets be set aside and invested and that only income can be paid out to the beneficiaries, the trustee must invest the assets sufficiently in income-producing instruments, even if these have effective rates of return lower than equity investments.

But the trustee must not invest too high a proportion of the assets for income. Because the language of the traditional income endowment forces the trustee to pay out all of the income generated, the trustee must also invest in instruments with potential for growth, so as to preserve the purchasing power of the assets.

Therefore, the traditional income endowment model forces trustees to invest in instruments that may not be generating the best overall rate of return. It also puts pressure on trustees to strike the right balance between the income and the capital growth generated by the investments. This balance can only be achieved by adjusting the asset mix.

The "Total Return" Model

The "total return" model does not compel the trustee to generate income or to pay out the income generated. On the contrary, it allows the trustee to concentrate on investing for the best overall return (just as a pension fund investor does), without having to make a decision about what portion of that return is income and what portion is capital growth. The amount distributed to beneficiaries is determined as a percentage of total value. The distribution rate should be variable, so that the trustee can accommodate the prevailing economic environment and the acceptable level of risk. By simply varying the percentage payout rate (as opposed to adjusting the asset mix), the trustee can attempt to ensure that the maximum amount possible is being distributed to carry out the donor's intentions and that, at the same time, enough is being retained to cover inflation so as to preserve the purchasing power of the corpus for the future.

The *Stillman* Decision

The Ontario court's decision in *Re Stillman Estate* is an example of where a trustee applied to court for help where the administration of a trust had become impractical.

Mrs. Stillman's Will, which was made in 1958, set up the traditional income endowment fund. It disposed of the residue of her substantial estate: "To set aside and keep invested the residue of my estate and to pay out of the annual net income derived therefrom . . . " to beneficiaries including two Ontario charities.

Because the trust was registered as a private charity under the *Income Tax Act*, it was required to disburse annually to the charities a stipulated minimum percentage of its total value. Over time the trust began to fail to meet this disbursement quota, and in addition, the value of its assets after inflation declined.

The Stillman trustee and the charities applied together to the court for approval of an agreement between them by which, among other things, they would substitute the "total return" model for the income endowment model set up in the Stillman Will.

The judge accepted that the only way the trust could meet its income tax disbursement quota would be to encroach on its capital, and this would increasingly erode its purchasing power, thereby frustrating Mrs. Stillman's intentions. He was also satisfied that the "total return" approach should enable the trustee to increase the overall return from the trust's investments and thereby protect the trust's purchasing power.

However, the judge was concerned about whether the court had the power to disregard the clear language of the deceased which stipulated that the capital was to be invested and only the income was to be distributed.

The judge decided the court did have this power because the administration of the trust, in accordance with Mrs. Stillman's directions, had become impractical.

Conclusion

The *Stillman* decision is authority for the narrow principle that where the assets of a perpetual charitable income endowment have lost real value and the trust has repeatedly failed to meet its income tax disbursement quota, then the endowment model can be replaced by the "total return" model. But it is also stands for the broader principle that where the administration of a trust has become impractical for any reason, the court has the power to permit the trustee to depart from the strict directions in a trust in order to realize the intentions behind its creation.

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