



**Law
Commission**
Reforming the law

Social Investment by Charities The Law Commission's Recommendations

Executive Summary

September 2014

THE LAW COMMISSION

SOCIAL INVESTMENT BY CHARITIES

THE LAW COMMISSION'S RECOMMENDATIONS

EXECUTIVE SUMMARY

INTRODUCTION

1. This paper summarises the Law Commission's recommendations concerning social investment by charities, following its formal consultation.¹ Our examination of social investment by charities forms part of a larger project in which we are considering a number of issues in charity law. The remaining issues will be the subject of a second consultation paper.

THE CURRENT LAW

2. Social investment is the use of funds to achieve both a financial return and a social good. We have been examining the ability of charities to make social investments.
3. The current law governing social investment by charities, in particular charity trustees' powers and duties, generally permits charities to make social investments. Nevertheless:
 - (1) while many charity trustees clearly have power to make social investments, in some cases there is uncertainty as to the adequacy of their powers;
 - (2) there is a misconception that charity trustees have a duty to maximise financial returns when making a social investment, and certain duties under the Trustee Act 2000 were not designed with social investment in mind; and
 - (3) there are misconceptions about the type of social investments that a charity can make, which may be making charity trustees over-cautious and may be discouraging social investment unnecessarily.

Most consultees thought the law was unsatisfactory, or at least agreed that it would benefit from clarification.

4. *Charities and Investment Matters: A guide for trustees* (CC14), published by the Charity Commission in October 2011, contains helpful guidance on social investment by charities. It is, however, guidance and not law, so cannot entirely overcome charity trustees' fears about their powers to make, and duties when making, social investments. In addition, many consultees thought that aspects of it were onerous, unclear, inconsistent or difficult to understand, and that it would therefore benefit from amendment.

¹ A detailed recommendations paper, *Social Investment by Charities: The Law Commission's Recommendations* (2014), and an *Analysis of Responses* are available on the Law Commission's website: www.lawcom.gov.uk > A-Z of Projects > Charity Law. The consultation paper, *Social Investment by Charities* (2014) Law Commission Consultation Paper No 216, was published on 24 April 2014 and is also available on the website.

5. Charity trustees and their advisers have legitimate concerns that social investment can involve the conferral of unlawful private benefits on third parties. Nevertheless, there was broad agreement that the law relating to private benefit does not generally prevent charities from making social investments.

A NEW STATUTORY POWER TO MAKE SOCIAL INVESTMENTS

6. We recommend that a new statutory power should be created, conferring on charity trustees the power to make social investments, so as to put the law beyond doubt.
7. A social investment is any use of funds from which charity trustees seek both:
 - (1) to further one or more of their charity's objects; and
 - (2) a financial return, which might include: (i) income, (ii) capital growth, (iii) full or partial repayment, or (iv) avoiding incurring financial liability at a future date.
8. We recommend that the new power should apply unless it has been expressly excluded or modified by the charity's governing document.

CHARITY TRUSTEES' DUTIES IN RESPECT OF SOCIAL INVESTMENTS

9. We recommend that the following duties should apply to all charity trustees.
 - (1) When making a social investment, charity trustees must be satisfied that it is in the best interests of the charity to do so, having regard to the expected overall benefit to the charity from the social investment, comprising the expected furtherance of the charity's objects ("mission benefit") and the expected financial return.
 - (2) Charity trustees must from time to time review the charity's social investments and consider whether they should be varied.
 - (3) When making a social investment and when reviewing an existing social investment, charity trustees must consider taking advice.
10. We recommend that these duties should apply to charity trustees in respect of all social investments (whether or not they could have been made without using the new statutory power). Where charity trustees are trustees in the technical legal sense (as opposed, for example, to directors of a company), these duties will apply instead of the investment duties prescribed by the Trustee Act 2000.

PERMANENT ENDOWMENT

11. Charities that have funds that cannot be spent in furtherance of their purposes are said to have permanent endowment.² Not all charities have permanent endowment.

² Permanent endowment may be "functional", meaning that it must be retained for use directly in furtherance of the charity's purposes (for example a village hall), or it may be "non-functional", meaning that only the income it generates, but not the capital itself, may be spent. Our project only considers the social investment of "non-functional" (also known as "investment") permanent endowment.

12. We take the view that the law currently permits a charity with permanent endowment to use it to make social investments, provided that the charity trustees expect that the capital invested will be preserved. Accordingly, we recommend that the new statutory power – and the duties in paragraph 9 above – should apply to all charity trustees, including those of permanently endowed charities.
13. This will not, however, authorise charity trustees to contravene the restrictions on spending permanent endowment; charity trustees will not, therefore, be able to exercise the new power to make a social investment that is not expected to preserve the capital invested. If they wish to do so, they can use existing legal mechanisms to release the restrictions on the expenditure of permanent endowment. We do not recommend the creation of a new mechanism to release those restrictions specifically for social investment. Instead, we recommend that the Charity Commission revise its guidance on the use of the existing mechanisms that enable charities to make social investments that are not expected to preserve the capital invested.
14. Any deficiencies in the existing mechanisms raised by consultees are not unique to social investment but affect permanent endowment generally. We therefore would like to include in the terms of reference for the remainder of our project a review of the procedures by which the restriction on the expenditure of permanent endowment can be released.

CHARITY COMMISSION GUIDANCE

15. We recommend that CC14 be revised to reflect the changes to the law that we recommend, to explain the duties set out in paragraph 9 above, and to advise charity trustees to consider the following additional matters when making a social investment (in addition to any other factors that they consider to be relevant):
 - (1) the duration of the social investment and how (and when) funds might be withdrawn;
 - (2) the risks of the social investment failing to deliver, or under-performing in the delivery of, the expected mission benefit and the expected financial return;
 - (3) how the performance of the social investment will be measured, assessed and monitored;
 - (4) the relationship between the social investment and the charity's overall investment portfolio (if any) and its spending or grant-making policies; and
 - (5) the tax treatment of the social investment.

16. We also recommend that the revised CC14 should:
- (1) explain that, in determining whether a social investment would be in the best interests of the charity, charity trustees must assess—
 - (a) the expected financial return and the expected mission benefit from the investment; and
 - (b) the likely cost of making the investment (in terms of any foregone financial return and/or any foregone mission benefit);however, charity trustees are not required to attach a precise monetary value to either the expected financial return or the expected mission benefit as part of that assessment (though they may choose to do so);
 - (2) explain that, if using permanent endowment, the trustees must anticipate that the social investment will preserve the capital for future beneficiaries;
 - (3) reframe its explanation of the law concerning private benefit, setting out the test consistently and acknowledging that social investments can be made by purchasing shares in private companies; and
 - (4) provide worked examples of social investment decisions made by charity trustees.

TAX

17. There is considerable concern on the part of charity trustees that legitimate social investment may nevertheless not be recognised as such by HM Revenue and Customs (“HMRC”) and may therefore result in a tax liability. There is also concern that charity trustees are required to take a view, and therefore a risk, about HMRC’s view, because there is no formal procedure to obtain HMRC’s prior clearance for social investments.
18. We recommend that HM Treasury review and seek to amend the legislation concerning approved charitable investments and loans to reflect the definition of social investment in paragraph 7 above and the new statutory power to make social investments.
19. We recommend that HMRC produce revised guidance to reflect the statutory reform proposed in paragraphs 6 and 7 above, any amendment of the tax legislation following our recommendation in paragraph 18 above, and our recommendations in paragraphs 15 and 16(1) above. It would be helpful for that guidance also to include anonymised details of social investments that have previously been approved, or not approved, as charitable investments or loans. The guidance should be consistent with the Charity Commission’s revised guidance.
20. We recommend that HM Treasury introduce a procedure by which charities can obtain prior clearance from HMRC as to the tax treatment of a proposed social investment.