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Capital and Income in Trusts: Classification and Apportionment

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The Law Commission

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CAPITAL AND INCOME IN TRUSTS: CLASSIFICATION AND APPORTIONMENT

Laid before Parliament by the Lord Chancellor and Secretary of State for Justice pursuant to section 3(2) of the Law Commissions Act 1965

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THE LAW COMMISSION

CAPITAL AND INCOME IN TRUSTS: CLASSIFICATION AND APPORTIONMENT

To the Right Honourable Jack Straw MP, Lord Chancellor and Secretary of State for Justice

PART 1 INTRODUCTION

BACKGROUND

1.1 Trusts are the invention of the English courts and have spread throughout the common law world on account of their potential for flexible management of a wide range of financial relationships. Their history goes back centuries, and the modern world of finance and real property is pervaded by them to the extent that many individuals are trustees, or are the beneficiaries of trusts, without having the slightest idea that that is the case.

1.2 The different types of trust are myriad, ranging from the relatively simple example of co-ownership of the family home, to pension funds, unit trusts as investment vehicles, and the arrangements set up for the safeguarding of property belonging to minors or to those suffering from mental incapacity. As well as private trusts there are also thousands of charitable trusts playing an important role in our society.

1.3 The trusts that are most relevant to this project are of two kinds. First, there are private trusts for interests in succession. One of the great flexibilities that a trust can provide is the ability to share property and its income over time; land, investments or other property can be held upon trust for one person for his or her lifetime and then for another after that person's death. A gift of investments upon trust "for A for life, with remainder to B", for example, means that the investments will be held by trustees in their own name, and that they will pay the income from those investments to A until A dies, and then transfer the investments to B. While A is alive we can say that the investments "belong", in different senses, to A, to B, and to the trustees. Secondly, there are charitable trusts with a permanent endowment. A permanent endowment is a protected fund which cannot freely be spent on the charity's purposes, save in the limited circumstances that statute allows (and in many cases only with the agreement of the Charity Commission).

1.4 The common feature of private trusts for interests in succession, and of charities with permanent endowment, that is relevant to this project is that in both cases trustees have to distinguish between capital and income in the way they manage and distribute the trust property.

Capital and income

1.5 The terms "capital" and "income" have a range of meanings in different contexts. They represent useful ideas in the fields of personal financial management, inheritance, investment returns, taxation, and the financial structure of companies and of corporate distributions. Their general significance is reasonably familiar

and intuitive. We can say that capital is to income as a tree is to its fruit; and it is easy (but sometimes misleading) to regard a shareholding as capital and dividends as income, or to see land as capital and the rent it generates as income.

1.6 Economists' definitions tend to be more purposive, for example:

> Income is the maximum amount the individual can consume in a week and still expect to be as well off at the end of the week as he was at the beginning.[1]

1.7 In law, the detailed significance of "capital" and "income" varies between different contexts, and in different contexts capital and income may be the subject of quite restrictive legal rules. The need for this project arose from the interaction of some of those rules and their effect upon the fairness and the efficient administration of trusts.

Classification and apportionment

1.8 The terms of reference for this project encompass two sets of trust law rules – the rules of classification and the rules of apportionment – which are intrinsically linked to the distinction between capital and income in the context of trusts.

1.9 The rules of classification set out whether a particular receipt or expense constitutes income or capital for trust law purposes. If the item in question is classified as income then it is payable to whoever is entitled to income (in the context of a life interest trust, the life tenant) and if it is classified as capital it is held for the capital beneficiary (the remainderman).

1.10 The rules of apportionment are a response to the rules of classification, operating in very limited circumstances defined, for the most part, in case law of some antiquity. They require the sharing of certain returns and outgoings between capital and income, and in some cases impose a duty to sell certain trust property. Well-drafted trust instruments exclude these rules; in most trusts where they have not been excluded (particularly those that arise by implication) they are either ignored or cause considerable inconvenience by requiring complex calculations of very small sums of money.

Balance

1.11 At the heart of this project are concepts of balance and of sharing value over time. Trustees who hold an investment fund for A for life with remainder to B have a duty to manage those investments in a way that balances the interests of A and B. Similarly, the trustees of a charity need to bear in mind the current and future charitable purposes - short-term and long-term - of the charity when they invest their funds, and those with a permanent endowment are subject to technical restrictions in this respect.

1.12 Balance pervades the policy issues examined in this Report. Ideally rules of classification should, so far as possible, respect balance by producing results

[1] JR Hicks, *Value and Capital* (1938) p 172 quoted in G Moffat, *Trusts Law* (4th ed 2005) p 488.

which do not disproportionately favour either income or capital. The rules of apportionment were designed to give effect to trustees' duty to balance in particular circumstances. It is therefore impossible to consider properly the rules of classification and apportionment without examining the content and application of the duty to balance.

Total return investment

1.13 The rules of classification make it difficult for trustees to achieve a fair balance between capital and income beneficiaries. Trustees with funds to invest will choose (or instruct others to choose) a range of investments that will provide a return that does not disproportionately favour either income or capital. They will do so with a view to the likely form of the return. However, as we go on to explain in Part 2, the rules of classification do not always meet trustees' expectations; having selected a portfolio designed to produce balance, trustees may find that it has generated an unbalanced return; and they have no power to adjust the classification of investment receipts. In a private trust for interests in succession this may mean that an investment receipt goes to the income beneficiary when it should more appropriately go to capital, or *vice versa*. In a charitable trust, a receipt may be classified as income, and so have to be spent, when it would be more appropriate to retain it to conserve the value of the trust fund.

1.14 The lack of a power to go beyond the classification rules generates a further problem, highlighted in the Parliamentary debates on the Trustee Bill in 2000: it prevents trustees from maximising their investment returns (within acceptable parameters of risk); in other words, from investing as profitably as they might otherwise do.

1.15 The Trustee Act 2000 made fundamental changes to the rules of investment for trustees. It repealed the Trustee Investment Act 1961, which had imposed severe restrictions upon the types of investment open to trustees. By authorising the majority of investments, the Trustee Act 2000 opened the way to a much wider choice of investments for trustees of both private and charitable trusts.

1.16 Concerns were expressed in 2000 during the course of the Parliamentary debates on the Trustee Bill about the Bill's failure to go further in removing the restraints upon trustees in their choice of investments. Comments were directed at the position of trustees of charitable trusts who are constrained by the rules that restrict their ability to deal with their permanent endowment. The solution, it was suggested, might be the adoption of total return investment policies. The point is equally relevant to the trustees of private trusts for interests in succession who are required to select investments with a view to the form of returns (in terms of capital or income), rather than the value of returns, so as to produce a portfolio that balances returns to the capital and income beneficiary.

1.17 Total return investment enables the selection of investments on the basis of the value of the returns they are expected to yield, without regard to the expected classification of those returns as capital or income. When total return investment is operated by trustees for interests in succession, the global investment return is allocated by the trustees to the income and capital beneficiaries according to what they might expect to enjoy in the light of their respective interests in the fund. This model for trustee investment is being operated by some charities and is facilitated by statute in the US. In England and Wales, private trusts for

interests in succession which have, for tax purposes, an interest in possession are not generally drafted so as to empower trustees to operate total return investment, for reasons that we explain in Part 3.[2]

THE LAW COMMISSION PROJECT

1.18 The Lord Chancellor undertook during debates on the Trustee Bill in 2000 to refer the issues outlined above to the Law Commission for consideration. The terms of the formal reference asked us to examine:

(1) the circumstances in which trustees may or must make apportionments between the income and capital of the trust fund;

(2) the rights and duties of charity trustees in relation to investment returns on a charity's permanent endowment;

(3) the circumstances in which trustees must convert and re-invest trust property; and

(4) the rules which determine whether money or other property received by trustees is to be treated as income or capital.

1.19 The Law Commission commenced work on the project in 2003 following publication of a consultation paper on another trusts project also referred by the Lord Chancellor during the passage of the Trustee Bill.[3] We published a Consultation Paper ("the CP") in 2004, and the Commissioner then responsible for the project, Stuart Bridge, presented the consultation issues at a public seminar at the Institute of Advanced Legal Studies. The CP elicited 42 responses from a wide variety of groups and individuals,[4] all of whom gave thoughtful and detailed responses which have influenced and assisted our thinking.

1.20 Completion of the project was deferred pending publication of our Report on Trustee Exemption Clauses[5] and then as a result of the reference to the Commission of a project on cohabitation, which was to be completed – at Government's request – within the two-year period from 2005 to 2007. Work on this project re-commenced in January 2008. We then held a number of meetings with an expert Advisory Group,[6] discussions with Her Majesty's Revenue and Customs ("HMRC") and with HM Treasury on the taxation aspects of the project, and meetings with representatives of the Charity Commission and the Charity Law Association.

1.21 We are publishing, alongside this Report, two further documents. First, an analysis of the responses to the 2004 consultation is available on our website at www.lawcom.gov.uk/citcat.htm. It provides a more detailed coverage of the

[2] See paras 3.23 to 3.29 below.

[3] Trustee Exemption Clauses (2003) Law Commission Consultation Paper No 171; Trustee Exemption Clauses (2006) Law Com No 301.

[4] A list of respondents to the CP is set out in Appendix C.

[5] (2006) Law Com No 301.

[6] The names of the members of the group, and the organisations represented, are set out in Appendix B.

substance of responses than is practicable within this Report, and reflects the learning and experience that consultees contributed to our project. Second, we have prepared a formal Impact Assessment, again available on our website, which sets out our proposals, and a discussion of the costs and benefits of their implementation.

ISSUES AND RECOMENDATIONS

1.22 The CP provisionally proposed, for private trusts, a scheme of simplified classification rules supplemented by a new trustee power of allocation. That power would provide the flexibility to mitigate any failings of the classification rules and would give those trustees of private trusts who wished to invest on a total return basis the opportunity to do so. The current rules of apportionment had no place in the proposed scheme and would be abolished. For charities, the CP discussed the rules surrounding permanent endowment and discussed ways of making more widely available the scheme for total return investment that was, by the date of the CP, offered by the Charity Commission.

1.23 We are not now recommending the legislative implementation of the CP's scheme for private trusts. We have reached that conclusion in the light of the tax consequences of that scheme for trusts, as we explain in more detail in Part 5. Accordingly, we are not able formally to recommend to Government the reforms that we believe would be appropriate for private trust law. HMRC and HM Treasury have stated that they have no policy objection to any of the reforms that we would like to make for private trusts; rather, they have explained the tax consequences that must follow from them. They stress that Government policy on tax fairness is that trusts should not be used as a means for trusts to gain a tax advantage over other individuals, and that Government policy and decisions about changes to the tax regime have to take this into consideration.

1.24 We therefore set out a limited range of formal recommendations to Government for immediate reform, while also explaining our view of how trust law should develop in this area. We are also able to make recommendations with respect to total return investment for charities.

1.25 The Report discusses, in Part 2, the rules governing the classification of investment receipts, and in Part 3 the linked issue of the facilitation of total return investment for private trusts. We go on to outline in Part 4 the provisional proposals of the CP on these issues and the reactions of consultees. In Part 5 we outline the recommendations we would have liked to make to offer improved classification rules for all trustees and to facilitate total return investment for those trusts for which total return investment would be attractive. We explain why we are not able to recommend those reforms. We recommend just one change to the classification rules, in the tax-neutral context of corporate demergers, an area generally considered to be particularly problematic.[7] We recommend a limited discretion to supplement that classification change.[8] In addition, we argue that it would be possible to devise a percentage trust model for those who wished to operate total return investment without prejudicing tax revenue and potentially guaranteeing a more stable and predictable return for the Exchequer. Part 5

[7] Draft Bill, cl 2.

[8] Draft Bill, cl 3.

closes with a recommendation that HMRC and HM Treasury work with the trust industry to devise a format for total return investment that would meet the economic priorities of all those involved.

1.26 In Part 6 we discuss the rules of apportionment, and the circumstances where trustees are currently placed under a duty to sell certain investments. We recommend the prospective abolition of those unpopular rules.[9] These recommendations do not have tax consequences and represent a straightforward simplification of the law of trusts.

1.27 In Part 7 we discuss the treatment of trust expenses. We describe two important developments that have taken place since the CP: publication by HMRC of guidance on trust management expenses and judicial consideration of the proper treatment of trust expenses in *Revenue and Customs Commissioners v Trustees of the Peter Clay Discretionary Trust.* We confirm the CP's provisional conclusion that the law regarding the classification of trust expenses should remain unchanged and that it should not be placed on a statutory footing. Consequently, we make no recommendations for reform in this area.

1.28 Finally, in Part 8 we discuss the issue of investment by the trustees of charitable trusts. An important development since the CP has been the enactment of the Charities Act 2006, which addresses and resolves a number of concerns about the rules relating to permanent endowment. Moreover, charity trustees have for some years now been able to operate total return investment by following the scheme devised by the Charity Commission pursuant to its powers under section 26 of the Charities Act 1993. We make a recommendation that will make total return investment more easily accessible to charity trustees.[10] We also recommend that the Charity Commission conducts a further consultation exercise about the provisions of its total return investment scheme, in the light of concerns expressed to us by a number of consultees about its details and the restrictions it imposes.

HUMAN RIGHTS IMPLICATIONS

1.29 We are confident that our recommendations have no adverse human rights implications. Our recommendation for a change in the classification of shares distributed to trustees on a demerger effects a change in the entitlement to shares distributed on a demerger. No beneficiary under a trust for interests in succession had any vested right to that distribution; only to income and capital as defined in law. Moreover, the change in classification will make the law reflect more accurately the meaning of capital and income within a trust. As to the rules of apportionment, our recommendations can have no human rights implications since they affect only trusts created after the implementation of our recommendations; settlors who want the rules of apportionment to operate will make express provision to that effect. Finally, as to charities, our recommendations extend the existing powers of the Charity Commission to authorise total return investment and the expenditure of permanent endowment; they have no effect upon property rights.

[9] Draft Bill, cl 1.

[10] Draft Bill, cl 4.

LOOKING AHEAD

1.30 What of the future? In the short term, we look forward to the implementation of the draft Bill, which we regard as uncontroversial. Although limited in scope, its provisions address serious problems with the current law – problems which were central to the reference of this project to the Law Commission. The Bill will facilitate investment in the charitable sector, leading more trustees to invest without the constraints imposed by the rules relating to permanent endowment. As to private trusts, the provisions of the Bill will simplify the operation of private trusts by sweeping away the outdated rules of apportionment and removing some of the most marked and notorious anomalies arising from the classification rules.

1.31 We look to Government in the longer term to consider how best to implement the recommendations we would have liked to make for the more effective and flexible facilitation of total return investment and for the revision of the classification rules for investment returns.

1.32 In an era where investment returns as well as business operations are threatened by economic downturn, it is increasingly unhelpful to have artificial constraints upon investment, and the removal of those constraints will have positive financial consequences for trusts and, given higher taxable average returns, for the national economy.

1.33 To that end, we think that the next step should be the acceptance of our recommendation at paragraph 5.104, that HMRC and HM Treasury work with the trust industry to devise a suitable vehicle for total return investment by private trusts, so as to facilitate investment without prejudicing tax revenue.

1.34 There has been much discussion of the negative impact on trusts of the changes to trust taxation introduced by the Finance Act 2006.Taxation is also a key issue in this project, and adverse tax consequences have prevented us from making a number of recommendations for trust law reform that we would otherwise have made. The Law Commission does not make recommendations about fiscal policy. We have held discussions with HMRC to explore the options available within current taxation law, and to ascertain whether there is any prospect of amendment of tax law to enable trust law reform. HMRC has worked with us to determine what is achievable but has given a clear message that it is not realistic to look for the changes to tax law that would be necessary to allow the type of trust law reform we would like to see. HMRC's position is that there will be tax advantages and disadvantages with any investment policy, and that while Government is happy to be advised of issues in the current system it cannot necessarily be expected to alter pre-existing tax policy merely because a particular type of trust does not fit particularly well within the tax regime.

1.35 We see no purpose in making recommendations that cannot benefit the trust industry without changes in tax legislation which cannot be regarded as achievable. We have therefore been able to work only within the constraints of current trusts tax policy.

1.36 However, while we restrict our formal recommendations to Government to those that are currently able to operate in a tax-neutral manner, we wish to stress the vital significance of competitive modern trust law to the individuals and companies who are either the settlors or beneficiaries of trusts or who provide

trust services.[11] The importance of trusts was recognised by the then Lord Chancellor, Lord Falconer of Thoroton, when speaking in the House of Lords in July 2006 at the launch of the Law Commission's Report on Trustee Exemption Clauses. Lord Falconer said:

> … the trust is one of the greatest creations of English law and trust business is a very important part of the UK's professional service industry. Trust law is a multi-faceted industry dealing with varied subject matter in charitable, pensions, commercial and family contexts. I believe that it is vital that the UK trust industry continues to innovate, and that it retains the flexibility that so often provides it with a competitive advantage.[12]

1.37 These sentiments are of direct relevance to this project. Lord Falconer referred to the need for flexibility in the trust industry, flexibility which lies at the heart of trusts themselves as the creation of the courts of equity. We appreciate that such flexibility presents difficult challenges to those responsible for combating the tax avoidance that can be associated with the use of trusts. But trusts are not simply tax avoidance vehicles.[13] Government rightly wishes to ensure that trusts bear an appropriate tax burden, but at the same time it seeks to encourage the trust industry to innovate so as to promote efficiency and competitiveness. We invite Government to accept and implement the tax-neutral recommendations which we now make. We encourage Government to accommodate, within the reasonable and proportionate constraints of fiscal policy, our other conclusions as to how the law in this area should more fairly and effectively develop.

ACNOWLEDGEMENTS

1.38 Law Commission reports are always the outcome of a collaborative process, and we have had a tremendous amount of help throughout the lifetime of this long-running project. Special thanks are due to the members of our Advisory Group, listed at Appendix B to this Report, with whom we have held extremely constructive discussions. We are particularly grateful to Rupert Allen, Murray Hallam, Simon Jennings, Christopher McCall QC, Edward Nugee QC, Francesca Quint, Nigel Reid, Paul Saunders, Geoffrey Sultoon, Arthur Weir and John Wood. We are also grateful for the assistance of the Trust Law Committee throughout this project. We would like to thank those within Government who have engaged with us, in particular James Dutton of the Charity Commission and officials at HMRC and at HM Treasury. Finally, we extend our warmest thanks to all who responded to the CP, listed at Appendix C.

[11] Trustees and trust administrators, lawyers, accountants and investment managers. For an analysis of the competitive importance of the trust in the UK financial markets see The Hayton Report: *Trusts and their Commercial Counterparts in Continental Europe: a Report for The Association of Corporate Trustees* (January 2002) and the companion volume prepared by Europe Economics, *Economic and Financial Analysis of Commercial and Private Trusts in the United Kingdom* (January 2002), both available at http://www.trustees.org.uk.

[12] http://www.lawcom.gov.uk/docs/sec_of_state_speech.pdf.

[13] HM Revenue and Customs, *Research Report 25 - Research on Trusts: Experience of Setting Up and Running Trusts* (2006).

WORK DONE BY OTHER BODIES

1.39 We are also indebted to the various bodies who have carried out prior work in this area and whose thinking influenced our own. In particular there have been a number of previous recommendations for reform in this jurisdiction and in Scotland:

(1) The Law Reform Committee 1982 Report on the Powers and Duties of Trustees:[14] this considered the equitable and statutory rules of apportionment, recommending that the equitable rules should be replaced by a general discretionary power for trustees to adjust the capital and income accounts of the trust and that the statutory rule should be amended so that in relation to wills and settlements income is treated as belonging exclusively to the income beneficiary on the date when it becomes due.

(2) The Trust Law Committee 1999 Consultation Paper on Capital and Income of Trusts:[15] this considered both the rules for classification of investment returns and the equitable and statutory rules of apportionment, proposing that the existing rules of classification should remain, that the equitable rules of apportionment should be abolished and that there should be a discretion for the trustees to reallocate income to capital and *vice versa*.[16]

(3) The Scottish Law Commission 2003 Discussion Paper on the Apportionment of Trust Receipts and Outgoings:[17] this covered both issues of classification and apportionment, proposing that the existing technical rules of apportionment should be abolished and replaced with a general discretionary power for trustees to decide on the allocation and apportionment of receipts and outgoings between income and capital, and a new power not to apportion periodical payments on a time basis when otherwise required to do so under the Apportionment Act 1870.

1.40 As will be seen, the conclusions of these law reform bodies and others world-wide, most notably The National Conference of Commissioners on Uniform State Laws in the US, provided a platform for some of the provisional proposals in the CP and for our conclusions in Part 5 of this Report.

[14] The Powers and Duties of Trustees (1982) 23rd Report of the Law Reform Committee, Cmnd 8733.

[15] Capital and Income of Trusts (1999) Trust Law Committee Consultation Paper.

[16] We comment on the Trust Law Committee's revised position in the light of its consultation at para 5.87 and following below.

[17] Apportionment of Trust Receipts and Outgoings (2003) Scottish Law Com Discussion Paper No 124.

PART 2
THE CLASSIFICATION OF TRUST RECEIPTS – THE CURRENT LAW AND ITS PROBLEMS

INTRODUCTION

2.1 The project's terms of reference require the Law Commission to examine "the rules which determine whether money or other property received by the trustees is to be treated as income or capital". These rules relate to the classification of returns from investments; those investments might be corporate, such as shares in a company, or non-corporate, for example land. In all cases the question arises: if the investor receives something from the property, is that receipt to form part of the investor's capital, or is it income? For individual investors the issue may not be particularly important, but for trustee investors it is crucial. If the trust is a private trust for interests in succession, different beneficiaries are interested in capital and income. If the trust is a charity with permanent endowment, the trustees are subject to strict requirements as to the expenditure of income and the retention of capital.

2.2 Trustees can hold a vast range of assets, each potentially giving rise to a variety of receipts. English trust law's classification of such receipts is rule-based. We said in the CP that "in most circumstances, the classification is straightforward and accords with common sense"[1] presenting the metaphor, often drawn on by the courts, of a tree and its fruit: property which can be characterised as the "tree" is usually classified as capital, whereas the "fruit" produced by the tree is treated as income.

2.3 The classification of receipts is not, however, always so straightforward.[2] In this Part we discuss the trust law rules of classification, with particular reference to corporate receipts, by which we mean receipts by trustee shareholders from corporate entities. Corporate receipts cause the most acute difficulties for trustees because their classification depends upon company law concepts of capital and income, which are rather different from trust law concepts. This gives rise to counter-intuitive and inconvenient results in some cases, particularly corporate demergers, of which our terms of reference make special mention.[3]

CORPORATE RECEIPTS

2.4 The classification of corporate receipts was the primary focus of the CP. This reflects the importance of such receipts to trustees and the extent of perceived problems with the current law.

The rule in *Bouch v Sproule*

2.5 In English law, the general rule that has developed for the classification of a receipt by a trustee shareholder from a company is commonly referred to as "the

[1] CP, para 2.1.

[2] And see the discussion of the tree/fruit analogy by Dyson LJ in *Commissioners of Inland Revenue v John Lewis Properties plc* [2002] EWCA Civ 1869, [2003] Ch 513 at [89].

[3] Eighth Programme of Law Reform (2001) Law Com No 174, p 20.

rule in *Bouch v Sproule*". *Bouch v Sproule* provides House of Lords authority,[4] but the classic exposition of the rule is found in Lord Justice Fry's judgment in that case in the Court of Appeal:

> When a testator or settlor directs or permits the subject of his disposition to remain as stocks or shares in a company which has the power either of distributing its profits as dividend, or of converting them into capital, and the company validly exercises this power, such exercise of its power is binding on all persons interested under him, the testator or settlor, in the shares, and consequently what is paid by the company as dividend goes to the tenant for life, and what is paid by the company to the shareholder as capital, or appropriated as an increase of the capital stock in the concern, enures to the benefit of all who are interested in capital.[5]

2.6 The fundamental principle established in *Bouch v Sproule* is therefore that a receipt by a trustee shareholder from a company is classified for trust law purposes in accordance with the company law analysis of the payment. A corporate receipt will therefore only constitute capital for trust purposes if it represents capital in company law terms.

2.7 A company will normally distribute profits by way of a dividend. This will result in a decrease in the value of the company's assets, since cash has been paid out; but the shareholders will instead hold cash in hand. Although the market value of the share will fluctuate before and after payment of a dividend, overall a healthy regular dividend return enhances the market value of shares.[6] This type of distribution is classified as income under the rule in *Bouch v Sproule*.

2.8 Capital distributions are less usual and require a little more explanation. The concept of "capital" underpins corporate limited liability and therefore is central to modern company law.[7] The Companies Act 2006 amended the rules concerning corporate capital, and abolished the concept of authorised capital.[8] Nevertheless, English company law retains detailed obligations and restrictions relating to capital. Companies must provide an initial statement of capital, there are restrictions on the reduction of capital, and public companies are subject to

[4] (1887) LR 12 App Cas 385.

[5] (1885) LR 29 Ch D 635, 653. This passage was quoted with approval by Lord Herschell in the decision of the House of Lords (1887) 12 App Cas 385, 397-398.

[6] The price of shares rises to a "cum dividend" value before the payment is made, and falls to an "ex dividend" value thereafter. Exceptionally, an abnormally large dividend may involve the payment out of value representing a large proportion of the company's underlying assets, and the market value of shares is likely to fall as a result of such a distribution: see para 2.20 below.

[7] For a discussion of the emergence of the company law concept of capital and limited liability as we now understand it, see P Ireland, "Capitalism Without the Capital: the Joint Stock Company Share and the Emergence of the Modern Doctrine of Separate Corporate Personality" (1996) 17 *Journal of Legal History* 41 and "Company Law and the Myth of Shareholder Ownership" (1999) 62 *Modern Law Review* 32. See further S Worthington, "Shares and Shareholders: Property, Power and Entitlement" (2001) 22 *Company Lawyer* 258 (Part 1) and 307 (Part 2).

[8] The provisions relating to company formation are due to come into force on 1 October 2009: Companies Act 2006 (Commencement No. 8, Transitional Provisions and Savings) Order 2008/2860, art 3.

minimum capital requirements.

2.9 In company law terms, a company's capital is "the value of the assets contributed to the company by those who subscribe for its shares".[9] This is initially the amount subscribed by the company's original shareholders (say, £100 for one hundred £1 shares). A company's legal capital is only increased if further shares are issued. A company whose initial share capital was £100 may decide later to issue further shares, but if the value of the original shares has risen it may do so at a premium, requiring a subscription of, say, £5 for each £1 share; the excess over the par value of the shares is known as share premium, and must be paid into the company's share premium account.[10] While the share premium account is generally regarded as part of the company's paid-up share capital, it differs from share capital (that is, the paid-up subscription at par value) principally in that it can be used to pay up bonus shares.[11]

2.10 The capital value of the company, in company law terms as just described, is not the same as its market value, which comprises the company's total worth, taking into account all its assets – cash, land, intellectual property, goodwill, debts and so on.

2.11 It is open to company directors who wish to return value to shareholders in the form of capital to do so by means of a capitalisation. This will occur when the company's reserves are used to issue paid-up shares to existing shareholders. This procedure is known variously (and often confusingly) as a "bonus", "capitalisation", "scrip" or "stock" issue or dividend. Value may then be returned to shareholders by the company redeeming, repurchasing or cancelling the shares issued by way of capitalisation.[12] Some schemes are structured so as to enable shareholders to choose whether to receive income or capital.[13]

2.12 The company law analysis of a corporate payment is therefore dependent on the mechanism employed by the company in making it. This is controlled by the directors whose choice will be governed by a range of commercial considerations. The essence of the rule in *Bouch v Sproule* is that the entitlement of the life tenant or the beneficiary in remainder flows from the decision of the company.

Restatement in *Hill v Permanent Trustee Company of New South Wales*

2.13 Although Lord Justice Fry's statement of the rule in *Bouch v Sproule* appears clear, elements of company law prevailing at the time of the case introduced a degree of ambiguity to the rule. Argument in *Bouch v Sproule* revolved around the proper classification of partly paid up bonus shares of a value equivalent to profits that had been transferred to reserve. The analysis was complicated by the

[9] P Davies, *Gower and Davies' Principles of Modern Company Law* (7th ed 2003), p 225. In rare circumstances a capital contribution can be made otherwise than in return for shares: *Kellar v Williams* [2000] 2 BCLC 390.

[10] Companies Act 2006, s 610.

[11] Companies Act 1985, s 130(2). See now Companies Act 2006, s 610(3).

[12] For example, by way of "B Share" schemes.

[13] N Adams, P Whitelock and D Stuttaford, "Returning Cash to Shareholders" [2005] *Practical Law Company* 29.

mechanism by which this was achieved. The company declared a dividend and a new issue of shares, giving the shareholders the option of taking the dividend in the form of cash or shares. This route was taken because of the company law rule at the time that a company might not use its own funds to pay up its shares. Consequently, a company could only capitalise its profits by first declaring a dividend and then using that dividend to pay up the bonus shares. As the form of the transaction was inconclusive as to the nature of the receipt, the court had to look to the intention of the company.

2.14 The Court of Appeal and the House of Lords reached different conclusions on the facts as a result of divergent judicial interpretations of the mechanism by which the bonus shares were distributed. The Court of Appeal considered that this procedure did not disclose a clear intention to capitalise the profits. Although no rational shareholder would choose to receive the dividend in the form of cash, there was in principle an option to do so. The House of Lords disagreed, concluding that this option was merely illusory and that a sufficient intention to capitalise had been manifested.

2.15 The detailed reasoning in *Bouch v Sproule* was closely linked to the facts under consideration, and in particular to the ambiguity of the company's actions in the light of prevailing company law. It is therefore helpful that the principle established in *Bouch v Sproule* was restated (and expanded upon) by the Privy Council in *Hill v Permanent Trustee Company of New South Wales*.[14] Lord Russell first explained the basic company law principle:

> A limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorised reduction of capital. Any other payment made by it by means of which it parts with money to its shareholders must and can only be made by way of dividing profits. Whether the payment is called "dividend" or "bonus", or by any other name, it still must remain a payment on division of profits.

2.16 That is not the case where shares are issued following a capitalisation:

> Other considerations arise when a limited company with power to increase its capital and possessing a fund of undivided profits so deals with it that no part of it leaves the possession of the company, but the whole is applied in paying up new shares which are issued and allotted proportionately to the shareholders, who would have been entitled to receive the fund had it been, in fact, divided and paid away as dividend.

2.17 Lord Russell went on to analyse the trust law consequences of both types of corporate action. Payments made to trustee-shareholders by way of a distribution of profits:

> … prima facie belong to the person beneficially entitled to the income of the trust estate. If such moneys or any part thereof are to be treated as part of the corpus of the trust estate there must be some

[14] [1930] AC 720 (PC). See CP, paras 2.14 to 2.17.

> provision in the trust deed which brings about that result. No statement by the company or its officers that moneys which are being paid away to shareholders out of profits are capital, or are to be treated as capital, can have any effect upon the rights of the beneficiaries under a trust instrument which comprises shares in the company.

2.18 This was contrasted with the issue of shares following a capitalisation:

> The result of such a dealing is obviously wholly different from the result of paying away the profits to the shareholders. In the latter case the amount of cash distributed disappears on both sides of the company's balance sheet. It is lost to the company. The fund of undistributed profits which has been divided ceases to figure among the company's liabilities; the cash necessary to provide the dividend is raised and paid away, the company's assets being reduced by that amount. In the former case the assets of the company remain undiminished, but on the liabilities' side of the balance sheet (although the total number remains unchanged) the item representing undivided profits disappears, its place being taken by a corresponding increase of liability in respect of issued share capital. In other words, moneys which had been capable of division by the company as profits among its shareholders have ceased for all time to be so divisible, and can never be paid to the shareholders except upon a reduction of capital or in a winding up. The fully paid shares representing them and received by the trustees are therefore received by them as corpus and not as income.[15]

2.19 This authoritative restatement builds on, and clarifies, the decision in *Bouch v Sproule*. It refocuses discussion away from the intention of the company, made necessary in *Bouch v Sproule* by the inherent ambiguity of the mechanics employed by the company in that case, and back onto the proper objective analysis of the corporate action.[16] The *Hill* approach was itself restated with approval by Lord Reid in *Rae (HM Inspector of Taxes) v Lazard Investment Co Ltd:*

> There is no doubt that every distribution of money or money's worth by an English company must be treated as income in the hands of the shareholders unless it is either a distribution in a liquidation, a repayment in respect of reduction of capital (or a payment out of a special premium account) or an issue of bonus shares (or it may be bonus debentures).[17]

2.20 The CP referred to a number of other leading cases in this area which confirm

[15] [1930] AC 720 (PC), 731 to 732.

[16] See also *Re Bates* [1928] Ch 682 (Eve J) in which a cash payment to shareholders was held to be income for trust law purposes on the basis that it was made out of profits which had not been capitalised, even though it was accompanied by a circular explaining that the payments were made out of capital and were "neither a dividend nor a bonus, but … a capital distribution and therefore not liable to income tax".

[17] [1963] 1 WLR 555, 565.

that where the law classifies a distribution of profits as income, that classification applies no matter what the source or extent of the distribution.[18] In particular, it discussed *Re Sechiari*[19] in which a “capital profits dividend”[20] caused the market value of the shares held by the trust, and therefore the value of the trust capital, to fall by over 75 per cent. The distribution was nevertheless held to be income for trust law purposes.

2.21 The rule in *Bouch v Sproule* is displaced by any express provision to the contrary in the trust instrument. The CP outlined a number of judicially recognised narrow exceptions to the rule.[21] These are: when the life tenant assented to the purchase of the original shares as a capital investment in the knowledge that the investment was motivated by the contemplated distribution; when a distribution is made after the testator’s death but relates to a transaction completed before the testator’s death; and when a company purports to accumulate profits as capital although it has no power to increase its capital.

2.22 The CP described a series of cases which considered the extent of judicial discretion to apportion, and noted that the decision in *Re Maclaren’s Settlement Trusts*[22] appeared to support a relatively broad power. However, subsequent case law has narrowed the extent of the discretion, such that it is now considered available only in “special circumstances” involving a breach of trust.[23]

Application of the rule to particular forms of distribution

Scrip dividends

CONVENTIONAL

2.23 A scrip dividend is a dividend which offers shareholders the choice of being paid in the form of cash or shares. In a conventional scrip dividend, the shareholder is given the option to receive a cash dividend or bonus shares of equal value to the cash dividend. Where the shareholder is a trustee, the receipt will almost always be treated as income whichever option is chosen.[24]

[18] It applies no matter what is distributed: a number of American cases concern distributions of coal.

[19] [1950] 1 All ER 417.

[20] It was so described by the directors; it consisted of British Transport Commission stock, received by the company in exchange for its road transport and haulage undertakings which it was obliged to sell as a result of nationalisation.

[21] CP, para 2.18.

[22] [1951] 2 All ER 414 (Harman J).

[23] *Re Rudd’s Will Trusts* [1952] 1 All ER 254, 261 (Upjohn J, quoting Vaisey J in *Re Kleinwort’s Settlement Trusts* [1951] 2 All ER 328).

[24] CP, para 2.33. This treatment appears to be widely accepted whether the option to take cash or shares is given before or after the dividend has been declared: D Hayton, *Underhill and Hayton: Law of Trusts and Trustees* (16th ed, 2003), pp 539 to 540 and J Mowbray QC et al (eds), *Lewin on Trusts* (18th ed, 2008), para 25-28. HMRC considers scrip dividends to be received as income in trust law and are therefore within the income tax provisions for stock dividends: s 249 of the Income and Corporation Taxes Act 1988 and s 409 of the Income Tax (Trading and Other Income) Act 2005.

ENHANCED

2.24 In the case of enhanced scrip dividends, where the bonus shares are worth more than the cash alternative, the situation is more fluid. If the trustee opts to take the cash dividend, the cash receipt will be classified as income under the rule in *Bouch v Sproule*. However, the trustee will usually opt to take the more valuable bonus shares. In this case, the classification of the bonus shares will depend on whether the company intended to capitalise its profits or intended to make a distribution. In the majority of cases, especially where (as is common practice) the company arranges for a third party to offer to purchase the new shares at market value to enable shareholders to realise their cash value immediately, the substance of the arrangement will be such that the shares will be received as income.

2.25 However, where the bonus shares are received as capital, it has in some cases been held that the income beneficiary is entitled to a lien over the amount of the cash dividend foregone; in effect, an apportionment of the receipt between income and capital.[25] HMRC's position, set out in Statement of Practice 4/94, is that it currently follows the trustees' decision as to the classification of enhanced scrip dividends for tax purposes, provided that their conclusion is supportable on the facts of their particular case.

Demergers

2.26 As noted in the introduction to this Part, this project's terms of reference draw attention to the problematic classification of demergers, making specific mention of the case of *Sinclair v Lee*.

GENERAL PRINCIPLES

2.27 A demerger involves the transfer by a company ("Company A") of part of its business to a new company ("Company B"), with the shareholders of the demerged company receiving shares in the new company by way of a declaration of dividend.

2.28 In a "direct" demerger, the dividend is satisfied by Company A transferring the entire share capital of Company B to its own shareholders. In an "indirect" demerger, a further step is interposed; Company A transfers all its shares in Company B to a separate holding company ("Company C") and, in consideration for this transfer, Company C satisfies Company A's dividend by issuing its own shares to the shareholders of Company A.

2.29 In the case of a direct demerger, the shares received by shareholders are classified strictly in accordance with the rule in *Bouch v Sproule*. Shares held by Company A in Company B do not form part of a Company A's legal capital; consequently a distribution of such shares by way of dividend (in effect an *in specie* dividend) will be received as income by a trustee-shareholder. That is the case even though the economic value of the shares in Company A will decrease significantly as a result of the transfer of the business to Company B, in turn reducing the capital beneficiaries' interest and in effect enforcing a distribution to the income beneficiary.

[25] CP, paras 2.35 to 2.36. See *Rowley v Unwin* (1855) 2 K & J 138; *Re Tindal (Deceased)* (1892) 9 TLR 24; *In Re Malam* [1894] 3 Ch 578.

SINCLAIR V LEE

2.30 This position was revisited in relation to indirect demergers by the Chancery Division of the High Court in *Sinclair v Lee*.[26] In that case, ICI plc wanted to hive off some of its business to Zeneca Ltd, which was to be a subsidiary of the Zeneca Group plc. The demerger took the following structure. First, Zeneca Ltd was formed as a wholly owned subsidiary of ICI plc. ICI plc then transferred its shares in Zeneca Ltd to Zeneca Group plc. In consideration for the transfer of Zeneca Ltd shares, Zeneca Group plc transferred a proportionate amount of Zeneca Group plc shares to ICI plc. ICI plc in turn declared a dividend to its shareholders, which it satisfied by the transfer of the Zeneca Group plc shares.

2.31 There were two reasons why the ICI plc shareholders were to receive the Zeneca Group plc shares. The first was to ensure that the directors of ICI plc obtained approval for the demerger. The second was to ensure that the ICI plc shareholders did not lose the commercial value of their current shareholding. However, for trustee-shareholders this caused a problem as, under the rule in *Bouch v Sproule*, the shares would be received as income. The question for the court was how the rule applied in a case of an indirect demerger.

2.32 Sir Donald Nicholls V-C held that the shares were received as capital, saying that this was his "instinctive reaction", and noting that this result would accord with the economic realities of the situation since after the demerger the combined values of the ICI and Zeneca shares would be approximately equal to the pre-demerger value of the ICI shares. He said:

> I venture to think that no one, unversed in the arcane mysteries I shall be mentioning shortly, would have any doubt over the answer to these questions. The ICI shares form part of the capital of the fund. For the future the ICI undertaking will be divided up, with one part belonging to ICI and the other to Zeneca Group. To compensate for this loss of part of the ICI undertaking, the ICI shareholders will be receiving a corresponding number of shares in Zeneca Group. No one would imagine that the Zeneca Group shares could sensibly be regarded as income.[27]

2.33 He conceded that the line of cases developing the rule in *Bouch v Sproule*[28] would appear to suggest that the Zeneca shares should be treated as income; he noted that none of them dealt with the precise situation of an indirect demerger, and therefore felt able to distinguish *Bouch v Sproule*.

2.34 However, that helpful decision has given rise to an unprincipled distinction between direct and indirect demergers. The formalistic ground for distinction adopted by the Vice-Chancellor enabled him to avoid what he considered to be an "absurd" result, but did not affect the equally absurd result that arises from direct demergers.

[26] [1993] Ch 497 (Sir Donald Nicholls VC). In the following paragraphs we refer to Lord Nicholls of Birkenhead using the title he held at the time of *Sinclair v Lee*.

[27] Above, 504.

[28] Above, 505. The line of cases referred to includes *Hill v Permanent Trustee Company of New South Wales* [1930] AC 720 (PC) and *Re Doughty* [1947] Ch 263 (CA).

CRITICISMS OF THE CURRENT LAW

2.35 A range of criticisms can be directed at the current law. The CP argued that the basis of the current law is illogical and, as a result, it gives rise to inappropriate, and unpredictable, results. Its complexity, and the need to obtain information about the mechanics of the company's actions, means that it can be hard to apply in practice. Its inconsistent application to different sorts of demergers is generally considered to be unfortunate. We think it likely that in many cases trustees will operate in ignorance of, or without regard to, the technical legal position.

Illogical basis of the rule

2.36 The basis of the rule in *Bouch v Sproule* is the company law distinction between capital and income. The meaning of capital and income in trust law is different, and it is illogical to base the classification of receipts by trustees upon the company law concept. Lord Russell commented in the *Hill* case[29] that whether a shareholder holds shares for him- or herself or as a trustee is immaterial to the company; the company directors usually will not know whether or not the shareholders are trustees, and it is of no direct consequence to them whether payments out constitute trust income or trust capital.[30]

2.37 The CP was therefore critical of the conflation, by the rule in *Bouch v Sproule*, of the concepts of share capital and trust capital:

> There is no reason why only those profits which become share capital (following capitalisation) should be treated as trust capital. Share capital, which cannot be returned to shareholders except by way of an authorised reduction or during a winding up, exists to protect creditors and other people who deal with a limited company. Trust capital on the other hand represents the full extent of the trust property.[31]

Inappropriate results

2.38 The potential for the current law to give rise to inappropriate results can be demonstrated by the example of the declaration of an abnormally large special dividend, representing a significant proportion of the market value of the company.

2.39 Normally, of course, the tendency of particular shares to yield a healthy dividend will enhance their market value. But if a company makes an unexpected and abnormal distribution of its profits in this way, the payment of such a dividend will result in a sharp fall in the market value of the company and so in the value of the trust's shareholding. Yet the payment will be received by shareholders as income and, if a shareholder is a trustee, will be paid to the life tenant. As a result, the capital value of the investment is eroded following the payment to the income

[29] [1930] AC 720 (PC).

[30] In *Village Cay Marina Ltd v Ackland* [1998] 2 BCLC 327 (PC) Lord Hoffman remarked: "Shareholders can hold their shares in trust for anyone they like; that is a matter between them and the beneficiaries. Company law is not concerned with trusts of shares".

[31] CP, para 2.41.

beneficiary. Where a trustee initially acquired the shares after the profit arose (but before it was distributed) the value of the reserves is likely to have been reflected in the purchase price paid. Unless special circumstances apply, the excessively large benefit to income represents an unexpected windfall.

2.40 The CP, and most commentators,[32] describe this result as unfair. "Unfairness" in this context is used to describe an outcome which, from an economic perspective, disproportionately benefits one set of interests at the expense of another. In the example given, the effect of the operation of the classification rule is to diminish the real value of capital. A classification of that receipt as income does not respect the ordinary meaning of capital as underlying value and income as the return on that value that can be expended without diminishing capital.[33] This is what Sir Donald Nicholls V-C was referring to in his decision in *Sinclair v Lee* when he said that to classify the Zeneca Group shares as income "would be to exalt company form over commercial substance to an unacceptable [extent]".[34]

2.41 The consequences of the mismatch between the narrow company law view of capital and capitalisation and the more expansive economic approach is most obviously demonstrated by a comparison of current rules governing trust receipts from direct and indirect demergers. A demerger, whether direct or indirect, will include an abnormally large distribution by way of dividend. If the demerger is direct, the rule in *Bouch v Sproule* will apply and the distribution will constitute income as a result of the application of the narrow concept of corporate capital. If the demerger is indirect, the *Sinclair v Lee* approach enables the common sense economic analysis that the receipt should be treated as capital to prevail.

Unpredictable results

2.42 Aside from the unacceptability of inappropriate classification, the fact that the current law can give rise to unanticipated returns (in particular, large income returns) presents particular problems for those selecting trustee investments.

2.43 As Part 3 explains, trustees are currently only able to balance the interests of beneficiaries interested in income and capital by means of the careful selection of investments. It would not be unreasonable, in normal markets, for a trustee to invest in an established company with a history of declaring market-average dividends with a view to securing a reasonable rate of income return and a degree of capital growth. If, however, the company in question decides to declare an abnormal special dividend – and so unexpectedly yields a large return which the law treats as income rather than capital - the intended function of the investment within the overall portfolio will not have been fulfilled, and the trustee can do nothing about this.

[32] Including many of our consultees: see para 4.62 and following below.

[33] For a classic exposition of the different meanings of capital from an economic perspective, see Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations* (in particular, chapter 1 of book 2; "Of the Division of Stock"). On the difficulty of the meaning of capital in the context of corporate receipts, see *Smith v Dana* (1905) 77 Conn 543; 60 Atlantic Reporter 117, 121.

[34] [1993] Ch 497, 514.

Applying the rule in practice

Complexity

2.44 The complexity of the law makes it difficult for trustees to comprehend and to apply. Lay trustees inevitably struggle with technical distinctions between capitalisation and distribution. Even professional trustees, and their advisers, may be unsure of the correct answers to difficult questions of company (rather than trust) law.

Availability of information

2.45 The application of the law in practice is complicated by the fact that it requires trustees to ascertain precisely what a company has done when making a particular payment.

2.46 For most shareholders, the technical company law distinction between capital and income is of little practical relevance. Consequently, companies may not supply sufficient information about a distribution to enable trustee shareholders to assess its true nature. For example, the labelling of a distribution as a "bonus issue", "bonus dividend", "scrip dividend", "stock issue" or a "special issue" does not inform the shareholder whether the company is capitalising profits or distributing profits. The company may be more concerned with presenting itself in a positive light in describing the benefits it is offering to its shareholders than with providing a technical description of the substance of the receipt.

2.47 In some cases, the company itself may not be entirely clear about what it is doing and may give misleading statements. For example, in *Bouch v Sproule* the directors of the company first resolved to make a "bonus dividend" but later resolved merely to issue a "bonus". This caused confusion as to whether the transaction was a distribution of accumulated profits as a special dividend or a capitalisation of the accumulated profits, with the dividend being used to pay up the issue of new bonus shares.

2.48 In most cases, the trustees can ascertain the technical nature of the receipt by careful study of the accompanying documentation supplemented, where necessary, by enquiries of the company. However, this process may be time-consuming and, especially where professional assistance is required, expensive.

Uncertainty in application to novel arrangements

2.49 We have seen how the law has been forced to create special rules for certain sorts of distribution, such as enhanced scrip dividends and indirect demergers. As companies continue to develop innovative new ways of distributing value to shareholders, perhaps in response to commercial or taxation changes, the difficulty of applying the rule in *Bouch v Sproule* may increase.

Ignorance or disregard of the rule

2.50 Anecdotal evidence suggests that, in practice, many trustees do not allocate corporate receipts in accordance with the strict rule in *Bouch v Sproule*. This is especially likely to be the case where trustees are not legally advised.

Corporate receipts: conclusion

2.51 The policy argument as to the proper classification of corporate receipts can be presented as a direct clash between the positions adopted by Lord Justice Fry and Sir Donald Nicholls VC.

2.52 The former argued that a trust law classification rule based entirely on the perspective of the company rather than that of the trust should accord with the expectations of trustees investing in shares as, by and large, distributions (classified as income), and the proceeds of capitalisation or a distribution on liquidation or winding up (classified as capital) are all that a shareholder is entitled to expect. As the House of Lords said in *Bouch v Sproule*:

> The division of the enjoyment of property between a tenant for life and a remainderman is itself artificial, and if any artificial rule has been established regulating such enjoyment, every settlor or testator may well be presumed to have intended that the objects of his bounty should share its benefits according to this rule.[35]

2.53 The alternative position holds that this is an unrealistic analysis which has an innate capacity to produce an inappropriate result. The price at which a trustee purchases a share will rarely bear any meaningful relation to the value of the company's share capital as the share's market value is affected by a myriad of other factors. Enquiry should be focused on the impact on the capital and income beneficiaries under the trust rather than on the effect on the legal capital of the company. From the trust's perspective, the capital expenditure on the share is likely significantly to exceed the company's legal capital and even its net asset value. This mismatch can lead to payments which in company law terms constitute income, but which lead to an erosion of the market value of the company and holdings in it.

2.54 In Part 4 of this Report we explain the CP's proposals for the improvement of the rules for the classification of corporate receipts.

NON-CORPORATE RECEIPTS

2.55 We have already noted that the CP concentrated on the classification of corporate receipts. The current law governing the classification of non-corporate receipts was discussed in much less detail. The category "non-corporate receipts" is very wide, comprising all those receipts that do not arise from a trustee's shareholding in a company. It includes receipts from leaseholds, loans, mortgages, mines and quarries, timber and intellectual property.

2.56 The following paragraphs summarise the current law governing the classification of traditionally some of the most common types of non-corporate receipts. This is an area where we make no recommendations, and so we go on to outline the CP's provisional proposals for reform of the classification of non-corporate receipts and consultees' reaction to those proposals, and then set out our conclusions.

[35] *Bouch v Sproule* (1887) 12 App Cas 385, 392 (Lord Herschell).

The current law

General

2.57 The guiding principle for the allocation of all non-corporate receipts between income and capital is settlor intention. In the absence of express provision in the terms of the trust, case law provides default principles for inferring or presuming a settlor's intentions as to whether the life tenant or remainderman should benefit from the receipt. These default principles historically depended on inferences from the settlor's own use of the trust property prior to the creation of the trust: if the settlor used the trust property to produce receipts for his or her enjoyment it would usually be inferred that the settlor intended those receipts to be enjoyed by the life tenant.[36]

Rents, leaseholds, loans and mortgages

2.58 The CP explained that rental receipts and receipts from loans now fall within the "straightforward" category of returns which follow the fruit/tree analogy; rents received from the letting of trust property[37] and interest received on loans of trust property should be classified as income and the return of the principal of a loan of trust property as capital.[38] Likewise with receipts from leasehold property and mortgages; the income beneficiary is entitled to the rent from the lease or the interest paid accruing on the mortgage during his term.[39] However, if the leasehold is sold, then the proceeds should be invested in an annuity that has as many years to run as did the leasehold.[40] The result is intended to mirror what the income and capital beneficiaries would have received had the leasehold been retained and can be understood as giving effect to the presumed intentions of the settlor.[41]

Open-mine doctrine

2.59 Receipts from mines[42] are not generally susceptible to the fruit/tree analogy. As Lord Blackburn explained in *Campbell v Wardlaw*:[43]

> Where there is "produce", such as minerals, which, when once taken away, is never replaced, it is in a very different position from, I may

[36] See *Simpson (Davidson's Trustees) v Ogilvie* (1910) 1 SLT 45, 48 (Clerk LJ).

[37] *Sinclair v Lee* [1993] Ch 497, 506 (Sir Donald Nicholls VC).

[38] *Re Atkinson* [1904] 2 Ch 160, 165 (Vaughan Williams LJ).

[39] *In re Hubbuck* [1896] 1 Ch 754; *Re Lewis* [1907] 2 Ch 296.

[40] The proceeds of the sale thereby being exhausted on the date that the leasehold would have ended (*Askew v Woodhead* (1880) LR 14 Ch D 27).

[41] Note also *Pagliaro v Thomas* [2008] WTLR 1417, which concerned interest payments receivable upon compensation paid by instalments to the trust fund by former trustees, pursuant to a settlement deed compromising litigation concerning alleged breach of trust and fiduciary duty. It was held, on somewhat unusual facts and as a matter of construction of the deed, that the interest payments were a mixture of capital and income and should be classified accordingly. That classification reflected the purpose of the compromise, which was to compensate the capital and income beneficiaries for what they would have received in the absence of any breach of trust.

[42] On the meaning of "mines and minerals" see *Earl of Lonsdale v Attorney General* [1982] 3 All ER 579.

[43] (1883) 8 App Cas 641.

say, apples or fruits of that kind, which are annually reaped and which replace themselves.[44]

2.60 Case law has, however, made distinction between receipts from "open mines" and "unopened mines". Receipts from "open mines" are classified as income while receipts from "unopened mines" are capital.[45] Generally, a mine is "open" if it was being worked at the time that the trust was established, whereas mines are unopened if they are only opened after the date of the settlement.[46]

Timber and trees

2.61 Generally, receipts from the sale of "timber" are classified as capital and receipts from the sale of other wood are income.[47] The reason is that the income beneficiary is not usually entitled to cut timber. However, where the timber is cultivated to produce saleable timber as part of a timber estate and timber is cut periodically, the periodical cuttings can be viewed as "part … of the annual fruits of the land".[48]

Intellectual property

2.62 Intellectual property rights include copyright, patents, designs and trade marks. Receipts from intellectual property will be classified in accordance with the presumed intentions of the settlor. Usually receipts such as royalties and profits arising from copyrights, patents, designs and trade marks owned by the settlor or testator before his death will be allocated to the income beneficiary, while receipts from the sale of intellectual property rights will be allocated to the capital beneficiary.

2.63 Where the trustees obtain intellectual property rights after the creation of the trust in works created by the settlor or testator before the creation of the trust, royalties and profits should be treated as capital. For example, *Simpson (Davidson's Trustees) v Ogilvie*[49] concerned royalties, profits and sums in respect of book sales, the copyright to which was held by trustees. It was held that receipts from works that had been published by the testator himself should be treated as

[44] (1883) 8 App Cas 641, 644. The principle underlying this is the duty to balance; the life tenant must not destroy the trust property as "the substance of the estate is to be preserved and not destroyed" (1883) 8 App Cas 641, 656 (Lord FitzGerald).

[45] Section 47 of the Settled Land Act 1925 makes special provision for the classification and apportionment of receipts from mining leases.

[46] Further considerations apply where, for example, the mine has been worked by the settlor or has been dormant for a period of time. *Halsbury's Laws of England* comments that "whether a mine is open or not is no longer a question of much (if any) practical importance": Volume 31, *Mines, Minerals and Quarries* (2003), para 7.

[47] See *Honywood v Honywood* (1874) LR 18 Eq 306. Section 66 of the Settled Land Act 1925 provides special classification and apportionment rules in relation to the cutting of timber by tenant for life under a settlement.

[48] *Honywood v Honywood* (1874) LR 18 Eq 306, 310. This case also establishes the meaning of "timber": a tree will be "timber" where it is oak, ash or elm; it is at least 20 years old; and it is "not so old as not to have a reasonable quantity of useable wood (*Honywood v Honywood* (1874) LR 18 Eq 306, 309 (Jessel MR). Trees that do not fall within this definition may nevertheless be classified as timber according to the local custom of the county.

[49] (1910) 1 SLT 45.

income. By contrast, receipts from works written by the testator but published by the trustees after the testator's death should be treated as capital.

Provisional proposal and consultation responses

2.64 The CP considered that the criticisms of the rules governing corporate distributions do not apply to the rules governing the classification of non-corporate receipts. It concluded that, even though some of the rules are not entirely straightforward, they do not appear to give rise to any significant problems in practice.[50] The CP therefore provisionally rejected the introduction of comprehensive statutory classification rules for non-corporate receipts and provisionally proposed that the existing rules for the classification of non-corporate trust receipts should be retained. Consultees were asked if they agreed and invited to give their views on whether the rules should be placed on a statutory footing.

2.65 The vast majority of the consultees who answered this question agreed that the existing rules for the classification of trust receipts other than distributions from corporate entities should be retained. They considered the current rules to be sufficiently clear and valued their flexibility. The Association of District Judges, for example, said that "there is little or no need for change [to] the existing classification, the law being in the main clear". One consultee agreed "subject to there being a fair allocation system".[51]

2.66 Some consultees felt that the existing rules for the classification of trust receipts other than distributions from corporate entities should be given a statutory basis. One argued that "trustees are more likely to take account of statutory provisions than rules of equity buried in case law that they have never heard of".

2.67 However, most of the consultees who answered this question did not think that the rules should be placed on a statutory footing. Consultees pointed to the difficulty of drafting provisions that would embrace the vast range of non-corporate receipts and the rigidity of a statute-based classification.

Conclusions

2.68 We conclude that the current law relating to the classification of non-corporate receipts should be retained. This was overwhelmingly supported in consultation. We have sympathy with the view that it would be desirable to place the current rules on a statutory footing,[52] but we do not consider that the case has been made for codification, bearing in mind the following points.

2.69 First, a comprehensive statement of trust law classification of receipts would be a monumental (if not impossible) undertaking. Trustees can invest in anything if the terms of the trust authorise them to do so, and in almost anything as a result of the statutory powers of investment given by the Trustee Act 2000. The general

[50] CP, para 5.13.

[51] Wills and Equity Committee of the Law Society.

[52] And we note the steps that have been taken in this regard in those US states that have implemented the Uniform Principal and Income Act: see Uniform Principal and Income Act, ss 405 (rental income), 410 (liquidating assets), 411 (minerals, water and natural resources) and 412 (timber).

power of investment in section 3(1) of the Trustee Act 2000 allows trustees to make "any kind of investment that he could make if he were absolutely entitled to the assets of the trust".[53] Trustees therefore have power to invest in company shares, futures, derivatives, hedge funds, debentures, bonds, freehold and leasehold property, mortgages, art, life assurance, timber, minerals, intellectual property rights and so on. Although rules of classification would not have to list each and every possible investment, it would be necessary to consider the proper treatment of the various classes of investment before setting such rules.

2.70 Aside from the breadth of current investment possibilities - and we have not listed them all - it is also inevitable that the types of investment trustees make will change. In the event that Parliament were minded to enact our recommendations for classification we could not expect further consideration of the issues in the foreseeable future and a code might become out of date quite quickly.

2.71 We are not convinced that the lack of a statutory code in this very specialised field is causing sufficient practical difficulties to warrant legislation. We agree with consultees that equity has to date provided generally acceptable classification rules, and that a statutory codification may stifle judicial development of those rules as new types of investment (and so of receipt) emerge.[54] It should be noted that the rules relating to the classification of non-corporate receipts are far more flexible in their operation than the rule in *Bouch v Sproule*. It is, of course, open to settlors who intend to settle property liable to give rise to receipts of this sort to include express classification provisions in the terms of the trust.

2.72 We therefore make no recommendation for the reform of the law relating to the classification of non-corporate receipts; the current law should be retained and should not be codified in statute.

[53] Trustee Act 2000, s 3(3) makes clear that land is not included in the general power of investment with the exception of loans secured on land. However, s 8 provides a special power for trustees to invest in freehold and leasehold property.

[54] Mr Justice Lloyd noted in consultation that "to lay down a rule in statute would incur the risk that some situation which is not foreseen might be dealt with in an inappropriate way" and that it would be "more desirable that the position … should continue to be laid down by judicial decision".

PART 3
TOTAL RETURN INVESTMENT

CLASSIFICATION AND THE SELECTION OF INVESTMENTS

3.1 We explained in Part 2 that the classification of corporate receipts as income or capital is governed by relatively inflexible rules, and that the rules may produce unexpected or irrational results. This causes difficulties when an investment fund is held on trust for successive interests; sometimes a return that amounts to capital for the trust has to be treated as income, and *vice versa*, with the result that it goes to the "wrong" beneficiary. We have also noted the more fundamental problem relating to trustees' selection of investments.[1]

3.2 The Trustee Act 1925 authorised trustees to invest only in a limited range of investments. The policy underlying trust investment was generally to conserve capital and obtain a reasonable fixed income during the life of the trust. Changing economic circumstances and an increasing variety of financial instruments meant that over time the restriction to authorised investments became problematic. The Trustee Investment Act 1961 went some way to resolving this by allowing trustees to invest up to 75 per cent of the trust fund in equities. However, broad investment powers had long been expressly included by numerous settlors in trust instruments, and the Trustee Investment Act 1961 was considered by many to be inadequate.[2]

3.3 The Trustee Act 2000, implementing the Law Commission's 1999 Report on Trustees' Powers and Duties,[3] went significantly further in widening trustees' investment powers. The Explanatory Notes to section 4 of the Trustee Act 2000 state that it "provides that in exercising a power of investment … a trustee must have regard to the suitability to the trust of the investment and, secondly, to the extent that it is appropriate in the circumstances, to the need for diversification of the trust's investments".[4]

3.4 However, trustees of trusts with successive interests continue to be constrained in their investment decisions. They are restricted by the combination of the rules that classify trust receipts as income or capital and the overarching duty to balance the interests of the life tenant and remainderman. Trustees must maintain the value of the trust capital while providing a proportionate income; they cannot invest wholly for capital growth, obviously, nor wholly for income return. Because they are bound by the form of the investment receipt, that balance between the successive interests must be achieved by investing with a view to the likely form – capital or income – that returns from particular investments will take. This inevitably skews investment decisions; instead of investing for optimum return, trustees who have no power to override the form of the receipt are forced to invest to obtain the best possible balanced return which may be significantly lower than that which they could have obtained if investing

[1] See para 1.13 and following above.

[2] See HM Treasury, *Investment Powers of Trustees* (1996).

[3] Law Com No 260.

[4] Trustee Act 2000 Explanatory Notes, para 23.

freely.

TOTAL RETURN INVESTMENT

3.5 Investment by trustees without those constraints is known as total return investment, which focuses on all the returns generated from a portfolio of assets regardless of whether they take the form of income or capital. The total return approach to investment potentially delivers a higher rate of return than one that isolates income returns from capital returns, because it facilitates the spreading of investments and removes restrictions from trustees' choices.

3.6 The effect of removing these restrictions is that trustees would be free to construct the investment portfolios which they and their relevant advisers consider appropriate. Section 4(3) of the Trustee Act 2000 sets out standard investment criteria to which trustees are to have regard when exercising any power of investment and from time to time:

> (a) the suitability to the trust of investments of the same kind as any particular investment proposed to be made or retained and of that particular investment as an investment of that kind, and
>
> (b) the need for diversification of investments of the trust, in so far as is appropriate to the circumstances of the trust.

3.7 The Explanatory Notes to that section explain that the "definition of the standard investment criteria in section 4(3) is closely modelled on section 6(1) of the Trustee Investments Act 1961 and accords with modern portfolio theory".[5] Modern portfolio theory puts forward an analysis of risk and return in accordance with a statistical model[6] and has been a popular investment theory for some decades. However, the underlying assumptions of modern portfolio theory, as well as the reliability of its associated mathematical models for financial decision-making, have been called into question.[7] The Trustee Act 2000 enables but does not require trustees to follow modern portfolio theory, and the same is true of total return investment. Investing on a total return basis would not oblige trustees to follow any particular investment theory; but it would free them from artificial restraints in constructing a portfolio. It would also enable them to make investment choices to compensate for unexpected or unbalanced investment returns.

3.8 We have appended to our analysis of consultation responses an explanation of the effects of total return submitted as part of the consultation response of the UK Society of Trust and Estate Practitioners Technical Committee ("STEP"). It sets out two contrasting portfolios, one constructed with an eye to achieving a particular level of income within the overall return, and the other constructed

[5] Trustee Act 2000 Explanatory Notes, para 25.

[6] See H Markowitz, "Portfolio Selection" (1952) 7(1) *Journal of Finance* 77; J Hirschleifer, "Efficient Allocation of Capital in an Uncertain World" (1964) 54(3) *American Economic Review* 77; E Ford, "Trustee Investment and Modern Portfolio Theory" (1996) 10(4) *Trust Law International* 102; I Legair, "Modern Portfolio Theory: a Primer" (2000) 14(2) *Trust Law International* 75.

[7] See eg B Mandelbrot, *The (Mis)Behaviour of Markets* (2008), in particular chapters 4 and 5.

without that objective. The latter portfolio is therefore able to include a higher proportion of investments that are known to generate significant capital growth; and accordingly the overall return is enhanced without loss of stability. We note this as an example of investment practice, and of the limitations of choice and potential effect upon returns where investment decisions are constrained by the classification of returns.

3.9 Clearly, as we write this Report the global financial markets are in crisis. A portfolio selected on the basis of total return is not immune from this because the risks that affect the entire investment market cannot be diversified away. But the principles of total return investment, and the importance of active portfolio management, remain constant; trustees of charities with permanent endowment, and of trusts for interests in succession who are unable to operate total return investment, may therefore be more vulnerable in the current climate than they need be. This is particularly pertinent for those who depend on returns to provide a relatively stable pattern of income.

Total return investment in the US

3.10 Moves towards total return investment have taken place in a number of other jurisdictions. The CP referred to reports from Canadian law reform bodies which have argued that "the formalistic distinction between capital and income is inimical to the movement away from a list-based approach to authorised investments.[8] The CP also noted that jurisdictions in Australia and the Bahamas have advocated the adoption of total return investment. But the most significant developments have taken place in the US, where there has been detailed academic discussion over a number of years[9] and the enactment by many states of the Uniform Principal and Income Act 1997 ("UPIA").[10]

The power of adjustment model: Uniform Principal and Income Act 1997

3.11 The UPIA detached trustees' investment strategies from their traditional impact on classification, allowing trustees to invest on a total return basis. To achieve this, the UPIA created a simple set of default classification rules and introduced a new power of adjustment[11] for use in relation to corporate receipts and certain other apportionable receipts. Section 104 of the UPIA provides a new power for trustees to adjust between capital and income, which is available when the following three conditions are met: (1) when the trustee invests as a prudent

[8] See CP, paras 5.33 to 5.40.

[9] See, for example, RB Wolf, "Defeating the Duty to Disappoint Equally – the Total Return Trust" (1997) 32 *Real Property, Probate and Trust Journal* 45 and "Estate Planning with Total Return Trusts: Meeting Human Needs and Investment Goals through Modern Trust Design" (2001) 36 *Real Property, Probate and Trust Journal* 169. Other recent works include AA DiRusso and KM Sablone, "Statutory Techniques for Balancing the Financial Interests of Trust Beneficiaries" (2005) 39 *University of San Francisco Law Review* 261 and RW Nenno, "The Power to Adjust and Total-Return Unitrust Statutes: State Developments and Tax Considerations" (2008) 42 *Real Property, Probate and Trust Journal* 657.

[10] As amended in 2000 and 2008. The UPIA should not be confused with the Uniform Prudent Investor Act 1994: see n 12 below. The relevant provisions of the UPIA are set out in Appendix D.

[11] Note that the term that we have used for this kind of power is "power of allocation"; see para 4.3 and following below.

investor;[12] (2) the terms of the trust require or allow a certain amount to be distributed to income; and (3) the trustee is unable to comply with section 103(b).

3.12 Section 103(b) states that the exercise of the power to adjust is underpinned by the duty of impartiality "based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favour one or more of the beneficiaries". A determination in accordance with the Act is presumed to be fair and reasonable to all of the beneficiaries. Section 105 of the Act provides that a court may not change a decision to exercise or not exercise the power to adjust unless it determines that the trustee's decision was an abuse of discretion.[13]

3.13 The notes accompanying the UPIA provide guidance on the conditions for the exercise of the power to adjust, the factors to consider in exercising the power and the limitations on the power. The notes also provide a number of examples to illustrate the application of the power to adjust.

3.14 Detailed guidance is given on what amounts to an abuse of the power to adjust. This provides an insight into how trustees are expected to exercise the power in accordance with the duty of impartiality: "Because [the duty of impartiality] involves the exercise of judgment in circumstances rarely capable of perfect resolution, trustees are not expected to achieve perfection; they are, however, required to make conscious decisions in good faith and with proper motives". The guidance makes it clear that the key element in this process is to determine "the appropriate level or range of income for the income beneficiary, and that will continue to be the key element in deciding whether and to what extent to exercise the discretionary power conferred by section 104(a)".

3.15 The guidance goes on to state that trustees have a broad latitude in choosing the methods and criteria to use in deciding whether, and to what extent, to exercise the power, and that the adjustment may be made either prospectively at the beginning of an accounting period (based on projected returns) or retrospectively.

3.16 Professor Edward C Halbach Jr, University of California at Berkeley, is the Reporter for the American Law Institute's Restatement of Trusts project. In January 2008 he indicated in correspondence with us that total return investment is now prevalent in the US, especially as a result of widespread adoption of the 1994 Uniform Prudent Investor Act (the equivalent of Trustee Act 2000). It readily became apparent that total return investment practices of trustees rendered traditional US principal and income accounting principles obsolete, leading to the Uniform Law Commission's 1997 promulgation of the now widely adopted UPIA. Whilst Professor Halbach has not been able to provide us with statistical data on the frequency of use of the UPIA's power of adjustment, he has stated that in California (one of the first states to adopt the Act) "use by trustees (even the initially reluctant) is widespread". Professor Halbach further notes that, in other states, despite a certain lack of familiarity and comfort regarding the power:

[12] The "prudent investor" is the standard of care adopted in the US in the Uniform Prudent Investor Act 1994.

[13] This amounts to a codification of the normal US rules governing the reviewability of fiduciaries' discretions.

> There is nevertheless a growing interest in and actual use of investment programs that will depend on application of adjustment/unitrust solutions to the impartiality issues that are inherent in such trust investment programs whenever the distribution rights of any beneficiary would be determined by trust-accounting income.

Percentage trusts

3.17 Not surprisingly there is more than one way to facilitate total return investment. Although the CP concentrated on the power of allocation, it also discussed percentage trusts. This is a model familiar in the US (where it is also known as the "unitrust") but not used, so far as we are aware, in England and Wales. The idea is that investment is carried out on a total return basis and at the end of each year a percentage of the net market value of the trust fund (the "unitrust rate") is allocated to income and paid to the income beneficiary.

3.18 In the US, the most significant unitrust statutes are those of Pennsylvania, Delaware, Illinois, Texas and Ohio. The Pennsylvania statute has served as the model statute for a number of states. It adopts a fixed four per cent unitrust rate and a three-year "smoothing rule"; this means that the trustees are directed to apply the unitrust rate to the net fair market value of the trust's assets averaged over a three-year period. This creates a more consistent stream of distributions.

3.19 Delaware was the first state to enact a unitrust statute. Its distinguishing feature is the trustee's ability to choose a rate for distribution to the income beneficiary within the range of three per cent to five per cent. Other states which have implemented unitrust statutes provide a lower limit to the unitrust rate, but without setting an upper limit (Missouri has three per cent).

3.20 Texas has provided a model based on the definition of income; a unitrust is defined as a trust whose terms require the distribution of a unitrust amount, defined as "a distribution mandated by the terms of a trust in an amount equal to a fixed percentage of not less than three or more than five per cent per year of the net fair market value of the trust's assets, valued at least annually", which may be done with or without a smoothing rule. Importantly, the distribution of the unitrust amount is then deemed to be "a distribution of all of the income of the unitrust" and a reasonable apportionment of the total return of the unitrust.

3.21 The Ohio model is slightly different in that it combines features of the power to adjust and the unitrust. It provides trustees with a "safe harbour" power to adjust whereby they can adjust trust accounting income upwards not to exceed four per cent of the trust's fair market value. Where they do this the propriety of the adjustment is conclusively presumed.

3.22 There are of course further possible variations. The percentage trust model of total return investment is only appropriate where there is a range of investments. It would be wholly unsuitable for a trust with a handful of investments, still less for one with a single asset, for example a farm or a shareholding in a family company. Nor would it be suitable where the trust's assets were difficult to value.

Total return investment in the UK

Charitable trusts

3.23 Total return investment requires an ability to retain or distribute investment yields without regard to the form in which they were received. Accordingly, the starting point for charities with permanent endowment is that they are prevented from operating total return investment because they are not able to spend capital receipts without the consent of the Charity Commission. It was concern about this issue that led to the reference of this project to the Law Commission.[14] We noted in Part 1 that total return investment has been made possible for charitable trusts with permanent endowment by the procedure published in Operational Guidance by the Charity Commission, which enables trustees to free capital from restriction for this purpose.[15] As we explain in Part 8, we received a number of consultation responses about the details of the Charity Commission's scheme, and we consider there the arguments for further reform. However, it is clear that in the charitable sector trustees are already investing profitably on a total return basis.

Private trusts

3.24 Private trusts for interests in succession can only operate total return investment if the terms of the trust enable them to distribute investment returns without regard to their form. If they do have such a power, then they are free to invest for maximum return (subject only to the need to balance risk and return), and can attribute receipts and expenses to income or to capital in proportions that maintain an appropriate balance between the capital value of the fund and its income yield. In choosing investments they therefore need not concern themselves with the likely form taken by returns, and can instead focus on maximising the growth of the trust fund as a whole.

3.25 Trusts for interests in succession may incorporate a power of advancement. This enables trustees to advance capital to the income beneficiary. It also enables a limited form of total return investment. The trustees are free to invest in funds that maximise capital growth, and can advance capital to the income beneficiary at their discretion. They may operate a form of percentage trust, distributing a percentage of investment return each year to the income beneficiary. But a power of advancement will not permit true total return investment. In particular, it does not enable an income return to be treated as capital; nor does it give total freedom across the range of possible investments.

3.26 Trustees for interests in succession can only operate true total return strategies if they have a power of allocation[16] enabling them to allocate investment returns to the income beneficiary or to capital, or if they are set up as percentage trusts.

3.27 There is nothing in the current law to prevent the establishment of power of allocation trusts by express provision in the terms of the trust instrument.[17] All that is required is a power to allocate capital receipts to income and *vice versa* in order to establish a balance. An example of such a power can be found in the

[14] See para 1.16 above.

[15] See para 1.28 above. See Part 8 below for details of the scheme.

[16] See n 11 above.

Encyclopaedia of Forms and Precedents:

> The [Trustees] may if they in their absolute discretion think fit from time to time and at any time decide whether any property received by them as such trustees shall be treated as income or as capital for the purposes of any one or more of the trusts powers and other provisions contained in or conferred by this settlement.[18]

3.28 However, we have been unable to find evidence of private power of allocation trusts being set up in this jurisdiction. To some extent that is a matter of culture; settlors and their advisers may be unwilling to venture into an unfamiliar model, of which there is little experience. However, the critical factor is that, as things stand, a power of allocation trust will not be drafted in the trust instrument for interest in possession trusts,[19] because of the perceived risk that a power of allocation would lead to the loss of that status.[20] The *Encyclopaedia of Forms and Precedents* states that the tax implications of such a power are "uncertain";[21] that is a risk that the vast majority of settlors would not be willing to take.

3.29 For similar reasons, the percentage trust has not been adopted in England and Wales. In particular, there is no specialised mechanism for taxing receipts and distributions by percentage trusts, with the result that they would attract disadvantageous tax treatment. In addition, because they inevitably attribute to capital some part of income in some years, percentage trusts falls foul of the rule against excessive accumulations. The latter problem, however, would disappear with the enactment of the Law Commission's recommendations on excessive accumulations.[22]

CONCLUSION

3.30 In this Part we have looked at the arguments for total return investment for trustees. Moves have been made in other jurisdictions to facilitate total return investment, through a power of allocation and through percentage trusts. Similar steps have been taken in this jurisdiction for charities, but not for private trusts. We revert to charities in Part 8; in Part 4 we explain the CP's provisional proposals to improve the rules for the classification of investment receipts, and to enable total return investment for trustees. In Part 5 we go on to explain our final recommendations.

[17] Provided their terms do not offend the rule against excessive accumulations.

[18] *Trusts and Settlements* Vol 40(1) (2007), Form 178 [4741].

[19] See Part 5, n 4 for our use of the term "interest in possession".

[20] See para 5.67 and following below for discussion of the taxation implications of a power of allocation.

[21] *Trusts and Settlements* Vol 40(1) (2007), para 146 [1380].

[22] A Perpetuities and Accumulations Bill was introduced in the House of Lords on 1 April 2009.

PART 4
THE CP PROPOSALS AND CONSULTATION RESPONSES

INTRODUCTION

4.1 We explained in Part 2 of this Report the difficulties arising from the current classification rules for corporate receipts, and in Part 3 we discussed total return investment and outlined the difficulties faced by trustees wishing to invest on a total return basis. In this Part we set out the CP's approach to those problems.

4.2 At the heart of the CP's provisional proposals for reform was the suggestion of a power of allocation. This was presented as a means of resolving the problems of trust classification and of enabling total return investment for trusts.[1] The following discussion focuses first on the CP's proposals for the power of allocation itself and concludes by outlining the CP's suggested reform of the classification rules in the light of the potential availability of a power of allocation. We also explain why the CP had also to consider a further fundamental issue - the trust law duty to balance. We discuss the CP's position on the percentage trust as an alternative total return investment vehicle to the power of allocation. We provide an overview of consultees' responses to all the CP's provisional proposals on these points.[2]

THE POWER OF ALLOCATION

4.3 The CP's provisional proposals for a flexible power of allocation built on the approach recommended by the Law Reform Committee in 1982, the Trust Law Committee in 1999 and the Scottish Law Commission in 2003. But its proposal of an allocation power, in parallel with revised classification rules, also drew on the approach adopted in many US states whereby a similar power not only allows flexible classification but also enables total return investment by trusts.[3]

Nature of the proposed power

4.4 The CP's proposed statutory power of allocation would enable trustees to allocate receipts and expenses to income or to capital in proportions that maintained an appropriate balance between the capital value of the fund and its income yield. Although the allocation power would in theory enable the allocation of each individual receipt (and we envisaged that such allocation could be in whole or in part), the trustees' objective would be to ensure that, over a period, a proportionate level of return was attributed to the classes of beneficiaries entitled to capital and to income. To achieve this result, trustees might need only to allocate one or two receipts, irrespective of how any imbalance had been caused.

[1] The power of allocation also underpinned the CP's proposals for the classification of expenses (discussed in Part 7 of this Report); and it was relevant, although less important, in the CP's discussion of the rules of apportionment (discussed in Part 6 below).

[2] Further detail on the results of consultation is available in our analysis of responses: available at http://www.lawcom.gov.uk/citcat.htm.

[3] See para 3.11 and following above for the relevant provisions of the US Uniform Principal and Income Act 1997, in particular its power to adjust. The CP also referred to Canadian recommendations for "discretionary allocation trusts" (see CP, para 5.33 and following).

Alternatively, they might take a more global approach, not unlike a percentage trust, allocating an appropriate proportion of the entire investment return to income and capital respectively. The exercise of the power of allocation would be underpinned by the trustees' overarching duty to balance the interests of the different beneficiaries; the proposed power would only be capable of exercise in so far as necessary to discharge the duty to balance and for no other purpose.[4]

4.5 The CP envisaged that trustees would be given a specified time limit in which to exercise the power of allocation, after which the default classification provided by the classification rules[5] would become conclusive. The CP argued that the new power of allocation would be "strictly 'administrative', in the sense that it was intended to facilitate the internal administration of the trust":

> … it will be available to trustees for one reason only; to enable them to discharge their overriding duty to balance the interests of the income and capital beneficiaries. It must be clearly distinguished from a "dispositive" power whereby trustees, having considered the various claims of beneficiaries, are entitled to make distributions out of the trust fund to particular beneficiaries at the expense of the others.[6]

4.6 The CP asked whether consultees agreed with its provisional proposal for a statutory power of allocation, and put forward a number of questions about the practical and accounting implications of the power.[7]

4.7 The CP debated whether the new power of allocation should be included in all new trusts by default (or by implication) or whether it should only be available where expressly included by the settlor. It invited consultees' views on whether the power of allocation should operate on an opt-in or opt-out basis. The CP also anticipated that the trustees of some existing trusts might wish to take advantage of the power of allocation. It invited the views of consultees on whether such trustees should be able, either unilaterally or with the sanction of the court, to opt into its proposed statutory power.

Advantages of the power

4.8 The power of allocation would enable trustees to overcome inappropriate classifications. It would ensure that neither income nor capital beneficiaries gained or lost disproportionately when investments made with a view to income return or capital protection had not performed as expected.

4.9 The power would also enable trustees to ignore the likely form of receipt when making investment choices and so invest on a total return basis. As the CP put it:

> A power of allocation would give trustees much greater freedom to

[4] For a discussion of the duty of balance, see para 4.10 and following below.

[5] See para 4.57 and following below.

[6] CP, para 5.56.

[7] Including the time limit from the date of a receipt or expense within which the power should be available, the basis of judicial review of the power, the consequences for trustees of failure to exercise the power and the procedure for dealing with disputes. See CP, para 5.41 and following for a detailed discussion.

> select investments, as they would no longer need to concern themselves with the likely form taken by returns, and they could instead focus on maximising the growth of the trust fund as a whole. The duty to balance could be satisfied by exercise of the power of allocation. In consequence, trustees would be able to postpone the balancing process from the time when investment policy is being formulated until after investment returns are received. This, we believe, would result in less speculative, better informed and more effective trusteeship.[8]

THE DUTY TO BALANCE

4.10 The power of allocation was not proposed in isolation; it was to be underpinned by the trustees' duty to hold a balance between those entitled to income and those interested in remainder. It is a fundamental principle of equity that trustees must not favour one beneficiary or class of beneficiaries over another in exercising their powers and fulfilling their duties. The duty that flows from this principle is known variously as the duty of even-handedness, the duty of impartiality, the duty to keep a fair balance and the duty to keep an equitable balance between the potentially competing interests of the income and capital beneficiaries.

4.11 While the duty to balance provides a general principle, it can be understood in both a positive and negative sense. In its negative sense, the duty requires trustees to act impartially between beneficiaries without favouring one class of beneficiary over the other. This expression of the duty is the focus of the current law, in particular in the context of trustees exercising their powers of investment.

The current law

4.12 Lord Justice Cotton set out the basis of the duty to balance in *Learoyd v Whitely*:

> [Trustees] must take such care in conducting the business of the trust as a reasonably cautious man would use, having regard, not only to the interests of those who are entitled to the income, but to the interests of those who will take in future.[9]

4.13 The meaning of balance was more recently considered by Sir Robert Megarry VC in *Cowan v Scargill* where he concluded that "the starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries".[10]

4.14 However, in *Nestle v National Westminster Bank plc*[11] Mr Justice Hoffmann, as

[8] CP, para 5.42.

[9] (1886) LR 33 Ch D 347, 350. Cotton LJ continued "... That is to say, it is not like a man simply investing his own money where his object may be a larger present income than he can get from a safer security; but trustees are bound to preserve the money for those entitled to the *corpus* in remainder, and they are bound to invest it in such a way as will produce a reasonable income for those enjoying the income for the present".

[10] [1985] Ch 270, 286 to 287.

[11] (29 June 1988), reported in (1996) 10(4) *Trust Law International* 112.

he then was, preferred the formulation that trustees "must act fairly in making investment decisions which may have different consequences for different classes of beneficiaries" to the image of holding scales equally between income and capital.[12] He rejected a mechanistic approach to discharging investment duties, holding that in reality trustees have "a wide discretion" in making their investment decisions. In the Court of Appeal Lord Justice Staughton reiterated that "the obligation of a trustee is to administer the trust fund impartially, or fairly … , having regard to the different interests of beneficiaries" but, like Mr Justice Hoffmann, noted that "at times it will not be easy to decide what is an equitable balance".[13]

4.15 The duty to balance was also embedded in the Trustee Act 2000. Section 4 requires trustees to have regard to the standard investment criteria in exercising their general power of investment under section 3. The standard investment criteria are "the suitability to the trust of investments of the same kind as any particular investment proposed to be made or retained and of that particular investment as an investment of that kind" as well as "the need for diversification of investments of the trust, in so far as is appropriate to the circumstances of the trust". The Explanatory Notes explain that "suitability" includes "considerations as to the size and risk of the investment and the need to produce an appropriate balance between income and capital growth to meet the needs of the trust".[14]

4.16 Under section 4(2) of the 2000 Act, trustees are required to review their investments in the light of the standard investment criteria, which the Explanatory Notes explain is a codification of the common law duty as stated in *Nestle*.[15] The Explanatory Notes also state that the general power of investment is not entirely unfettered as trustees remain subject to their fundamental duties, including "the duty to act in the best interests of the present and future beneficiaries".[16]

The CP's provisional proposals on balance

4.17 The duty to balance underpinned the power of allocation proposed by the CP. The power would allow trustees to overcome inappropriate classifications that caused an imbalance, to restore a balance where investments made with a view to a particular form of return had not performed as expected, and to allocate the global receipts from an investment portfolio selected on a total return basis. The duty to balance would place an active duty on trustees to consider whether or not to exercise the power of allocation. The CP's proposals amounted to a new positive manifestation of the duty to balance.

4.18 The proposed extension of the duty to balance into the post-investment stage of

[12] (29 June 1988), reported in (1996) 10(4) *Trust Law International* 112, 115. See also the statement of Chadwick LJ in *Edge v Pensions Ombudsman* that in constructing an investment policy "the essential requirement is that the trustees address themselves to the question what is fair and equitable in all the circumstances" ([2000] Ch 602, 627).

[13] [1993] 1 WLR 1260, 1279.

[14] Trustee Act 2000 Explanatory Notes, para 23.

[15] Trustee Act 2000 Explanatory Notes, para 24. See *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260, 1282G (Leggatt LJ).

[16] Trustee Act 2000 Explanatory Notes, para 21.

trust administration was a novel concept.[17] Under current law, there is no general duty on trustees to effect a balance between income and capital beneficiaries on receipt of investment returns as there is no power to allocate investment returns; the availability of the power of allocation would allow balance to be considered later than is currently the case:

> In consequence [of the availability of the power of allocation], trustees would be able to postpone the balancing process from the time when investment policy is being formulated until after investment returns are received.[18]

4.19 The CP made a number of provisional proposals about the duty to balance. It considered that the duty to balance should remain a central component of all trusts, unless excluded or modified by the settlor (either expressly or by necessary implication).[19] It concluded that the duty should not be excluded by implication merely on the basis that the subject matter of the trust constitutes an unauthorised investment or a specific gift, nor merely because there is a power to postpone conversion of the original trust assets.[20] The CP invited consultees' views on whether the duty to balance should be placed on a statutory footing.

4.20 The CP did not consider there to be any need to provide further statutory guidance to trustees as to the meaning of balance. In particular, the CP considered, but rejected the possibility of providing a non-exhaustive statutory list of relevant factors to help trustees determine whether or not a balance has been maintained between competing beneficiaries.[21]

The relevance of personal circumstances to balance

4.21 In *Nestle v National Westminster Bank plc*, Mr Justice Hoffmann and Lord Justice Staughton took the view that the personal circumstances of beneficiaries are a relevant factor in discharging the trustee's duty to balance when selecting investments.[22] The CP considered the issue of whether trustees should take into account the personal circumstances of beneficiaries in discharging their duty to balance in the context of its discussions of a proposed new power of allocation.[23]

4.22 In line with its view of the nature of the power of allocation, the CP considered it "essential that the personal circumstances of beneficiaries should not be a relevant consideration in the exercise of the statutory power of allocation".[24] The CP considered that to require or permit trustees to consider personal circumstances would blur the distinction between an administrative and a dispositive power. To do so would potentially have an adverse tax impact on

[17] Except to the extent that the rules of apportionment can be understood as restoring a balance.

[18] CP, para 5.42.

[19] CP, para 5.29.

[20] CP, para 5.31.

[21] CP, paras 5.67 to 5.77.

[22] See paras 4.11 and 5.27; consider further discussion in CP, paras 5.67 to 5.76.

[23] See CP, paras 5.56 to 5.76.

[24] CP, para 5.57.

trusts benefiting from the new power; it would provoke legal uncertainty, increasing the risk of litigation against trustees; and it would depart from the express intentions of the settlor.[25]

4.23 This conclusion was at odds with the understanding of the pre-investment duty to balance established by *Nestle*. The CP therefore considered whether or not personal circumstances ought to remain a relevant consideration in contexts other than the exercise of the power of allocation; in particular, when formulating an investment policy.[26] The CP noted the difficulty in justifying a position where personal circumstances were relevant to some aspects of the exercise of the duty but not to others, and invited consultees' views on the relevance of personal circumstances in exercising the power of investment.

PERCENTAGE TRUSTS AS AN ALTERNATIVE VEHICLE FOR TOTAL RETURN INVESTMENT

4.24 We have outlined how the CP's proposed power of allocation would have enabled trustees to invest on a total return basis. As explained in Part 3, the power to allocate is not the only way to achieve total return investment. Percentage trusts - known in the US as unitrusts – are another tried and tested method. The CP outlined their operation, noting that English law does not prohibit a settlor from constituting a percentage trust. However, it explained the "significant obstacles to the widespread adoption of percentage trusts in England and Wales".[27] In addition to a number of practical issues,[28] the CP noted two major technical impediments to the current adoption of the percentage trust model.

4.25 The first was tax. The current tax system for trusts is based exclusively on the traditional income/capital dichotomy. Percentage trusts are based on the entitlement of different beneficiaries (or classes of beneficiaries) to a percentage of the value of the trust fund rather than on the traditional income/capital divide. From a tax perspective therefore, their structure does not map onto the current system, and so it has been unclear how they would be treated for taxation purposes; settlors have understandably been unwilling to venture on to unknown territory in that respect. The second problem is presented by the rule against excessive accumulations. Percentage trusts technically involve the accumulation of income receipts by the trustees. The current rule against excessive accumulations limits the maximum duration of accumulation to one of a number of permitted periods.[29] Government accepted in 2001 the Law Commission's recommendations that any limitation on accumulation should be abolished for private trusts, but at the time of the publication of the CP the rule against excessive accumulations in effect limited the duration of percentage trusts to 21 years. As we noted in Part 3, a Bill has been introduced to remove this difficulty.

[25] CP, para 5.58.

[26] CP, paras 5.67 to 5.76.

[27] See CP, para 5.36 and following.

[28] Such as the fact that such a structure will not be suitable for all types of trust property, the lack of general awareness of the model and scarcity of precedents.

[29] See The Rules Against Perpetuities and Excessive Accumulations (1998) Law Com No 251 for a full account of the current law and the Law Commission's recommendations for reform.

4.26 The CP made no recommendations about percentage trusts. Instead, it invited the views of consultees on the advantages and disadvantages of promoting percentage trusts in England and Wales.

CONSULTATION RESPONSES

Consultees' general comments on total return investment

4.27 Many of our consultees' specific comments about the proposed power of allocation have connotations for total return investment generally. Likewise, comments in response to the CP's discussion of percentage trusts and investment by charity trustees[30] provide some general comment on the utility of total return investment.

4.28 A number of consultees expressly supported the adoption of total return investment by trustees. For example, the Wills and Equity Committee of the Law Society considered that "it is not helpful for trustees to be constrained in their investment policy by the requirement to generate a certain level of income". STEP's response included an analysis of comparative returns demonstrating the improved results which should be achieved under a total return policy.[31] We also note below support from various consultees for percentage trusts, which by definition operate on a total return basis. Moreover, many of our respondents who focused on charitable trusts were in agreement that total return investment is a desirable objective for many trusts with charitable status.

4.29 However, other responses were more cautious about the widespread adoption of total return investment. Some consultees questioned the economic argument that the requirement imposed by the current law to invest so as to balance income and capital returns really does obstruct trustees in maximising returns for the trust. For example, the Law Reform Committee of the General Council of the Bar did not necessarily agree that

> … the need for balance in the choice of investments means that total returns are not maximised. The best returns on many family trusts have been secured over the last generation or two by those which invested in property, particularly for occupation. That investment has not been recognised as a balanced one by the courts, yet it has often maximised returns. The need for balance has not prevented an unbalanced investment strategy. We believe that the failure to achieve the best returns over the past decades has arisen from a misunderstanding of how to balance investments.[32]

4.30 Others concentrated on the potential effects on trustees and beneficiaries, and noted that total return investment was not suitable for all trustees. They argued that where trusteeship was taken on by inexperienced lay trustees (or, in effect, imposed on them in the case of a trust arising on intestacy), total return was likely to be an overly complicated concept to expect trustees to deal with.

[30] See paras 4.50 to 4.56 and 8.50 and following below.

[31] See analysis of responses, available at http://www.lawcom.gov.uk/citcat.htm.

4.31 Some were concerned about the potential effect of some forms of total return investment on life tenants in periods during which there was a negative total return. If the vehicle for total return provided the life tenant with no income in such circumstances, the life tenant, who might be wholly reliant on trust income, would be placed in a difficult position. This might be remediable by the exercise of a power of capital advancement, but such a power is not available in all cases. These consultees argued that such a problem is less likely to occur under the current approach to investment which can provide a level of income return independent of capital performance.[33]

4.32 It is important to note that not all these concerns apply to all types of total return trust. Most obviously, where a proportion of the value of the trust (rather than the return in any period) is paid to the income beneficiary, a relatively stable level of income is guaranteed. We therefore turn to consultees' comments on the particular mechanisms of total return investment discussed in the CP.

Reactions to the power of allocation

4.33 The following paragraphs do not describe consultees' comments on every aspect of the CP's provisional proposals for a statutory power of allocation.[34] Instead, we concentrate on general support for and opposition to the CP's proposal that there should be such a power, and on the more contentious areas of the policy provisionally proposed in the CP.

General response

4.34 Over two-thirds of those who answered the question agreed that a statutory power of allocation should be made available to the trustees of private trusts. However, some qualified their agreement with misgivings about issues such as the creation of uncertainty, potential tax consequences and the possibility that the power might be used for dispositive rather than merely administrative purposes.

4.35 Those who opposed the introduction of a statutory power of allocation raised two major areas of concern. The first was the practical implications of such a power for trust administration. Consultees pointed to a number of undesirable possible consequences. These included: exposure to more lawsuits; changes to accounting procedures and computer systems; increased use of suspense accounts and the delayed distribution of trust receipts to income beneficiaries;

[32] See also the comments of David Palfreyman, Bursar of New College, Oxford University, whose response, specifically addressing investment by permanently endowed charities, is reproduced at length in our analysis of responses to the CP.

[33] In the course of 2008 our Advisory Group echoed this concern, noting that for many trusts the provision of a steady income stream for the life tenant is more important than maximising total return.

[34] In particular, we do not comment on reaction to the provisional proposals that the exercise of the power of allocation should be subject to a time limit from the date of a particular receipt or expense, that the power should be reviewed by the courts on the same basis as any other discretionary power conferred upon a trustees or that an action for breach of trust should lie against trustees who fail to discharge their duty to balance by exercising the power of allocation, all of which were supported either unanimously or by the vast majority of those who commented. Nor do we discuss reactions to the suggestion of a special protocol for dispute resolution. These issues are covered in detail in the analysis of responses.

difficulties for inexperienced trustees; and the need for more detailed record-keeping. It was argued that these consequences, in particular the increase in the current workload of trustees, would give rise to an increase in trust management expenses to the detriment of beneficiaries.

4.36 For many of these consultees, the introduction of requirements that trustees take any steps on receipt of returns other than the distribution of such returns would be an unwelcome addition to trust administration. Such consultees preferred to continue to follow current practice of investing with the aim of creating a balance rather than investing solely to balance risk and return and then to take steps to adjust the fruits of investment on a total return basis.

4.37 The second area related to the tax consequences of the power of allocation. A number of consultees were concerned about the potential tax implications of the introduction of a power of sort described in the CP. Some were concerned that HMRC would not accept the CP's view that the power could genuinely be classified as administrative. Others saw difficulties in integrating the proposed regime within the existing tax system for trusts, leading to difficulty in persuading HMRC to adopt a tax-neutral approach to the provisional proposals.

Opt-in or opt-out?

4.38 Most of the consultees who answered the CP's question thought that the CP's proposed power of allocation should be available on an opt-out basis. The main reason for this view was that, in the words one consultee, "the proposals are intended to provide a better and more equitable trust regime, and … should plainly apply automatically and immediately to all new trusts".[35] It was also suggested that those trustees who were unaware of the existence of the new power were unlikely to be affected "in the sense that they're closer than some of the present rules to the approach they do or would probably take anyway".[36]

4.39 It is difficult to assess how far those consultees who favoured the introduction of an opt-out power of allocation truly supported the effective imposition of total return investment. Moreover, the CP's proposed simple classification rule for corporate receipts (discussed below) was closely connected with the power of allocation, so that it was difficult to support the former (as a suggested replacement for very unpopular current classification rules) without accepting the latter as an opt-out power. Equally, the consultees who thought that the power of allocation should be introduced on an opt-in basis were generally those who were concerned about the possible practical consequences of operating that particular power. These concerns do not translate to all forms of total return investment.

4.40 It is therefore not possible to determine conclusively on the basis of consultation responses the wider question of whether any total return investment power should operate on an opt-in or an opt-out basis.

Reactions to the duty to balance

4.41 The vast majority of consultees who answered the relevant question agreed that

[35] Mr Justice Etherton.

[36] Simon Gardner, University of Oxford.

trustees should be subject to the duty to balance, except in so far as the settlor expressly, or by necessary implication, excluded or modifies that duty in the terms of the trust. A similar majority agreed that the duty should not be impliedly excluded merely on the basis that the subject matter of the trust constituted an unauthorised investment or a specific gift.

4.42 As to placing the duty on a statutory footing, a majority of consultees who answered this question were in favour of doing so – some because of its fundamental importance, others on the basis of the new role the duty would play in underpinning the CP's proposed power of allocation.

4.43 Some consultees were, however, concerned that to place the duty to balance on a statutory basis would give it artificial prominence, and might even detract from trustees' other fundamental trust obligations. Two consultees highlighted the difficulties in drafting the concept of "balance" given the wide range of possibilities for which the statutory definition would be intended to cater. One consultee observed that placing the duty to balance on a statutory footing would detract from the flexibility of equity.

4.44 The vast majority of those who answered the question agreed that statute should not set out a list of factors relevant to determining whether or not a balance has been struck between income and capital. Consultees commented that such a list would not be suitable for all circumstances and would be unlikely to meet all possibilities. STEP suggested that a list of factors "would potentially create a 'box-ticking' compliance mentality".

4.45 Consultees were evenly split on the question of whether or not the personal circumstances of beneficiaries should be a relevant factor in the exercise of the statutory power of allocation. Some consultees made the general point that allowing trustees to take account of personal circumstances would blur the distinction between interest in possession and discretionary trusts. For example, Mr Justice Lloyd agreed with the CP that "if a settlor wishes [the trustees] to take [personal circumstances of the beneficiaries] into account, he should give them a dispositive discretionary power for the purpose".

4.46 Other consultees emphasised the practical implications of allowing trustees to take account of personal circumstances in the context of the proposed power of allocation. The British Bankers' Association and Barclays Bank Trust Company commented that "bringing the personal circumstances of the beneficiaries into account would not only impose a greater burden on trustees, but would also have a strong tendency to promote conflict between the beneficiaries and also between beneficiaries and trustees". Another consultee, Charles Russell solicitors, made what we considered to be a critical point when drafting the CP: that "allowing trustees to take account of personal circumstances may create difficulties with the tax implications of the power of allocation".

4.47 In contrast, a number of consultees thought that trustees should be permitted, but not obliged, to take account of beneficiaries' personal circumstances when exercising the power of allocation. Several emphasised the importance of trustees' flexibility in exercising their discretions. The Trust Law Committee commented that trustees "are not mechanical administrators of an impersonal fund of investments", and that in reality "many trustees would find [taking into

account personal circumstances] irresistible in practice … ". It was also suggested that there might be difficulties with excluding personal circumstances in a way which made clear exactly what are the circumstances to be disregarded.

4.48 Consultees were similarly split as to the relevance of personal circumstances to the duty to balance in the traditional pre-investment context. Slightly more than half of the consultees who responded to this question agreed with the *Nestle* approach and thought that personal circumstances should be a relevant factor when formulating a balanced investment portfolio. Several consultees noted that personal circumstances are just one of many factors taken into account, whether consciously or unconsciously, when trustees exercise their powers of investment. One consultee commented that in small family trusts it is fair to assume that the settlor would have wanted the beneficiaries' personal circumstances to be taken into account.

4.49 The remainder of those who replied to the question considered the *Nestle* approach to be incorrect. The Association of Corporate Trustees and HSBC observed the "practical difficulties for trustees knowing and accommodating beneficiaries' personal circumstances when making investment decisions". Simon Gardner commented "I am glad that you have noticed the overtly dispositive note in *Nestle*, and regard it as objectionable – I'd begun to think I was in a minority of one in troubling over this".

Reactions to percentage trusts

4.50 A number of consultees who commented on percentage trusts were not in favour of their promotion. Several noted the practical obstacles to such trusts in the context of private trusts, identified above. Just as the CP implied that the jump from current trust structures to the percentage trust model was too great a leap, so too a number of consultees were put off by the impediments to the adoption of the model identified above.

4.51 Some went further and questioned the desirability of percentage trusts. Christopher McCall QC argued that the percentage trust model "… suffer[s] from almost as many objections as the present law in being inflexible and all too likely to do as much harm as good. Even in the period in which the Trust Law Committee has been discussing this subject the level at which a fair percentage return might have been set has changed radically, and in my view percentages assume a degree of arithmetic exactitude which simply does not fit the multifaceted world of trusts."

4.52 The Trust Law Committee summarised its position in the following terms: "If [the rule against excessive accumulations] is abolished, there can be no objection in principle to percentage trusts … . There does not, however, appear to be any considerable pressure for change in this area of the law and we do not believe the Law Commission should feel obliged to recommend that the law should be changed merely to facilitate their adoption." This suggests a certain ambivalence towards percentage trusts, perhaps equivalent to that exhibited in the CP.

4.53 However, other responses, including responses from bodies representing large numbers of trust practitioners, were more positive.

4.54 STEP commented that percentage trusts have "considerable merit". In a similar

vein, the Wills and Equity Committee of the Law Society could "see some merit in promoting percentage trusts, which would be particularly useful where trustees wish to operate on a 'total return' basis. It would remove much of the artificiality which often occurs in operating a trust and would clearly make distribution calculations easier."

4.55 Mr Justice David[37] strongly supported the development of percentage trusts for the furtherance of total return investment. He commented that "the time has come to introduce the 'percentage trust' or 'unitrust' into English (and Welsh) law" and encouraged the Law Commission to "take this opportunity so as comprehensively to deal with capital and income and the total return approach to investment". He suggested that the introduction of such trusts would, amongst other things, lessen the administrative burden on trustees and remove the problematic issue of the relevance of factors such as the personal circumstances of beneficiaries. Mr Justice David Hayton suggested that "the function of the Law Commission is to be bold and look at things with fresh eyes, starting with a clean sheet of paper" and concluded by encouraging us to "be bold: go the whole way and not three quarters of the way".

4.56 However, Mr Justice David Hayton, in common with a number of the consultees supportive of percentage trusts, and those opposed to them, recognised the importance and difficulty of formulating an appropriate tax structure for such trusts.[38] Although some consultees suggested ways of taxing percentage trusts,[39] HMRC in its consultation response was less positive, stating that "we still see significant practical difficulties in determining the correct tax treatment of such entities".

CLASSIFICATION RULES

The CP's provisional proposals

4.57 The CP stressed the utility of the power of allocation in overcoming the deficiencies of the rule-based classification of trust receipts. The provision of a flexible power to change a default classification would enable trustees to overturn any inappropriate results produced by the underlying rules. However, the CP recognised that, whether the power was provided on an opt-in or opt-out basis, there would be trustees who were unable to rely on the power of allocation to correct inappropriate classifications. Consequently, the problems with the rules of classification of corporate receipts could not be ignored, and there remained a need to reform the current law. In any case, as the power of allocation would operate following classification there remained an onus to put in place as straightforward and accurate a set of base rules as could be reasonably achieved.

4.58 As we explained in Part 2, the CP expressed the view that the current rules

[37] Of the Caribbean Court of Justice, formerly Professor of Law at King's College London, and current editor of *Underhill and Hayton: Law of Trusts and Trustees*.

[38] STEP noted that percentage trusts would require "an appropriate adaptation of the taxation framework of such trusts".

[39] The Wills and Equity Committee of the Law Society said that they could see no reason why percentage trusts could not be accommodated by analogy with the rules relating to annuities within the present trust tax regime.

governing the classification of corporate receipts rest on principles of questionable relevance and fail to deliver either certainty or fairness.[40] It described this position as "illogical and capricious" and provisionally proposed that the current rules governing the classification of corporate receipts should be abolished.

4.59 In examining what should take the place of the current law, the CP expressed a preference for a rule of general application rather than a list of specific provisions for particular distributions. It accepted that it might not be possible to draft a general rule that would give a perfectly acceptable result in all situations,[41] but it noted that the power of allocation would allow trustees to achieve a balance in circumstances where the rule did not.[42]

4.60 The CP provisionally proposed a simple rule based on the form of the receipt whereby cash distributions to trustee-shareholders by corporate entities, or distributions which trustees could have taken in cash, should be classified as income and non-cash distributions should be classified as capital.[43] In order to preserve the classification of receipts that *Bouch v Sproule* appropriately classifies as capital, the CP noted that the treatment of payments made on liquidation and authorised reductions of capital would be unaffected by the rule.[44]

4.61 The CP suggested that the new rule would give rise to a default classification if the proposed power of allocation were available and to a conclusive classification if it were not. The proposed rule of classification would be subject to any contrary provision in the terms of the trust. The CP stressed the relative simplicity of the proposed new rule as opposed to the complexity of the rule in *Bouch v Sproule*. It also suggested that the rule would operate in the majority of circumstances to produce an economically appropriate result, so providing an acceptable balance between those interested in income and those interested in capital.

Reaction of consultees

4.62 All the consultees who answered our question about the rule in *Bouch v Sproule* agreed that it should be replaced. The Wills and Equity Committee of the Law Society stated "in our view the existing classification rules result in confusion and uncertainty and random outcomes". In a similar vein, STEP stated that "the current rules of classification generate arbitrary and illogical results and can create considerable complexity and uncertainty for trustees and their advisors".

4.63 Almost all of those who addressed the question agreed that the rules of classification for trust receipts should be subject to any contrary provision in the terms of the trust.

[40] See para 2.35 and following above. See para 2.55 and following above for a discussion of non-corporate receipts.

[41] CP, para 5.4.

[42] CP, para 5.11.

[43] CP, paras 5.6 to 5.12. This approach is similar to the classification rule in the UPIA and the Massachusetts rule.

[44] See para 5.54 below for the similar treatment of the proceeds of the repurchase and redemption of shares.

4.64 Most of the consultees who commented on the proposed cash/non-cash classification rule supported it. Responses stressed the need for a clear and simple rule, particularly if a power of allocation were also available. The Association of District Judges thought that it was "important that the replacement rules should be as simple as is possible to avoid the necessity in the vast majority of cases for trustees to have to take expensive advice and/or court proceedings to clarify treatment". One consultee favoured the provisional proposal "in the interests of simplification, in place of the current rules, so long as it were coupled with availability to the trustees of a separate power to allocate in order to deal with any perceived imbalance".

4.65 While a number of consultees expressly predicated their support for the CP's proposed rules of classification on the availability of a power of allocation, some thought that a simple rule was desirable in its own right. One consultee commented that the rule "would provide a clear and certain rule which would help trustees know what to do and make for less difficulty in the administration of trusts".[45]

4.66 Despite this high level of support, a number of important concerns were raised in relation to the proposed cash/non-cash rule. A few consultees commented on the mismatch between the classification produced by the proposed rule and the treatment of receipts under the tax rules. We discuss the interaction of our proposed reform to the classification rules and tax at paragraphs 5.75 to 5.78 below.

4.67 Some consultees expressed concerns about how the cash/non-cash distinction would be drawn. Obviously, if the definition of cash were not sufficiently clear and relatively easy to apply, then the introduction of the CP's proposed rule could shift disputes from the meaning of income/capital to cash/non-cash.

4.68 Consultees acknowledged that, as well as being simpler and more certain than the current law, the CP's proposed rule of classification would produce more appropriate results in a number of areas; for example, in cases of a direct demerger.[46] However, a number of responses pointed out that the proposed rule also had the potential to produce what they considered to be inappropriate results, in particular by classifying as income certain types of cash receipts which are properly treated as capital. These included unusually large dividends paid in cash, and enhanced scrip dividends where the cash option would be worth very much less than the shares.

4.69 The CP acknowledged that its proposed rule would produce the same result as the current law in the case of capital profits dividends[47] and for large distributions of accumulated trading profits. If the profits were distributed in the form of an enhanced scrip dividend the rule would produce an arguably less appropriate result than the current law (where part of the dividend may be apportioned to

[45] Moore & Blatch.

[46] See CP, para 5.10.

[47] CP, para 5.11.

capital).[48]

CONCLUSION

4.70 We have presented the CP's proposals, and consultees' responses in 2004, as a "package", because that is where matters rested for over three years. We explained in Part 1 that our work on this project had to be suspended because of other urgent law reform work. As a result, a fresh start was made in 2008. By then, Government policy on the taxation of private trusts had changed dramatically. That very different tax climate, as well as the lapse of time, led us to undertake further informal consultation in 2008. The outcome of that final year of work, so far as it concerned classification and total return investment, is presented in Part 5.

[48] CP, paras 2.35 to 2.36.

PART 5
RECOMMENDATIONS

INTRODUCTION

5.1 The response to our 2004 consultation demonstrated that there is widespread dissatisfaction with the existing rules for the classification of corporate receipts. Most consultees supported the CP's provisional proposal of a simple cash/non-cash rule to replace the rule in *Bouch v Sproule*, in the context of the provisional proposal for a power of allocation. Most also supported the power of allocation. But it was equally clear that the extent and diversity of the trusts sector make it extremely unlikely that there would ever be unanimity as to the way forward.

5.2 In re-opening this project in 2008, our task was to respond to the breadth of views expressed in consultation, as well as to pursue the taxation aspects of the project which, in 2004, had been left for future discussion in the light of consultation responses and of the planned reform of the trust taxation system. We had made it clear in the CP that any change we might recommend must be tax-neutral, neither increasing the tax burdens on trust beneficiaries nor threatening tax revenue.[1]

5.3 In 2004, HMRC was in the process of consultation in preparation for its Trusts Tax Modernisation programme. We held preliminary discussions with HMRC before publication of the CP, but at that stage it was not possible to say for certain how trusts would be taxed if a power of allocation were made available to trustees; as the CP acknowledged, the tax treatment for trusts subject to any new apportionment and classification regime would "need to fit within the modernised system of trust taxation on which the Inland Revenue is currently consulting".[2] The CP therefore recognised HMRC's interest in this area and underlined the need to design reform which was tax-neutral and so did not give rise to concerns about tax savings or the potential for abuse.

5.4 HMRC's formal response to the CP noted that a power of allocation would give rise to a number of tax issues. First, HMRC expressed concern that the power might offer tax avoidance opportunities by allowing trustees to treat as income what HMRC viewed as capital, and to treat as capital what HMRC viewed as income.

5.5 Secondly, HMRC took the view that if the exercise of the power had the effect of changing the nature of the receipt, that is, overturning an initial classification,[3] then the result might be that two identical corporate receipts would be classified differently, depending on whether they were paid to an individual or a trustee. This would run counter to the aim of HMRC's Trust Tax Modernisation programme to reduce any tax distinction between asset-holding by trusts and by individuals.

5.6 On the other hand, if the exercise of the power did not change the classification

[1] CP, paras 5.63 and 5.100.

[2] CP, para 5.101.

of a receipt but allowed the trustee to decide whether to pay it to the income beneficiary or retain it as capital, HMRC warned that the power might cause an interest in possession trust to lose its status as such for both income tax and, where relevant, inheritance tax purposes,[4] thereby increasing its income tax and inheritance tax liabilities. This was a concern that we raised in the CP, and indeed is well-established as a reason why a power of allocation is not currently a normal feature of trusts for interests in succession, despite the availability of precedents for such a power.[5]

5.7 The CP had expressed the hope that HMRC would either find itself able to approve our proposed scheme as tax-neutral within the current law or to co-operate in the modification of the tax rules in order to allow the scheme to operate tax-neutrally.[6] HMRC's consultation response explained that, as things stood, there was a range of obstacles to both of those objectives. However, as noted, trust taxation was in a state of flux at the time of consultation and further engagement was planned.

5.8 There have been a number developments in trust taxation since the close of the consultation period. The most significant for this project relates to inheritance tax. The Finance Act 2006 introduced sweeping changes to the taxation of trusts. The tax advantages previously enjoyed by accumulation and maintenance trusts were removed,[7] and the circumstances in which the income beneficiary of an interest in possession trust will be regarded for inheritance tax purposes as beneficially entitled to the underlying assets were restricted.[8] As a result, the range of trusts that now fall within the "relevant property regime"[9] has been significantly expanded. It is important for those trusts that now fall outside the relevant property regime to remain outside it (unless they choose otherwise). We would not make any recommendation for reform that would automatically deprive them of that status. Nor would there be any realistic likelihood of take-up for any reform which required trustees to change the tax treatment of the trust.

5.9 Since work on this project recommenced in 2008 we have held extensive discussions with HMRC about the tax consequences of the type of trust law reform that we would wish to see introduced. We are grateful to officials at HMRC for their assistance while we have been formulating policy. Our objective has remained to work with HMRC to devise ways in which trust law reform might be introduced tax-neutrally.

3 This was the intention behind the CP: see CP, para 5.64.

4 See paras 5.67 and following below. We use the term "interest in possession" to describe both an interest in possession for inheritance tax purposes and a trust in relation to which one or more beneficiaries have an immediate entitlement to the income of the trust as it arises and s 479 of the Income Tax Act 2007 ("ITA 2007") does not apply for the purposes of income tax.

5 See paras 3.27 to 3.28 above.

6 See CP, para 5.63.

7 Inheritance Tax Act 1984 ("IHTA 1984"), s 71 as amended by the Finance Act 2006.

8 IHTA 1984, s 49 as amended by the Finance Act 2006.

9 That is, the provisions set out at Chapter III of Part III IHTA 1984 applying to "relevant property" as defined at s 58(1). See further para 5.70 below.

5.10 However, that objective has proved to be attainable only to a very limited extent. HMRC has explained the tax consequences that would follow from our desired reforms in the context of current tax law and policy. We believe that the settlors, trustees and beneficiaries of interest in possession trusts would find such consequences unacceptable. Debate on the interpretation of the current tax legislation and case law cannot overcome these consequences as they flow from trust tax policy which could be reinforced, if necessary, by provisions in a Finance Act. We do not consider it appropriate to make recommendations for reform which cannot be implemented without adverse tax consequences - either for the Exchequer or for trusts and their trustees and beneficiaries.

5.11 This Part therefore includes two sorts of proposals for law reform. First, we say what we consider, from a trust law perspective, the law should be. Our proposals include the replacement of the rule in *Bouch v Sproule* with new classification rules, and the provision of a statutory power of allocation on an opt-in basis to offer flexibility and, for those who wished to achieve this, facilitate total return investment. However, as these proposals cannot be put into effect without unacceptable tax consequences, they are not the subject of formal recommendations. Instead, we make recommendations for immediate consideration by Government which can be implemented without adverse tax consequences either for the Exchequer or for trusts and their beneficiaries.

OUR PREFERRED POLICY

5.12 We start by outlining our conclusions on total return investment as a necessary precursor to a discussion of the rules of classification for corporate receipts.

Total return investment

5.13 Three things were clear from the consultation exercise. One was that there is considerable support for total return investment within the trust industry as a profitable approach to investment. Many trustees would like to be able to operate it and are frustrated by their current inability to do so. Secondly, we are satisfied that total return investment would not be suitable for all trusts. It requires a level of expertise and confidence on the part of the trustees which not all possess. Thirdly, we were encouraged by the response to the CP's discussion of percentage trusts. The CP treated percentage trusts with some caution, because of their unfamiliarity and the current impediments to their adoption, and indeed many respondents did not comment on them. But although a number of consultees were opposed to the promotion of percentage trusts, there were significant supporters, including STEP and the Wills and Equity Committee of the Law Society, who together represent a great many practitioners and trustees, as well as Mr Justice David Hayton.[10]

The power of allocation

5.14 We remain of the view that total return investment should be facilitated for private trusts by means of the power of allocation advocated in the CP, but on an opt-in basis. We would like settlors of private trusts who believe that the trust fund should be invested on a total return investment basis to be able to provide their

[10] Of the Caribbean Court of Justice, formerly Professor of Law at King's College London, and current editor of *Underhill and Hayton: Law of Trusts and Trustees*.

trustees with a defined power of allocation, without fear of adverse taxation consequences.[11]

5.15 In light of concerns raised in consultation we no longer consider that the power should operate on an opt-out basis as we do not think that a power of this kind is appropriate for all trusts. We have in mind particularly the position of lay trustees, many of whom act for trusts implied on intestacy and who may not have investment expertise. We consider that a power of allocation should be a facility offered to settlors, not a power that all trustees are under a duty to exercise. It should, however, be open to the trustees of existing trusts to opt into a total return investment regime and in effect provide themselves with such a power, with the consent of their beneficiaries.[12]

5.16 The power of allocation would allow trustees, taking the trust's receipts over a given period, to allocate all or part of one or more trust receipts as necessary in order to ensure that a balance was kept between classes of beneficiaries entitled to capital and to income. The power would therefore allow trustees to overcome inappropriate classifications produced by the default rules (if there remained a net imbalance, looking at receipts as a whole over the period) and to maintain a balance where investments made with a view to income return or capital protection had not performed as expected. It would also enable trustees to ignore the likely form of receipt when making investment choices and so invest on a total return basis.

5.17 The power would be framed so as to make it clear that it was administrative rather than dispositive. There would be a time-limit from the receipt of an investment return, after which the default classification would become conclusive.[13] The power should be reviewable by the courts on the same basis as any other discretionary power conferred upon trustees. We see no case for any statutory protection or immunity and an action for breach of trust should lie against trustees who failed to discharge their duty.

PRACTICAL IMPLICATIONS OF A POWER OF ALLOCATION

5.18 We reach these conclusions after reflection on the points raised about the power in consultation. Overall, we are not convinced by the concerns of some consultees about the practical implications of a power of allocation.

5.19 We remain of the view that the introduction of such a power would rarely give rise to successful claims against trustees, on the basis that perceived imbalances could usually be redressed by further exercise of the power. We do not envisage that the power would have to be used regularly, or in relation to a significant number of receipts, in order to achieve a balance, taking investments as a

[11] See paras 3.27 to 3.28 above.

[12] Arrangements would have to be made to safeguard minors and others incapable of consenting. Further consultation and discussion would be required to settle the details of arrangements for existing trusts to opt in, given the strong majority view in consultation that a court application in these circumstances would make opting in extremely unattractive.

[13] Consultees commented on a number of options linked with the tax year or the date of receipt; a rule would have to be agreed with HMRC.

whole.[14] The conclusions we reach below about the appropriate meaning of balance in the context of the exercise of the power of allocation would further simplify its operation.

5.20 Crucially, the type of power of allocation that we are now proposing would be made available on an opt-in basis. Consequently, those trustees who were concerned about the relative benefits of total return investment for their trusts would not need to concern themselves with the power; nor would those without the skill and experience necessary to invest on a total return basis.

PERSONAL CIRCUMSTANCES

5.21 We consider in the light of consultation responses that the balance underlying the power of allocation should be tightly defined so as to indicate to trustees that they should be aiming to achieve an impartial balance between income and capital. Their only relevant consideration would be to ascertain what would represent a reasonable rate of income return. In practical terms, this would allow trustees to settle on a level of return falling within a relatively narrow range,[15] and would make for ease of administration. It would also emphasise that the power is an administrative rather than a dispositive one.

5.22 It follows from this that we think that a power of allocation should be defined so as to prevent trustees from taking account of factors such as the personal circumstances of beneficiaries.

Percentage trusts

5.23 In view of the support for percentage trusts expressed on consultation, we would also like to see more work done in order to develop a model of percentage trust for this jurisdiction. However, some respondents took issue with whether it was the Law Commission's role to promote percentage trusts. For example, the Law Reform Committee of the General Council of the Bar doubted that "… law reform is the appropriate tool for the promotion of a new type of trust". We agree that that work must be the task of the trust industry itself, in partnership with HM Treasury and HMRC; we revert to that point later.

The duty to balance

5.24 Consultation responses demonstrated that the meaning of the duty to balance depends on the context in which the duty is being applied.

5.25 We are content that the general meaning of that duty, including the relevance of the personal circumstances of beneficiaries to investment decisions, should remain subject to developments in the law of equity. We note that a narrow majority of the consultees who addressed the CP's questions about the relevance of personal circumstances to investment decisions supported the approach advocated by Mr Justice Hoffmann at first instance in *Nestle* and by Lord Justice Staughton in the Court of Appeal. Nevertheless, we retain the concerns

[14] See CP, paras 5.47 to 5.48 and 5.80 to 5.82 for a discussion of the reasons for our view that the introduction of the power would rarely provoke litigation and that its exercise should not be excessively onerous in practice.

[15] Guidance could be provided, either by the trust industry or conceivably by HMRC.

expressed in the CP about the effect of what we called the "*Nestle* approach". Consultation has emphasised that it remains controversial for many. In the absence of re-examination by the courts, settlors who wish their trustees to ignore the personal circumstances of their beneficiaries when investing may make express provision to that effect in the trust instrument.

5.26 It follows that we do not consider that the general duty to balance should be placed on a statutory footing. As consultees warned, any attempt to "capture" the duty may have unintended consequences.

5.27 We have commented above on the meaning of the duty to balance in the context of the exercise of the power of allocation. The CP discussed whether the duty in that context would mean the same as it currently does in relation to trustees who have to keep a balance in the selection of investments. A duty to balance applying post-investment when exercising a power of allocation would be a positive obligation, going beyond the negative sense of the current duty as it applies to the selection of investments; this is a new context for the duty, and its meaning in that context would need to be spelt out in the statute.

5.28 The CP commented that "it is difficult to frame a principled justification for the position where the same duty informs trustees' decisions in two different contexts but the content of that duty is significantly different in each context".[16] We have concluded in the light of consultation that this is not a real difficulty. There is no reason why these two manifestations of the trustee's equitable duty to balance should give rise to the same considerations in different contexts. Accordingly, we consider that a statutory requirement to balance investment returns arising under a power of allocation should apply solely in the context of the exercise of the power of allocation. The obligations of trustees in selecting investments on a traditional basis with a view to achieving a balanced return would not be affected by such legislation.

5.29 In conclusion, we consider that it would be preferable for the general duty to remain as an equitable duty of general application and for any statutory provision setting out a power of allocation to spell out the basis on which that power operates for those purposes only.

Classification of corporate receipts

Abolition of existing rules

5.30 In the light of the difficulties generated by the rule in *Bouch v Sproule*, in particular its illogical basis, its tendency to produce unexpected or arbitrary results, and the difficulties of applying it in practice,[17] we remain of the view that it should be abolished and replaced. All the consultees who answered our question about the rule agreed.[18] Rather more difficult is the decision what to put in its place. That decision is made all the more difficult by the range of trustees for whom the rule will apply; experienced paid trustees taking professional advice, trust companies conducting high-volume business and lay trustees acting for low-

[16] CP, para 5.72.

[17] See para 2.35 and following above.

[18] See para 4.62 above.

value trusts. Although, as we go on to explain, we think that it should be open for settlors to specify their own classification rules if they wish to do so, any rule that we recommend should be capable of being operated by all types of trustee.

Rules or discretion?

5.31 The first step is to decide whether to replace the rule in *Bouch v Sproule* with a rule or rules, or with discretion. We received a very detailed consultation response from Mr Arthur Weir, on behalf of the City of Westminster and Holborn Law Society, arguing strongly against any rule-based approach to classification and advocating an alternative approach to classification to be guided by good accountancy practice, possibly underpinned by a Statement of Recommended Practice ("SORP").[19]

5.32 The City of Westminster and Holborn Law Society approached the classification rules from the basis that "the function which trustees must perform when allocating a receipt is an accountancy function". It took the view that:

> … classification is a matter of judgment. [It] does not require an esoteric science unique to trusts and charities. It is a routine function in accounting for an organisation to classify each receipt and payment according to what the accounting person judges to be its true nature in relation to the organisation and the purpose for which the accounting is required. As in all exercises of judgment the accounting person … must consider all the circumstances of the case and give weight to those deemed relevant.

5.33 The adoption of such an approach to classification would avoid the problems inherent in any rule of classification and would be sufficiently flexible to cater for future changes in corporate distributions. Professional trustees with accountancy skills, or trustees employing accountancy professionals to deal with tax, would not find it onerous.

5.34 However, many trustees are not accountants, and do not employ them, or would be unwilling to give their accountants more extensive instructions. The content of "generally accepted accounting practice" is not understood by non-professionals and the correct application of SORPs would not be straightforward. The approach suggested by the City of Westminster and Holborn Law Society would, we think, give rise to other practical problems. Critically, if classification depended on the trustees' decision, receipts would be left unclassified until trustees had reached a view, which could potentially have tax consequences and also delay the administration of the trust to the detriment of the beneficiaries.

5.35 It is open to debate how far the sort of approach advocated by the City of Westminster and Holborn Law Society should properly be viewed as "discretionary". We consider that such an approach is ultimately discretionary. There would be no underlying rule for the classification of receipts as they arise

[19] The Accounting Standards Board explains that "SORPs are recommendations on accounting practices for specialised industries or sectors. They supplement accounting standards and other legal and regulatory requirements in the light of the special factors prevailing or transactions undertaken in a particular industry or sector": Accounting Standards Board Statement, *SORPs: Policy and Code of Practice* (July 2000).

to the trust; classification would be based on the individual judgement of the trustee. The fact that such judgement should be in some way guided by accountancy practice (and possibly a SORP) does not, in our view, render the judgement non-discretionary. While accountants may regard such practice and SORPs as professionally binding, most trustees are not accountants, and many trustees will not be professional. Even to accountants, SORPs provide guidance, but are not in the final analysis determinative. The team was referred to examples of SORPs for investment trusts and unit trusts.[20] While these establish a number of principles, and set out quite detailed guidance in certain circumstances, the user of the SORP is left with significant discretion depending on the circumstances of the case.

5.36 We discussed the City of Westminster and Holborn Law Society's suggestions with HMRC and are satisfied that such an approach to classification would cause changes to the tax treatment of interest in possession trusts. It would also add to administrative burdens since it would lead HMRC to require full accounts from all trusts. We discuss below the taxation consequences of any element of decision-making, even falling short of discretion, in classification; a discretionary approach, even one a involving a narrow discretion, would certainly attract these consequences.

5.37 Accordingly, we do not favour the classification scheme advocated by the City of Westminster and Holborn Law Society, or any other discretionary approach to classification.

Cash/non-cash

5.38 We consider that consultation has confirmed our view that the basis for the classification of corporate receipts should be the form-based rule proposed in the CP: that cash distributions to trustee shareholders, or distributions which trustees could have taken in cash, should be classified as income and all other distributions from corporate entities should be classified as capital. As we discuss at paragraph 5.54 below, the rule would be formulated to ensure that the treatment of certain sorts of payment made by companies to their shareholders which are properly classified as capital under the current law would not be affected by the new rule.

5.39 A form-based approach has the merit of simplicity. The CP's proposal was rooted in a desire to avoid complex provisions that we thought would be difficult for many trustees to apply, at least without professional advice. The CP accepted the difficulty of formulating a sufficiently certain rule capable of operating appropriately in all circumstances, but noted that its proposed approach would overcome some of the inappropriate classifications of corporate receipts generated by the current law. However, as Part 4 describes, while consultees generally supported the CP's proposed rule, a number of respondents outlined

[20] See The Association of Investment Trust Companies, *Statement of Recommended Practice: Financial Statements of Investment Trust Companies* (revised December 2005) (available at http://www.theaic.co.uk/files/technical/aitcrevised%20SORPDecember2005.pdf) and Investment Management Association, *Statement of Recommended Practice: Financial Statements of Authorised Funds* (November 2008) (available at http://www.investmentfunds.org.uk/news/standards/sorp.pdf).

circumstances in which it would not give rise to what they considered a fair classification.

5.40 It is important that the simple rule advocated in the CP is viewed in the context of the CP's overall policy recommendations. In particular, the CP's provisional proposals for classification were premised on the availability of a power of allocation which would be available to trustees to smooth the outcomes produced by a new rule of classification. The potential problems created by the CP's proposed rule of classification would be of reduced significance where a power of allocation was available, as that power would enable the trustee to create an overall balance between the capital and income beneficiaries whatever the classification of individual receipts.

5.41 However, our preferred policy is now an opt-in power of allocation, and we accept that many trusts would not opt into the power. Accordingly, any rule of classification introduced in substitution to the rule in *Bouch v Sproule* must work in isolation, without the assistance of a power of allocation.

5.42 The most significant problems with a cash/non-cash rule concern cases, such as abnormally large cash dividends or scrip dividends, where the capital value of the shareholding is materially reduced by a distribution which is classified as income.[21]

5.43 Our preferred policy builds on the basic approach taken by the CP (and supported by consultees) in order to address the classification of large dividends, so far as we consider it practicable to do so. It attempts a slightly more refined exercise than that demanded by the CP's proposed rule, by introducing a further test (see paragraph 5.44 and following, below), but still places a premium on ease of operation by trustees. However, no rule, however nuanced, can produce an entirely satisfactory outcome in every case, and so our preferred policy also incorporates an additional opt-in power to adjust individual corporate receipts.

A 20 per cent threshold

5.44 A number of consultees commended the provisions of the UPIA as a means of providing a more adequate rule of classification than that proposed in the CP. These included STEP, the largest trust industry body in the UK and world-wide.

5.45 The basic approach of the CP to the classification of corporate receipts was in line with that of the UPIA; both rely to a greater or lesser degree on a default rule based on the form of receipt which can be adjusted by a trustee power. However, the UPIA modifies its basic form-based rule with a number of additional provisions not replicated in the rule provisionally proposed in the CP.[22]

5.46 One of the most significant sophistications provided by the UPIA is the way in which it deals with proportionately large corporate distributions which take a form which the simple form-based rule would classify as income. Section 401(c)(3) of the UPIA allocates money received in "total or partial liquidation" to capital. Partial liquidation is defined in section 401(d)(2) to include a distribution or series of

[21] See para 2.20 above.

[22] A copy of the relevant provisions of the UPIA can be found in Appendix D.

related distributions totalling more than 20 per cent of the entity's gross assets. Such receipts are therefore classified as capital no matter what form they take.[23] The effect of this provision is to supplement the basic form-based classification rule with a percentage cut-off.

5.47 In the US, percentages have, in the past, been used as a means of classifying corporate stock distributions. Small stock dividends were classified entirely as income and large stock dividends were classified entirely as capital, with the size of the dividend being determined by the relative size of the stock distribution to the company's capital. The rule is commonly known as the "six per cent rule" on the basis that it was common for stock dividends of less than six per cent to be classified as income, and those above six per cent to be classified as capital.[24]

5.48 We do not consider that this sort of percentage approach would, on its own, be an appropriate rule of classification, since it is to some extent arbitrary and can give rise to unusual or inappropriate results. Perhaps most significantly, a rule which in practice requires trustees to gather information as to the percentage of every distribution as against the company's existing capital (which may not be obvious from the documentation provided by the company) is clearly onerous. However, we do consider that it would be appropriate to adopt the UPIA's 20 per cent figure as the cut-off under a new classification rule. The practical effect of the cut-off would be that very large cash distributions would be prevented from benefiting the income beneficiary. As a result, some of the potentially inappropriate results of the CP's proposed rule of classification would be avoided.

5.49 20 per cent is rather a high threshold for this purpose. However, it would be performing a significantly different function than the threshold under an entirely percentage-based rule such as the six per cent rule. The threshold supplements a form-based classification which itself provides an imperfect, but nevertheless useful, classification. Its purpose, however, is to limit the exception to the form-based rule to distributions which are clearly extraordinary. This is essential to ensure that trustees need not be concerned to quantify run-of-the-mill distributions which will clearly fall below the 20 per cent threshold. We commented above that the application of a percentage rule to classify all receipts as income or capital would be onerous. A 20 per cent threshold will only need to be considered for obviously abnormally large receipts. Receipts in excess of 20 per cent will be very rare and it will be obvious to trustees when they need to consider whether the threshold has been crossed. When sufficiently large receipts do arise they will almost certainly be flagged by the distributing entity.[25]

5.50 In addition, the basis of valuation that we would advocate would make the trustees' task rather easier. The UPIA rule applies the 20 per cent test to gross assets as shown by the entity's year-end financial statements immediately preceding the initial receipt. While we understand the reasons for imposing a test based on statements of gross assets, we see practical problems in requiring trustees to obtain the information necessary to make such a calculation. A

[23] The entire receipt is classified as capital, not just the amount that exceeds 20 per cent.

[24] See MC Devine, "Principal and Income Allocation of Stock Distributions: the Six Per Cent Rule" (1966) 64(5) *Michigan Law Review* 856.

[25] Note that provision would be required to cater for the application of the 20 per cent threshold to a series of linked distributions by analogy with s 401(d)(2) of the UPIA.

company may not have filed up-to-date accounts and so available information may be out of date.

5.51 Accordingly, we would prefer a valuation based on the total market value of its shares. That would be relatively simple to calculate for a listed company and would broadly reflect the proportionate value of the distribution as against the trust's shareholding in the company. Applying the rule to unlisted companies would be far less easy. There might not be any recent valuation of the company, and it would not be realistic (or in many cases possible) to require one. Therefore, although distributions of over 20 per cent will be rare (and those on the borderline of the 20 per cent threshold would be still more unusual) we are concerned that imposing a 20 per cent test based on the market value of an unlisted company could be onerous.[26]

5.52 We therefore propose that the 20 per cent threshold rule should be limited to listed companies.[27] If settlors of shares in unlisted companies are concerned that the basic form-based rule is capable of causing unfairness then they should consider opting into the power to adjust, discussed below.

Summary of our proposed new classification rule

5.53 Accordingly, our preferred policy for the classification of corporate receipts is that cash distributions to trustee shareholders, or distributions which trustees could have taken in cash, should be classified as income and all other distributions from corporate entities should be classified wholly as capital; but that in any event and regardless of form, if the distribution of which the receipt forms part represents more than 20 per cent of the market value of a listed company then it should be classified as capital. Our proposed new rule would be applicable to receipts from all companies (UK and overseas).

5.54 We have said that the rule should apply to "distributions". That term is not used in the technical company law sense;[28] but, as the CP suggested, the framing of the application of the new rule is important. The proposed rule would apply solely to replace the rule in *Bouch v Sproule* in respect of payments made by companies to shareholder trustees in their capacity as shareholders. As the CP made clear, payments made to trustees by companies for other reasons, such as in repayment of principal or interest on a loan, would not be affected by the rule. The CP also explained that the rule would not apply to payments "made on liquidation or otherwise on an authorised reduction of capital".[29] Equally, form-based classification should not apply to share repurchases and redemptions, payments which are properly classified as capital under the current law. Neither the form-based nor the 20 per cent threshold elements of our proposed rule would affect the treatment as capital of payments made in exchange for all or part

[26] It might also be inappropriate; the value of shareholdings in an unlisted company may vary depending upon whether or not they amount to a controlling stake. Moreover, it is arguable that, irrespective of valuation issues, the rule should not be extended to unlisted companies as such companies are more likely to make irregular distributions which could exceed the threshold but which most would consider should be classified as income.

[27] Shares listed on a recognised stock exchange.

[28] For the company law definition of "distribution", see Companies Act 2006, s 829.

[29] See CP, para 5.9, n 5.

of the trust's shareholding.[30]

5.55 We consider that our proposed rule would overcome many of the shortcomings of the current law identified by the CP and in consultation. The rule would be more easily understood than the current law, as it is not wholly reliant on company law concepts. Nor does it require trustees to obtain information from companies about the detailed mechanics of payments. Although simple in comparison to existing law, the rule would be sufficiently sophisticated to produce appropriate results in the majority of cases. In particular, in classifying distributions of shares (on demerger or otherwise) and very large cash distributions by listed companies as capital, the rule would overcome many of the unrealistic outcomes of the current law.

5.56 Settlors who wished, for whatever reason, to take a different approach to classification could do so by means of express contrary provision in the terms of the trust, which could adjust or disapply part of the rule, or provide an alternative rule entirely. In addition, we suggest, they should be able to choose to give their trustees a more flexible power to classify receipts.

A power of adjustment for corporate receipts

5.57 The classification rules outlined above would classify the majority of corporate receipts in a way that most would consider appropriate. However, in the absence of the power of allocation there remains scope for further refined classification. The new rule proposed above is still capable of producing results that some would view as incorrect; for example, a large one-off dividend that fell just short of the 20 per cent threshold and classified as income.

5.58 We therefore consider that there is scope for enabling trustees to hone the classification of receipts from companies further and reduce the risk of an inappropriate classification. This cannot be achieved by more detailed rules. To achieve this level of sophistication it is necessary to provide trustees with a more flexible power to adjust the classification of individual corporate receipts. The objective of the power would be to classify a receipt more precisely than is possible by means of rules. It might, for example, be relatively clear that the distribution referred to in paragraph 5.57 above would consist wholly or largely of capital and should be adjusted accordingly.

5.59 Such a power should not apply by default to all trusts. We are content that the refined rules of classification outlined above produce an appropriate result in most cases. The extra layer of sophistication that a power to adjust would bring may be considered valuable by some settlors and by some trustees, but it is not a necessity. Consequently, a power of adjustment should only be available where there is an express provision to that effect in the trust deed.[31] It should be seen

[30] There are obviously various ways in which legislation could achieve that outcome. We note the approach taken under section 401(c)(2) of the UPIA where money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest is expressly allocated to principal. Alternatively, the ambit of the rule could be limited so that it did not apply at all in such circumstances. In deciding on a particular formulation the concern would be to produce a rule which is as straightforward as possible.

[31] There would also be scope for provisions to enable trustees of existing trusts to opt in to this power; but see para 5.14 and n 12 above.

as a facilitative tool for trustees rather than something imposed upon them.

5.60 The power to adjust should be clearly distinguished from the power of allocation provisionally proposed by the CP. The power of allocation would enable trustees to invest without regard to the likely form of return and to adjust as necessary to achieve balance across an entire portfolio. A power to adjust would attach to individual receipts. Trustees with a power to adjust would therefore need to continue to invest on the basis of a balanced portfolio, aiming to balance income and capital returns. They could not rely on the power to adjust to create a balanced set of returns where they had failed to take account of balance in formulating investment policy.

5.61 The power would be a narrow one. It would be available only where the trustee reasonably considered that the classification rule for corporate receipts had produced a substantial imbalance between the income and capital interests, having regard to the preservation of the real value of capital and to the need to achieve a reasonable return on the trust investment.[32] The power would not be exercisable where the trustees foresaw or ought reasonably to have foreseen that the investment would perform so as to favour income or capital.[33] This is necessary to take account of the fact that some investments will have been specifically selected at the portfolio-building stage even though they were likely to produce predominantly income or capital returns; the power to adjust should not apply to those investments merely because they have, as anticipated, favoured one class over another.

5.62 The considerations in the preceding paragraph determine the circumstances in which the power would be available. Where it was available, the trustee's objective in exercising the power would be to restore, so far as reasonably practicable, a reasonable balance between the income and capital interests. In determining a reasonable balance, the trustee would be required to have regard to the preservation of the real value of capital and to the need to achieve a reasonable return on the trust investment, and to any special reason why the particular investment was made.

5.63 The effect of the exercise of the power would depend on whether it was exercised before or after the distribution is received by the trustees.

5.64 If exercised prospectively, the power would allow the trustees to overturn the classification that would otherwise be produced by the classification rule. This is particularly important in relation to a receipt which would otherwise be income; by exercising the power prospectively, the trustees would be able to ensure that the income beneficiary never became entitled to the receipt.

5.65 Trustees would also be able to exercise the power to adjust after receipt of the

[32] We are grateful to Christopher McCall QC for drafting suggestions made in the course of Advisory Group discussions which assisted us greatly in formulating the proposed power.

[33] The most obvious example of a receipt excluded on those grounds would be a share purchased at a high price at a point when a dividend is expected. The power of adjustment could not rectify the inevitable imbalance created by the decision to invest in those circumstances. Likewise, if an investment chosen as part of a balanced portfolio was expected to produce capital returns, the capital returns produced could not be adjusted on the basis that they favoured the remainderman at the expense of the life tenant.

distribution, subject to a time-limit, by making a compensatory payment. Compensating income out of capital would be straightforward. Compensating capital out of income would be less easy. The power would not allow trustees to "claw-back" a receipt paid out to the income beneficiary, but would allow compensatory payment to be made from future income. Provision would have to be made to ensure that the income beneficiary was not entitled to further payments until the compensatory amount had been recovered.

5.66 It is important to stress that we see the power to adjust as a power that would not have to be exercised as a matter of course; and we have suggested that it should be framed in a way which limits the circumstances in which it would be engaged. The power should only be exercisable to rectify classifications of corporate receipts which substantially failed to keep an objective economic balance between income and capital and where the trustee reasonably considers that to be the case. Imbalanced returns which were intended or objectively foreseeable when the investment was made should be excluded. A power framed in these terms would only be engaged where necessary and not in relation to all, or indeed to most, corporate receipts. This would limit the cost of exercising, and considering the exercise of, the power and would protect trustees from criticism that they had not used the power when they could have done so. Section 61 of the Trustee Act 1925 would provide further protection for trustees from liability for any wrongful exercise or failure to exercise the power. Settlors choosing to provide the power might also consider it appropriate to offer trustees exemption from liability arising from the exercise of the power in good faith.

THE TAX CONSEQUENCES OF THOSE PROPOSALS

5.67 The measures outlined above form a package: a power of allocation offering flexible classification and enabling total return investment on an opt-in basis, together with revised classification rules in the form of a basic cash/non-cash classification subject to:

(1) a 20 per cent threshold: any distribution from a listed company, worth more than 20 per cent of the value of the company, would be capital; together with

(2) an opt-in power to adjust the classification of individual receipts.

5.68 As we indicated at the beginning of this Part, proposals for reform in this area are only workable if they do not have adverse taxation consequences for the trusts that would make most use of them. Key to understanding those consequences is the distinction for tax purposes, to which we have already referred, between trusts with an interest in possession and those without.[34] The distinction affects both the income and capital taxation of the trust.

5.69 By default, the general rule is that trustees are charged to income tax on trust income at the dividend ordinary rate of 10 per cent (dividend income) or the basic rate of 20 per cent (other income), as appropriate. However, if the trustees can decide what to do with income, to accumulate it or pay it out at their discretion, they will be liable for tax on income received at the dividend trust rate of 32.5 per

[34] On the use of the expression "interest in possession" see n 4 above.

cent (dividend income), or the trust rate of 40 per cent (other income).[35] Hence, a trust fund that is not subject to an interest in possession for income tax purposes is taxed at the trust rates regardless of the marginal rate of any beneficiary who may receive the income (which may be lower).[36] In addition, certain receipts which in trust law are classified as capital, but are treated as income for the purposes of income tax, are charged at the trust rate even in the context of a trust fund which is subject to an interest in possession for income tax purposes.[37]

5.70 For inheritance tax purposes, since the reforms in the Finance Act 2006, only limited categories of new interest in possession trusts are now treated for inheritance tax purposes as though the income beneficiary were beneficially entitled to the underlying assets. Accordingly, the trusts for which our preferred policy would have the most impact from the inheritance tax perspective are trusts with a pre-22 March 2006 interest in possession,[38] and trusts created after 22 March 2006 establishing an interest in possession which is an immediate post-death interest within section 49A Inheritance Tax Act 1984 ("IHTA 1984")[39] or a disabled person's interest within section 89B IHTA 1984. It is of great importance to such trusts that the interest in possession remains a qualifying interest in possession for inheritance tax purposes.[40] If the fund ceased to be subject to a qualifying interest in possession, it would suffer a 20 per cent charge to inheritance tax at the point of entering the relevant property regime[41] and thereafter periodic charges, at a maximum rate of 6 per cent on every 10-year anniversary of the trust, and proportionate exit charges on property leaving the trust between 10-year anniversaries.[42]

5.71 Accordingly, any reform that caused an involuntary change to the income tax and/or inheritance tax regime applicable to an interest in possession trust would be one that we could not recommend. We take the three elements of our preferred "package" in order.

[35] ITA 2007, s 479.

[36] When income is distributed by the trustees of such a trust, the recipient beneficiary will receive a credit at the trust rate (40 per cent) reflecting the tax paid by the trustees. A beneficiary who is a basic-rate taxpayer, or a non-taxpayer, may be able to claim repayment of some or all of this tax. However, this introduces an additional administrative step. In addition, if the tax pool of the trust is not sufficient to give the beneficiary's payments the benefit of the 40 per cent tax credit, the trustees will be liable to additional income tax under ITA 2007, s 496.

[37] ITA 2007, ss 481 and 482.

[38] Including those in relation to which a transitional serial interest within IHTA 1984, s 49B has arisen following the pre-22 March 2006 interest in possession.

[39] These can only be created by will or under the intestacy rules.

[40] There can also be capital gains tax implications; under Taxation of Chargeable Gains Act 1992 ("TCGA 1992"), ss 72 and 73, on the death of a person entitled to such an interest in possession no chargeable gain accrues on the trustees' deemed disposal of the trust property.

[41] An event whereby assets which were previously treated under IHTA 1984, s 49 as assets to which the income beneficiary is beneficially entitled become instead relevant property is a chargeable transfer which is not potentially exempt, and is charged to tax at half the death rate under s 7(2); this may be increased to a maximum of 40 per cent in the event of the income beneficiary's death within seven years.

[42] Pursuant to IHTA 1984, ss 64 to 69.

Total return investment vehicles

5.72 HMRC's position is the same for both the power of allocation and for percentage trusts. They take the view that if a trust opted into a power of allocation, or were to adopt a percentage trust format, its income would then be regarded as accumulated or discretionary income for income tax purposes and the trust fund as falling within the relevant property regime for inheritance tax purposes. This is because they analyse the power of allocation as enabling trustees to make a decision as to the entitlement of the income beneficiary.

5.73 That reasoning might seem more obviously relevant to a power of allocation than to a percentage trust. For percentage trusts the procedure for determination of the appropriate percentage for distribution to the income beneficiary would vary depending upon the type of percentage trust adopted; but in some models, at least, it would be determined by the settlor or by statutory instrument, or would have to be within a range fixed by statutory instrument, thus involving far less scope for real discretion by the trustees. But HMRC's position is the same in both cases because in either case the form of the trust means that something that would otherwise be income can become capital.

5.74 As the CP explained, the purpose and effect of our proposed measures would be to define income and capital, rather than changing entitlement to them, but HMRC regards entitlement from the point of view of conventional classification and would take no account of the trust classification. This accords with the current policy to promote consistency of treatment for trust beneficiaries and individuals; and of course an individual cannot choose whether to treat a receipt as income or as capital.[43] Accordingly, HMRC's position remains that, without tax legislation, the introduction of a power of allocation or percentage trusts would give rise to adverse consequences for interest in possession trusts.

Classification rules: cash/non-cash and the 20 per cent rule

5.75 It follows from what we have said already that taxation difficulties are likely to arise from any classification rules that run contrary to Government policy that individuals and trusts should receive equivalent tax treatment, and accordingly from any rule – or facility, for example to turn income into capital – that applies to trusts and not to individuals.

5.76 Revised classification rules for trusts would mean that receipts classified by HMRC as income might be treated as capital, and *vice versa*. There is already special provision for receipts that would in some circumstances be treated as income but are capital for other purposes, in section 383 of the Income Tax (Trading and Other Income) Act 2005. Pursuant to that section, any such receipts would be taxed as income, but at the basic rate. HMRC's concern is that the diversion to the trustees of what would otherwise be income might deprive them of the higher rate tax which would be payable if the income were received by an income beneficiary who paid income tax at the higher rate.

5.77 Accordingly, HMRC's view is that, because of the potential for tax avoidance,

[43] We do not question that policy, but are concerned to ensure that trusts are not penalised, in tax terms, for behaviour that would not penalise an individual; for an individual there is simply no equivalent to the tax treatment of discretionary and accumulation trusts.

either of the two elements of our revised classification scheme would be likely to result in an extension of the deeming provisions of sections 481 and 482 Income Tax Act 2007. The effect of this would be that the corporate receipts to which our new rules applied would be taxed at 40 per cent (the trust rate; or, where appropriate, the dividend trust rate of 32.5 per cent). In effect, the main income tax advantage of non-discretionary trusts would be entirely lost.

5.78 The extension of the deeming provisions in response to the proposed classification rules would render the latter impracticable, and indeed would lead to the disappearance of the interest in possession trust as a meaningful concept, in so far as the income taxation of corporate distributions is concerned. Such a move would be unacceptable to the trust industry and we cannot recommend it.

Power of adjustment

5.79 The likely taxation consequences referred to above in the context of the rest of our preferred "package" would be equally relevant to the power of adjustment. Legislation making available a power to adjust would again, in HMRC's view, run the risk of the extension of the deeming provisions of sections 481 and 482 of the Income Tax Act 2007. Moreover, and more seriously, trusts with the power to adjust would lose their status as interest in possession trusts for both income tax and, where relevant, inheritance tax purposes. Legislation would be needed to prevent that consequence. Even if that were forthcoming, HMRC would be concerned with the need to impose safeguards to ensure that the power was being exercised objectively, such as: very tight definitions; the involvement of an accountant to certify the legitimacy of a decision to adjust; perhaps a Financial Reporting Standard to cover the situation. HMRC personnel were also concerned about the practical implications of policing the exercise of the power.

5.80 There is a possible analogy here with Statement of Practice 4/94, which states that HMRC will abide by trustees' decisions as to classifications in the unusual case of enhanced scrip dividends.[44] In such a case a dividend can be taken in cash, or in the company's own shares, but the shares are worth more than the cash. The existence of Statement of Practice 4/94 could be taken to suggest that there might be potential for an extension of the circumstances where the tax classification might follow the trusts classification as determined by the trustees. However, HMRC officials observed that the Statement of Practice was devised in response to very specific circumstances; HMRC would oppose any suggestion that Statement of Practice 4/94 be widened.

The effect of taxation on our preferred policy

5.81 The consequence of the tax considerations set out above is that we cannot recommend that a power of allocation be made available to trusts, because the taxation consequences would be such that very few settlors (or trustees, subject to transitional arrangements for existing trusts) would regard it as worthwhile to opt in. The same is true of the power to adjust.

5.82 As to our preferred classification rules, we cannot recommend these because of the likely consequence in the extension of the "deeming provisions" described above, which would lead to the income in trusts being taxed at the trust rate

regardless of the marginal rate of the income beneficiary. This is all the more serious since, as a classification *rule,* our preferred approach to the classification of distributions from companies would affect all interest in possession trusts and therefore the taxation consequences would be inescapable, whereas the power of adjustment would of course be optional for settlors. In any event, aside from those tax consequences, we would be reluctant to recommend the introduction of such a rule in isolation from the other reforms that we have indicated we would like to take place. As our discussion of the adequacy of our preferred classification rule indicates,[45] we consider that its introduction should be accompanied by the option of more refined classification (via a power of adjustment) or of total return investment (in the form of a power of allocation or a percentage trust). We have referred above to "the three elements of our preferred 'package'" of reform.[46] Careful thought would need to be given to any suggestion to introduce some, but not all, of that package.

5.83 Tax considerations therefore prevent us from making the recommendations that we would like, from a trust law perspective, to make for reform of the law for private trusts. That does not, however, mean that there is nothing that we can recommend that would improve the current law.

OUR RECOMMENDATIONS FOR REFORM

Classification

5.84 One of the particularly unhelpful results arising from the rule in *Bouch v Sproule* is that shares distributed in a direct demerger are classified as income, despite the fact that the shares distributed represent the capital of the trust.[47] It should be noted that the similar situation that arises on an indirect demerger has been addressed by the courts.[48] In *Sinclair v Lee*[49] the Chancery Division of the High Court distinguished *Bouch v Sproule* and held that the shares issued pursuant to an indirect demerger were to be classified as capital. This was a formalistic distinction made in order to avoid what the Court clearly regarded as an absurd result.[50]

5.85 We recommend that shares distributed in demergers be classified as capital. For direct demergers, this would reclassify shares currently received as income. We have referred above to the tax consequences of changing the classification of income receipts to capital.[51] However, this does not apply in relation to shares received after a demerger. Despite their current classification as income, the income beneficiary does not have to pay income tax on them, because they are

[44] See para 2.24 to 2.25 above.

[45] See para 5.57.

[46] See para 5.71 above.

[47] See paras 2.27 to 2.29 above.

[48] See paras 2.30 and following above.

[49] [1993] Ch 497 (Sir Donald Nicholls VC). This is a decision of a lower Court and therefore vulnerable to judicial amendment.

[50] See paras 2.30 to 2.34 above.

[51] See para 5.82 above.

defined as exempt distributions. Accordingly, a change to the classification of such distributions has no tax implications and is not a concern to HMRC.

5.86 We raised the potential for reform of the classification of exempt demerger shares with our Advisory Group, focusing on the desirability of overturning the current treatment of some demerger shares as income and introducing more consistency of treatment between direct and indirect demergers. We have discussed with the Trust Law Committee how a new rule should be framed.

5.87 The Trust Law Committee had, in 2001 in the light of its own consultation on classification and apportionment, similarly narrowed its reform proposals from the general discretion to re-allocate, advocated in its consultation paper, to more targeted reform. The Trust Law Committee's revised view at that time was that a direct demerger should be classified as capital, with a discretion in exceptional cases to benefit income.[52]

5.88 The Trust Law Committee takes the view that there should be a discretion for trustees to make a payment out of capital to the income beneficiary following the distribution of demerger shares. It does so because of a concern that the demerger may give rise to a loss of dividend income. The Committee has outlined circumstances in which a company planning a demerger will decide to "roll up" profits in the demerger shares rather than making a dividend. For individual shareholders this merely provides a different means of realising value, since the shares can be sold if an immediate return is wanted; but for trustee shareholders such a procedure would, absent any discretion, prejudice the income beneficiary.

5.89 There is also a more technical reason why the interests of income beneficiaries might suffer in the case of a demerger. For a company to effect a demerger, distributable reserves have to be available in order for the company to be able to declare a dividend and are converted into share capital where a demerger proceeds by way of dividend; even without deliberate rolling up of profits in the demerger shares, this may lead to a temporary diminution in the funds available for dividends.

5.90 In many cases it would not be in the interests of the company to interrupt the normal flow of dividends in this way. Where a direct demerger would use up distributable reserves to an appreciable extent, the directors would opt for a different method of demerger, for example by way of indirect demerger by means of reduction of capital which would not affect the distributable reserves.

5.91 The Trust Law Committee accepts that prejudice to the income beneficiary would be a relatively rare occurrence. Nevertheless, it reports cases concerning trusts of company shares in which, absent any discretion, significant hardship would be suffered by the income beneficiary if the shares were classified as capital.

5.92 We share the Trust Law Committee's concern that the unsatisfactory current

[52] A similar rule was considered appropriate for enhanced scrip dividends. STEP also identified demergers as a distinct problem which could be addressed by legislation, in its response to our CP. While on balance favouring an approach akin to the UPIA model, STEP remained "open-minded as to the best way to proceed" and noted that "where specific legislation might be considered is in the area of 'direct' demergers".

classification rules for demergers should not be reformed in a way which is capable of causing significant prejudice to one set of beneficiaries over another. We are anxious not to impose unhelpful complications upon trustees in order to deal with what we think will be quite a rare occurrence, but we have concluded that on balance it would be appropriate to provide a discretion to make a payment of the sort envisaged by the Trust Law Committee.[53] Of course, as indicated earlier in this Part, our preference would be for a straightforward general classification rule for corporate receipts supplemented, where the settlor considers it appropriate, by a power of allocation or adjustment. However, given that at this stage it is not possible to recommend these powers, we accept that a more limited discretion for some demergers is required.

5.93 If the trustees did exercise their discretion to advance capital to the income beneficiary to compensate him or her for the fact that the demerged shares now form part of capital, there would be no income tax consequences as the beneficiary would not be receiving income. For qualifying interest in possession trusts, there would be no charge to inheritance tax, since the income beneficiary in such cases is already treated as the owner of the property for inheritance tax purposes. In the case of relevant property trusts, there would be an exit charge when the property left the trust. There would be a disposal for capital gains tax purposes[54] in respect of the assets advanced, but in the case of relevant property trusts a holdover claim could be made[55] since this is also an occasion where inheritance tax is payable.

5.94 Accordingly, we recommend that shares distributed in an exempt demerger should be treated as capital of the trust. Trustees should have a power to make a payment of capital to beneficiaries interested in income where otherwise there would be prejudice to those beneficiaries.

Recommendation

5.95 **We recommend that all distributions falling within sections 213(2) or 213A of the Income and Corporation Taxes Act 1988 (defined as exempt distributions in section 218) should be classified as capital for trust law purposes.[56] When such a distribution is made, the trustees should have a power to make a payment of capital to beneficiaries interested in income where otherwise there would be prejudice to those beneficiaries.[57]**

5.96 We would have preferred not to single out any particular form of distribution for reform, and it will be appreciated that we do so now only in the absence of other tax-neutral options. We are mindful of the constantly changing landscape of corporate distributions and of possible future changes in taxation. Accordingly, the draft Bill makes provision for the Secretary of State to be given power to extend this category, with the consent of HM Treasury, in the event that new forms of exempt distribution - similar to that currently available for demergers -

[53] See draft Bill, cl 3.

[54] Under s 71 TCGA 1992.

[55] Under s 260 TCGA 1992.

[56] Draft Bill, cl 2(1) and (3)(a).

[57] Draft Bill, cl 3.

are devised in the future.

Recommendation

5.97 **We recommend that the Secretary of State should be given power by statutory instrument to provide, with HM Treasury consent, for similar amendments to trust classification in the event that developments in tax legislation create new exempt distributions.**[58]

Total return investment

5.98 We share the inevitable disappointment of many in the trust industry that in the light of current tax law and policy we have decided not to make any recommendations for total return investment for private trusts. We appreciate that it is the prerogative of Government to determine tax policy, in the context of numerous competing interests that affect any tax regime. Nevertheless, we consider that our inability to recommend a total return scheme at this time is a loss not only to individuals but also to the economy, because total return investment would potentially generate a higher overall tax revenue from trusts. We remain optimistic that it will be possible in the future for our preferred policy, set out in this Part, to be developed.

5.99 One of the statutory functions of the Law Commission is to advise Government departments about the reform of the law. Accordingly, we conclude this Part with a recommendation that HMRC and HM Treasury work with the trust industry to devise a mechanism for total return investment in a way that facilitates investment while remaining satisfactory from the point of view of taxation.

5.100 This is a recommendation that envisages engagement and action over time rather than a "quick fix". The technical details would require close engagement by HMRC, and the work we are recommending can take place only if there is support from HM Treasury.

5.101 We would add that in our view, the model for total return investment that we think most likely to be successful is not the power of allocation, as originally envisaged in the CP, but the percentage trust. In discussing total return investment vehicles with HMRC, it became clear that any legislation to facilitate total return investment would probably have to include some percentage measure for the distribution of income.[59] In other words, of the two models, the percentage trust, while probably more alien at present to HMRC due to its unfamiliarity, is less inimical.

5.102 As tax law stands, a percentage trust would not be regarded as an interest in possession trust, and therefore a percentage mechanism would be unacceptable for interest in possession trusts. But we take the view that a percentage model should be far less troublesome in principle, from a tax point of view, than a power of allocation, because it need not involve a decision on the part of the trustees about the entitlement of individuals to a particular receipt; the percentage rate may be set by the settlor or indeed by statutory instrument. It is possible,

[58] Draft Bill, cl 2(1) and (3)(b).

[59] See para 5.73 above.

therefore, to devise a model that incorporates the elements of objectivity and predictability that would be important to HMRC. This should allay concerns about the abuse of the structure; and it would be possible to devise a method for taxing such trusts in a manner that is satisfactory to the trust industry while safeguarding tax revenue.

5.103 We are disappointed that we are unable, as things stand, to make more recommendations for legislative reform. Nevertheless, we are confident that our conclusions offer immediate improvements and map out potential future developments.

Recommendation

5.104 **We recommend that HMRC and HM Treasury in the longer term enter into discussions with the trust industry as to the feasibility and mechanics for total return investment for trusts within the parameters of current tax policy, to the extent that is possible, or in the event of future developments in policy.**

PART 6
THE RULES OF APPORTIONMENT

INTRODUCTION

6.1 It is a fundamental principle of equity that trustees must not favour one beneficiary or class of beneficiaries over another in exercising their powers and fulfilling their duties. We have discussed the equitable duty to balance and its implications in the context of the classification rules and the possibilities for developing total return investment for private trusts. The rules under consideration in this Part arise from the view taken by the courts, often many decades ago and in circumstances much less likely to arise today, of the implications of the duty to balance in specific circumstances.

6.2 The "rules of apportionment" encompass a number of situations where receipts or expenses classified as income or capital have to be shared. Most derive from case law and one from statute. That general description traditionally encompasses the trust for sale imposed by the first limb of the rule in *Howe v Earl of Dartmouth* which, rather than requiring apportionment, imposes a trust for sale.[1]

6.3 We commented in Part 4 that the duty to balance can be understood in both a positive and negative sense. The rules of apportionment, like the exercise of the CP's proposed power of allocation, can be regarded as a positive manifestation of the duty to balance, which requires trustees actively to balance the interests of income and capital in circumstances where the law presumes an imbalance. We can summarise the rules as follows.

The implied trust for sale under the first branch of *Howe v Earl of Dartmouth*

6.4 The equitable rule commonly known as "the first branch of the rule in *Howe v Earl of Dartmouth*" creates an implied trust for sale, putting the trustees under a duty to convert (sell and reinvest) residuary personal estate, held on trust for persons in succession, if it is an unauthorised investment and of a wasting or hazardous nature.

6.5 Trusts for sale do not only arise under the rule in *Howe v Earl of Dartmouth*; they may also be created expressly.[2]

The equitable apportionment rules

6.6 There are several rules:

(1) the second branch of the rule in *Howe v Earl of Dartmouth* compensates the capital beneficiary for loss pending conversion of trust investments;

[1] (1802) 7 Ves Jr 137 and 2 Ves Jr Supp 14.

[2] Trusts for sale may also be imposed by statute, as was the case before 1996 in relation to trusts arising on intestacy and to the conveyance of a legal estate to joint owners: see CP, para 3.5 and n 7 below.

(2) the rule in *Re Earl of Chesterfield's Trusts* compensates the income beneficiary for loss of present income from future property where trustees have exercised a power to defer sale;

(3) the rule in *Allhusen v Whittell* apportions debts, liabilities, legacies and other charges payable out of the residuary estate between capital and income beneficiaries;

(4) the rule in *Re Atkinson* apportions the loss caused to the trust by authorised investments in loan stock where the borrower is unable to meet his obligations and there is insufficient security to make up the shortfall; and

(5) the rule in *Re Bird* apportions the loss caused to the trust by unauthorised investments in loan stock where the borrower is unable to meet his obligations and there is insufficient security to make up the shortfall.

6.7 The second branch of *Howe v Earl of Dartmouth* and the rule in *Re Earl of Chesterfield's Trusts* only operate where the trustee is under a duty to convert. The other apportionment rules operate independently of the duty to convert.

Apportionment Act 1870 and *Re Joel*

6.8 Section 2 of the Apportionment Act 1870 is a rule of time apportionment. The effect of the section is that income beneficiaries are entitled only to the proportion of income that is deemed to have accrued during their period of entitlement.

6.9 *Re Joel* is a necessary interpretation of section 2 of the Apportionment Act 1870. Many trustees have a power to apply trust income for the maintenance of a class of minors, for example under section 31(1) of the Trustee Act 1925. The rule in *Re Joel* is that trustees are only permitted to maintain an individual member of the class out of the income which can be apportioned to a period when they were alive and therefore eligible to receive the benefit of the income.

General points

6.10 With the exception of the statutory time apportionment rule, these rules are based on the presumed intention of the settlor or testator that the life tenant and the remainderman should enjoy the benefit of the trust equally. All are theoretically logical and sensible developments of the classification rules and the duty to balance. The difficulty is that they are commonly excluded from express trusts, because they generally require complex calculations relating (usually) to very small sums. They are without doubt honoured more in the breach than in the observance in implied trusts, where it is unlikely that the trustees will be aware of their existence. That said, there may be trusts set up expressly with a view to the trustees holding a type of property - perhaps reversionary interests - where one or more of the rules might be useful.

6.11 The CP discussed the equitable rules of apportionment, the implied trust for sale and section 2 of the Apportionment Act 1870, in the context of its provisional proposal for a power of allocation, and proposed that the rules be abolished. We discuss the details of the current law and the reasons for the CP's proposals

below, and the response of our consultees. Clearly, in the absence of a recommendation for a power of allocation, the CP's reasoning has had to be re-examined, but our conclusion, as we go on to explain, remains largely the same.

CURRENT LAW

Trusts for sale

6.12 A trust for sale is a trust where the trustees are under an obligation to sell or convert the trust property, known as a duty to convert. A trust for sale may be expressly created by a settlor or testator. No specific form of words is required, but the terms of the trust must place the trustee under a duty to sell or reinvest the trust property.

6.13 A trust for sale may also be implied under the first limb of the rule in *Howe v Earl of Dartmouth*.[3] The scope of the rule is very limited. A trust for sale will only arise in relation to residuary estate; it does not apply to realty; it only applies where the trust is for persons in succession; and it only applies to unauthorised investments (of which there are very few since the Trustee Act 2000), not to authorised investments that are either wasting or hazardous.[4]

6.14 The implied trust for sale is said to be based on the presumed intention of the testator that the income and capital beneficiaries should benefit equally.[5] Consequently, there is no implied trust for sale where it can be demonstrated that it was the intention of the testator that the trustee should not be placed under an immediate duty to convert, nor where it can be demonstrated that the testator intended to make an *in specie* gift.

6.15 An express power to retain existing investments, or an express discretionary power to sell, will be sufficient to exclude the implication of a trust for sale under the rule.[6] The rule is excluded in relation to trusts arising on intestacy, as the power of sale under section 33(1) of the Administration of Estates Act 1925 is inconsistent with the duty to sell.[7] However, a power to postpone sale is not generally sufficient to exclude the rule,[8] unless it amounts to a power to postpone

[3] (1802) 7 Ves Jr 137 and 2 Ves Jr Supp 14. See J Mowbray QC et al (eds), *Lewin on Trusts*, (18th ed, 2008), paras 25-70 to 25-87. *Halsbury's Laws of England* (4th ed 2007 (Reissue)) Volume 48, para 966, suggests that an implied duty to convert arises in relation to hazardous and unauthorised investments more generally. However, the cases cited therein are better explained on the basis of an express trust for sale coupled with a power to postpone sale, or a discretionary power of sale.

[4] *Re Gough* [1957] Ch 323.

[5] See *Hinves v Hinves* (1844) 3 Hare 609.

[6] *Gray v Siggers* (1880) LR 15 Ch D 74; *Re Sheldon* (1888) LR 39 Ch D 50; *Re Pitcairn* [1896] 2 Ch 199; *Re Bentham* (1906) 94 LT 307; *Re Bates* [1907] 1 Ch 22; *Re Wilson* [1907] 1 Ch 394; and *Re Nicholson* [1909] 2 Ch 111.

[7] Previously a trust for sale with a power to postpone sale was imposed where a person died intestate under s 33(1) of the Administration of Estates Act 1925. However, this was amended by the Trust of Land and Appointment of Trustees Act 1996 which replaced the trust for sale with a trust with a power of sale, without amending the accompanying sidenote describing the section as imposing a trust for sale.

[8] *Re Berry* [1962] Ch 97.

and retain permanently for the benefit of the tenant for life.[9]

The equitable rules of apportionment

6.16 The rationale of the equitable rules of apportionment is to balance the competing interests of successive beneficiaries in circumstances where there would otherwise be an imbalance. The rules are premised on the presumed intention of the settlor or testator and consequently will be excluded by express or implied contrary intention.

Apportionment pending conversion

6.17 When a trustee is under either an express or implied duty to convert, trustees must sell and convert the trust property within a reasonable period.[10] Two complementary apportionment rules were developed to remedy the imbalance arising in the period between the imposition of the duty to convert and actual conversion: the second limb of the rule in *Howe v Earl of Dartmouth* apportioning hazardous or wasting investments and the rule in *Re Earl of Chesterfield's Trusts* apportioning reversionary interests.

6.18 The second limb of the rule in *Howe v Earl of Dartmouth* applies to all trusts for sale, whether express or implied,[11] where hazardous or wasting property is held for persons in succession. The rule is that pending actual conversion of the property, the life tenant is not entitled to the actual income that the property produces but rather to a sum calculated by applying a specified level of interest (usually four per cent) to the estimated value of the property. This sum is intended to reflect the "fair equivalent" of what he or she would have received had the property been converted into authorised investments.[12]

6.19 The second limb of the rule in *Howe v Earl of Dartmouth* is wider than the first (discussed above) in two respects. First, it is not limited to residuary estates of testators. Secondly, it is not limited to personalty; it extends to leasehold (but not freehold) interests.[13]

6.20 The rule in *Re Earl of Chesterfield's Trusts* is complementary to the apportionment rule in *Howe v Earl of Dartmouth*, in that it secures income from property that does not produce any income until it falls into possession. The rule

[9] See *Re Thomas* [1891] 3 Ch 482; *Re Chaytor* [1905] 1 Ch 233; *Re Inman* [1915] 1 Ch 187; *Re Rogers* [1915] 2 Ch 437; and *Re Berry* [1962] Ch 97.

[10] Usually taken to mean one year (*Bate v Hooper* (1855) 5 De GM & G 338). That is the case even where the duty is stated to be at the trustees' absolute discretion: *Re Atkins* (1899) 81 LT 421.

[11] *Gibson v Bott* (1802) 7 Ves Jun 89.

[12] See CP, paras 3.15 to 3.30.

[13] Section 8 of the Trustee Act 2000 authorises investments by trustees in leaseholds. However, under section 9 the trust instrument may expressly exclude leasehold interests from the list of authorised investments. In these circumstances the second limb of the rule in *Howe v Earl of Dartmouth* will still apply where there is an express or implied duty to convert. Consider further AJ Oakley, *Parker & Mellows: The Modern Law of Trusts* (9th ed 2008), p 759.

provides that where a reversionary interest[14] which ought to be converted is retained until it falls into possession, part of it is to be treated as arrears of income and paid to the life tenant. The calculation is complicated, but broadly the amount to be treated as capital is that which, if invested at four per cent compound interest with yearly rests (and subject to deduction of income tax), would have produced the sum actually received. The difference between those two amounts is to be treated as the arrears of income.[15]

Apportionment of debts, legacies and annuities

6.21 Where a testator's residuary estate is left to persons in succession, the rule in *Allhusen v Whittell*[16] functions to apportion debts, legacies, annuities and other charges payable out of the residuary estate between income and capital beneficiaries. The rule demands that payments made to discharge the obligations of the residuary estate should be taken to consist of a combination of income and capital. The purpose of the rule is to place the beneficiaries in the same position as they would have been in had the debts been paid at the moment of the testator's death so as to prevent the life tenant from benefiting from the portion of capital required for discharging debts.

6.22 The rule requires a calculation of the net average income of the estate from the date of death to the date of payment. The income beneficiary is then charged with interest at the rate of the net average annual income, so that once the debt is paid it is regarded as having been paid partly from income and partly from capital.

6.23 The rule also applies where a testator has personally covenanted to pay a life annuity and bequeathed residuary estate to persons in succession; each instalment of the annuity should be apportioned between income and capital in accordance with *Allhusen v Whittell*.[17] Where a legacy is contingent, the life tenant is entitled to the income that arises until the contingency occurs,[18] but contingent liabilities are to be apportioned.[19]

6.24 As with the second limb of the rule in *Howe v Earl of Dartmouth* and the rule in *Re Earl of Chesterfield's Trusts*, the rationale of the rule is the settlor or testator's presumed intention to maintain a fair balance between income and capital beneficiaries. However, this rule is not dependent on any duty to convert.

6.25 The rule in *Allhusen v Whittell* may be more flexible than the other equitable rules

[14] Although the paradigm application of the rule is reversionary interests, the rule also applies to outstanding personal estate which falls in after the exercise of a power to postpone sale, such as mortgage debt with arrears or arrears of an annuity with interest: see J Mowbray QC et al (eds), *Lewin on Trusts* (18th ed 2008), para 25-118.

[15] See CP, para 3.31 to 3.35. See further AJ Oakley, *Parker & Mellows: The Modern Law of Trusts* (9th ed 2008), pp 757 to 759.

[16] (1867) LR 4 Eq 295.

[17] *Re Perkins* [1907] 2 Ch 596. See further Capital and Income in Trusts (1999) Trust Law Committee Consultation Paper, para 4.3.

[18] Eg *Re Fenwick's Will Trusts* [1936] Ch 720.

[19] *Re Whitehead* [1894] 1 Ch 678.

of apportionment. In *Re McEuen*[20] it was expressly stated that the court did not wish to lay down a single mechanical approach to apportionment in this context, and in *Re Poyser*[21] it was held that the method of apportionment is in the discretion of court.

Apportionment of deficient securities

6.26 A successful investment in loan stock benefits both the life tenant and the remainderman; the remainderman is interested in the return of the principal debt while the life tenant receives income in the form of interest paid. Where the borrower defaults, the security for the loan (if any) will sometimes not be sufficient to make up the shortfall of principal, and while some interest may have been paid on the investment, further interest repayments may be outstanding on the debt. Receipts from the sale of authorised and unauthorised securities are apportioned between income and capital by the rules in *Re Atkinson*[22] and *Re Bird*[23] respectively.

6.27 The rule in *Re Atkinson* provides that a deficient security taken on an authorised loan must be apportioned rateably between income and capital in proportion to the outstanding debt owed to each beneficiary.[24] The rule is not limited to mortgages, but extends to the situation where on the winding up of a company there are insufficient funds to pay off debenture stock plus the interest due thereon.[25] The rule only applies once the security has been realised; until then the life tenant is usually entitled to the income arising from the security.[26] However, any income received before realisation in excess of any arrears due on a mortgage, for example, should be apportioned to capital.[27]

6.28 The position is different where the securities are unauthorised.[28] Generally the rule does not apply to investments made by trustees in breach of trust where no loss of capital is sustained; in these circumstances the income beneficiary is entitled to retain the full amount of income. However, where an investment is made in breach of trust which causes loss to the capital beneficiary then neither the income beneficiary nor the capital beneficiary should be able to gain an advantage. In these circumstances "from the very nature of the transaction one has to consider the rights of the parties at the time when the investment was made. Almost of necessity one must go back and adjust the rights as they stood at that time".[29] In *Cox v Cox*[30] the general principle was stated that neither the life tenant nor the remainderman should gain an advantage from the trustee's breach

[20] [1913] 2 Ch 704.

[21] [1910] 2 Ch 444.

[22] [1904] 2 Ch 160.

[23] [1901] 1 Ch 916.

[24] See CP, paras 3.55 to 3.59.

[25] *Re Walker's Settlement Trusts* [1936] Ch 280.

[26] *Re Broadwood's Settlements* [1908] 1 Ch 115.

[27] *Re Coaks* [1911] 1 Ch 171.

[28] See CP, paras 3.60 to 3.62.

[29] *Re Atkinson* [1904] 2 Ch 160, 167.

[30] (1869) LR 8 Eq 343.

of trust: "The two must share the loss in the same way as they would have shared it had it occurred when they first became entitled in possession to the fund".[31] This was applied in *Re Bird*,[32] where it was held that the life tenant and the remainderman should bear the loss rateably in proportion to the total income and capital that would have been received, in the same period, from an authorised security.

6.29 The apportionment rules do not apply after the security is realised following an order for foreclosure (where the borrower's equitable right to redeem is extinguished and the security holder becomes the owner of the property subject to the security both at law and in equity).[33]

Time apportionment under section 2 of the Apportionment Act 1870

6.30 Section 2 of the Apportionment Act 1870 provides that:

> All rents, annuities, dividends, and other periodical payments in the nature of income (whether reserved or made payable under an instrument in writing or otherwise) shall, like interest on money lent, be considered as accruing from day to day, and shall be apportionable in respect of time accordingly.

6.31 The apportionment required by the Act is known as "time apportionment". In the trusts context, the effect of section 2 is to apportion the income paid in respect of a period during which the entitlement to receive trust income changes. Rather than accruing on a particular date and being allocated to the person who is entitled to income on that date, income is deemed to accrue at a uniform rate across the entire period. Each beneficiary is entitled only to the proportion of the income which is deemed to accrue during the period of his or her entitlement. This is not necessarily realistic; a company's profits may accrue very unevenly between dividends, and it may even operate at a loss from time to time.

6.32 Time apportionment also applies in relation to trusts for the maintenance out of capital of a class of minors who are contingently entitled to the trust capital on attaining a specified age. This is known as the rule in *Re Joel*.[34] The rule, which is a necessary interpretation of section 2, provides that, where a child is born into the class of beneficiaries entitled to income, the "trustees can only maintain the new beneficiary out of income that arises after the birth, so the income has to be apportioned at the date of birth".[35]

6.33 Section 2 expressly applies to rents, annuities and dividends,[36] but it also applies to other periodical payments in the nature of income, such as mortgage and other

[31] (1869) LR 8 Eq 343, 344.

[32] [1901] 1 Ch 916.

[33] In *Re Horn's Estate* [1924] 2 Ch 222 it was held that following an order for foreclosure the life tenant is entitled to receive the whole of the net income from property, and that there is no general rule of apportionment dealing with income of property which had become discharged from the right of redemption by an order for foreclosure.

[34] [1967] Ch 14. See CP, para 3.79.

[35] J Mowbray QC et al (eds), *Lewin on Trusts* (18th ed 2008), para 25-139.

[36] See Apportionment Act 1870, s 5.

interest. Periodical, in this context, means "recurrent"; it is not limited to income that is "payable in respect of a period".[37] The rule also applies to a liability to make payments, so apportionment is required in respect of trust expenses.[38] Certain income receipts have been held not to be subject to time apportionment: policies on assurance of any description;[39] natural produce[40] and profits of a business or partnership.[41]

PROVISIONAL PROPOSALS

Trusts for sale

6.34 In the CP we noted that, following the Trustee Act 2000, most investments are now authorised, and that the notion of converting an unauthorised investment into an authorised investment has become somewhat outdated.[42] Moreover the requirement of the first limb of the rule in *Howe v Earl of Dartmouth* to sell wasting or hazardous investments is arguably no longer relevant. Trustees are under a duty of care in selecting a balanced portfolio and it may be that there is a place for such investments alongside other holdings. The CP consequently provisionally proposed the abolition of the *Howe v Earl of Dartmouth* implied trust for sale.[43]

6.35 The CP provisionally proposed retaining express trusts for sale.[44] It was felt that there was no reason to prevent a settlor or testator creating an express trust for sale, but equally that there was no reason to impose a duty to sell in trusts which do not have an express duty. This proposal was made on the basis that there are better ways of discharging the duty to balance than a prescriptive duty to sell. The CP preferred the policy of allowing trustees to choose whether or not to exercise the general power to sell investments.

The equitable rules of apportionment

6.36 In the CP we criticised the apportionment rules individually, but the main thrust of the criticisms was that the rules are routinely excluded in professionally drafted trusts, and for trusts where the rules still technically apply, they are honoured more in their breach than in their application.

6.37 The second limb of *Howe v Earl of Dartmouth* and the rule in *Re Earl of Chesterfield's Trusts* were criticised for being overly complex.[45] In many cases they are disproportionately expensive to apply. It was also pointed out that

[37] *Re Griffith* (1879) LR 12 Ch D 655 and *Re Jowitt* [1922] 2 Ch 442.

[38] *Bishop of Rochester v Le Fanu* [1906] 2 Ch 513 and *Re Joel* [1967] Ch 14.

[39] Apportionment Act 1870, s 6.

[40] *Hassell v Perpetual Executors Trustees & Agency Co (WA) Ltd* (1952) 86 CLR 513 (HCA), cited in J Mowbray QC et al (eds), *Lewin on Trusts* (18th ed 2008), para 25-134.

[41] *Jones v Ogle* (1872) 8 Ch App 192.

[42] CP, paras 3.8 and 3.13. See para 2.69 above for the general power of investment provided by the Trustee Act 2000. But note that investments may still be made unauthorised by the express terms of the trust.

[43] CP, paras 5.90 to 5.91.

[44] CP, para 5.89.

[45] CP, paras 3.36 to 3.39.

changing economic circumstances, and the changes brought about by the Trustee Act 2000 (referred to above), have undermined the rationale of these rules.[46]

6.38 Although the justice of the rule in *Allhusen v Whittell* was not doubted, there was concern that the rule requires cumbersome calculations, in many cases affecting only small sums of money.[47] Similar criticisms to those made of the rule in *Allhusen v Whittell* were noted in relation to the apportionment of deficient securities.[48]

6.39 The CP provisionally proposed that all the existing equitable rules of apportionment should be abolished,[49] an approach already taken in relation to the second limb of the rule in *Howe v Earl of Dartmouth* in Western Australia[50] and New Zealand,[51] and in relation to the rule in *Allhusen v Whittell* in New Zealand[52] and in a number of states and provinces in Australia[53] and Canada.[54] This was also in line with the Law Reform Committee, Trust Law Committee and Scottish Law Commission's recommendations.[55]

Time apportionment under section 2 of the Apportionment Act 1870

6.40 The CP criticised the time apportionment rule as inconvenient and unfair, causing hardship in certain circumstances to life tenants[56] and placing an onerous burden on trustees to make difficult investigations into the precise periods for which dividends have been declared.[57] It provisionally proposed that section 2 of the 1870 Act should cease to apply to trusts except in so far as the terms of the trust expressly, or by necessary implication, demonstrate a contrary intention.[58] The policy underlying this was that periodic payments of income should be paid to the beneficiary who is entitled to income at the time when the payment becomes due.

[46] CP, paras 3.41 to 3.43.

[47] CP, para 3.53. The Trust Law Committee commented in relation to one manifestation of the rule in *Allhusen v Whittell* that it involves "minuscule amounts": Capital and Income in Trusts (1999) Trust Law Committee Consultation Paper, para 4.3.

[48] CP, para 3.63.

[49] CP, paras 5.83 to 5.85.

[50] Trustees Act 1962, s 105.

[51] Trustee Act 1956, s 85.

[52] Trustee Act 1956, s 84.

[53] Wills, Probate and Administration Act 1898, s 46D (New South Wales), Trustee Act 1958, s 74 (Victoria), Trusts Act 1973, s 78 (Queensland) and Trustees Act 1962, s 104 (Western Australia).

[54] Trustee Act RSO 1990, c T23, s 49(1)(a) (Ontario), Trustee Act RSBC 1979, c 414, s 101(1)(a) (British Columbia) and Trustee Act RSM 1987, c T160, s 32 (Manitoba).

[55] See CP, Part 4.

[56] The CP provided the example of a testator who bequeaths a life interest in his residuary estate to his widow; the widow will not receive income from dividends paid after the testator's death which accrued during his life as these receipts will be apportioned to capital: see CP, para 3.81.

[57] CP, paras 3.81 to 3.87.

[58] CP, paras 5.86 to 5.87.

6.41 In place of the 1870 Act provision, the CP provisionally proposed that there should be a new statutory power to apportion between successive income beneficiaries, when and in the manner in which the trustees, in their absolute discretion, deem it just and expedient.[59]

CONSULTATION RESPONSES

Trusts for sale

6.42 All consultees who addressed implied trusts for sale agreed with the provisional proposal to abrogate the first limb of the rule in *Howe v Earl of Dartmouth*. One consultee noted that the rule could not co-exist with modern portfolio investment:

> … the application of the rule was governed by the list [of authorised investments] both in its definition of what investments were unauthorised and in its requirement that the proceeds of sale of unauthorised investments should be invested within the list. It epitomised the investment-by-investment, list bound approach to trust investing.[60]

6.43 A narrow majority of consultees agreed that trustees should continue to be under a duty to convert the trust property and reinvest the proceeds of sale where the settlor or testator expressly creates a trust for sale. The Association of District Judges could "see no valid reason to remove from a settlor the right expressly to impose a trust for sale without power to postpone". A number of those who disagreed with the proposal did so on the basis that settlors or testators "frequently settle individual assets of personal connection or significance where there is an expectation that they will be retained unsold".[61] Other consultees doubted whether there was any usefulness in the trust for sale concept at all on the basis that there is little or no demand from settlors and that "a substantial part of the legal profession is unaware of its implications".[62]

The equitable rules of apportionment

6.44 All consultees who considered the equitable rules of apportionment were in agreement (or qualified agreement) with the provisional proposal to abolish them. The Association of District Judges stated that the rules have "outlived their usefulness". A number of consultees drew attention to the fact that the "problem with the equitable rules of apportionment is not the nature of the rules but the cost of implementing them in practice".[63] WA Lee commented that the rules "are now pretty well totally irrelevant, although the general objective, of ensuring fairness between capital and income accounts, is the same". Mr Justice Lloyd (now Lord Justice Lloyd) commented that the rules "serve little purpose already, and would be wholly unnecessary if a statutory power of allocation were

[59] CP, para 5.88. A specific statutory power was considered necessary as the CP's proposed power of allocation could not function in this context as that power allowed receipts to be allocated between capital and income, but not between successive income entitlements.

[60] WA Lee.

[61] Richards Butler.

[62] British Bankers' Association; Barclays Bank Trust Company.

[63] Geoffrey Shindler.

introduced".

6.45 Some consultees expressly qualified their agreement with concerns about the proposal to replace the fixed rules with a new power of allocation. Others took the contrary position, and emphasised the need for the power of allocation to fill the gap left by the proposed abolition of some or all of the equitable apportionment rules. Edward Nugee QC explained the problem relating to the abolition of the rule in *Re Earl of Chesterfield's Trusts*:

> Where assets subject to a trust include a reversionary interest, it may well be imprudent for trustees to try to sell it during the life tenant's lifetime; but when it falls into possession the life tenant may justifiably say that s/he should be compensated for having had no enjoyment of it while it was in reversion. The calculation in [paragraph] 3.33 [of the Consultation Paper] demonstrates that there can be quite a large sum to which the life tenant has a justifiable claim … . It needs to be made clear in some way that the trustees' duty to act fairly entitles them, and may require them, to carry out a *Chesterfield* type of apportionment when a reversionary interest falls in.

6.46 He therefore agreed with the provisional proposal to abrogate all the existing rules, "provided that there is no doubt that the power of allocation can be used in appropriate circumstances where the rules now apply".

The statutory time apportionment rule

6.47 Nearly all the consultees who considered time apportionment agreed that the statutory apportionment rule should not apply to trusts except in so far as the terms of the trust express a contrary intention. Edward Nugee QC commented that "there is not much point in apportioning post-death income to a deceased life tenant in most cases".

6.48 A narrow majority of consultees agreed with the provisional proposal to provide trustees with a statutory power to apportion income receipts between successive income beneficiaries. However, a significant number dissented, some on the basis of the cost of administering such a power. The British Bankers' Association and Barclays Bank Trust Company made the following comment on the introduction of such a power:

> This proposal is really neither one thing nor the other. Abolition of the application of the rule, but leaving it open to trustees to apply it at their discretion, is a further recipe for conflict between trustees and beneficiaries. Given the current antipathy of professional trustees towards apportionment it is more likely that such a power would never be used, but giving the trustee the power will, at the very least, oblige him to consider its application (at further expense to the trust).

6.49 Others were concerned about the extent of the discretion proposed, arguing that, in effect, it appeared to confer a new dispositive power on trustees.[64]

[64] Mr Justice Lloyd; Mr Justice Etherton.

REVISED POLICY AND RECOMMENDATIONS

Trusts for sale

6.50 The Commission has noted the divided opinion of consultees with regard to express trusts for sale. We consider that it is correct to question the continuing relevance of a rule which requires trustees to sell and reinvest in authorised investments where almost all investments are authorised under section 3 of the Trustee Act 2000. Section 4 of the Trustee Act 2000 requires trustees to review from time to time the investments of the trust and consider whether they should be varied. In considering whether investments should be varied, trustees are required to have regard to the standard investment criteria.[65] The Commission considers that in the context of modern portfolio investment this performs a comparable function to the duty to convert.

6.51 Nevertheless, it would be an odd step to deny settlors and testators the opportunity to impose a trust for sale expressly. The decision to do so may be accompanied by the express narrowing of the range of authorised investments, in which case the duty to convert remains relevant. The Commission therefore does not consider it necessary or desirable to abolish express trusts for sale.

6.52 However, in light of the unanimous support of consultees, the Commission recommends the abolition of trusts for sale implied under the first branch of the rule in *Howe v Earl of Dartmouth* in its entirety and in relation to all future trusts. Underpinning this recommendation is the view that trustees should no longer be placed under a specific duty to sell the unusual investments to which that rule applies;[66] rather, the sale and reinvestment of trust property ought to form part and parcel of a trustee's investment duties under the Trustee Act 2000. This recommendation should take effect for all trusts created after the implementation of our recommendations; the rule will continue to apply to trusts created already in existence at that point, except where it was excluded expressly or by implication.

Recommendation

6.53 **We recommend that the first part of the rule known as the rule in *Howe v Earl of Dartmouth* shall not apply to any future trusts.**[67]

The equitable rules of apportionment

Abolition, replacement or retention?

6.54 The CP took the view that all the equitable apportionment rules should be abolished in parallel with the provision of a new power of allocation. The power of allocation was the CP's preferred means of achieving a flexible classification of receipts, which would allow trustees to invest on a total returns basis. The power of allocation was also presented as replacing the equitable rules of apportionment, offering a modern alternative to the rigid existing apportionment

[65] Trustee Act 2000, s 4(2).

[66] Their power to sell such investments is implied by the power to invest in s 3(1) Trustee Act 2000; in *Re Pope* [1911] 2 Ch 442, 446 Neville J held that "where there is no special reason against it, a power to vary investments may be implied from a power to invest".

[67] Draft Bill, cl 1(2)(a) and (4).

rules.

6.55 As we explained in Part 5, it has not been possible to recommend the introduction of a new power of allocation. As the CP suggested and consultees made clear, the equitable apportionment rules have a sound underlying principle; the problem is that the rules are complex, unclear in places and involve cumbersome calculations often relating to disproportionately small sums of money. Given that the power of allocation is no longer recommended, should the rules should be abolished, replaced or retained?

6.56 A number of considerations encourage us to recommend abolition. The rules are routinely excluded in professionally drafted trusts, and both academic and practitioner texts recommend their exclusion.[68] For example, *Hanbury & Martin's Modern Equity* states:

> The duty to apportion is in practice nearly always excluded, both in respect of income from unauthorised securities and in respect of reversionary interests.[69]

6.57 James Kessler QC's Drafting Trusts and Will Trusts states:

> The calculations involved are so complex and the costs and administrative difficulties are quite out of proportion to any advantage that arises. It is hardly surprising that the rules are excluded in all well drafted trusts, and if not excluded are more honoured in the breach than in the observance.[70]

6.58 The rules are not, of course, excluded from implied trusts, with the result that lay trustees are burdened with rules which they cannot operate (in the unlikely event that they are even aware of them). As noted above, a number of other Commonwealth jurisdictions have already abolished some of the equitable apportionment rules. The CP's provisional proposal for abolition was also overwhelmingly supported. We therefore take the view that the existing rules should either be abolished or replaced.

6.59 Would it be possible to replace the existing apportionment rules? The abolition of the rule in *Re Earl of Chesterfield's Trusts* without replacement, for example, would, without express provisions to the contrary, mean that the retention of

[68] See JE Martin, *Hanbury & Martin's Modern Equity* (18th ed 2009), pp 584 to 590; G Thomas and A Hudson, *The Law of Trusts* (2004), para 10.25; D Hayton and C Mitchell, *Hayton and Marshall's Commentary and Cases on the Law of Trusts and Equitable Remedies* (12th ed 2005), para 9.157; J Mowbray QC et al (eds), *Lewin on Trusts* (18th ed 2008), para 25-74. The Standard Provisions of the Society of Trust and Estate Practitioners (1st ed) state that "Income and expenditure shall be treated as arising when payable, and not from day to day, so that no apportionment shall take place" (para 8, available in the *Encyclopaedia of Forms and Precedents* (5th ed 2007) Volume 40(1) Trusts and Settlements, p 326 [3582].

[69] JE Martin, *Hanbury & Martin's Modern Equity* (18th ed 2009), para 19-008. Express exclusion is not a straightforward option: CH Sherrin et al (eds), *Williams on Wills* (9th ed 2008) states that "the rules concerning … exclusion are by now a nightmare of complexity and technicality" (Volume 2, [214.35]).

[70] J Kessler QC, *Drafting Trusts and Will Trusts – a Modern Approach* (8th ed 2007), para 19.32.

reversionary interests would benefit the remainderman and no apportionment to the life tenant could occur without express provision in the terms of the trust. Likewise, where loan stock is invested for the benefit of both the life tenant (interest payments) and the remainderman (preservation of real capital value) and the debt is not repaid, this will be to the detriment of both the life tenant and remainderman, but without an apportionment rule the realisation of the security only compensates the remainderman. In such circumstances, where a rule of apportionment is well-principled, the abolition of the equitable rules without replacement may lead to an imbalance and unfairness between successive beneficiaries.

6.60 The Law Reform Committee, in its 1982 Report on the Powers and Duties of Trustees, recommended that the existing apportionment rules be replaced by a general discretionary power for trustees to adjust between income and capital accounts.[71] The Trust Law Committee also proposed that the existing equitable apportionment rules, with the exception of the rule in *Allhusen v Whittell*, should be abolished, and replaced with a general discretion to apportion receipts and expenses in order to discharge their duty to maintain a fair balance.[72] The Scottish Law Commission proposed a similar power.[73]

6.61 We have considered whether it would be possible to provide a general discretion or power of apportionment in place of the equitable rules of apportionment. However, we have concluded that it would not be possible to do so for three reasons. First, it would be difficult to provide a firm basis for the exercise of such a discretion or power beyond the broad principles of balance and fairness. Secondly, such a discretion or power may appear overly dispositive. Finally, such a discretion or power would suffer the same problems as those associated with the CP's provisionally proposed power of allocation, discussed above, and in particular would inevitably give rise to unwelcome tax consequences.

6.62 Would it be possible to provide a series of localised, limited discretions to maintain the requirement of balance in contexts in which the current equitable rules operate? This would allow, for example, a discretionary adjustment between income and capital on the realisation of a reversionary interest or a deficient security.

6.63 While desirable in principle, there are a number of problems with creating a series of discretions in this context. First, we consider in light of consultation responses that such discretions may be considered burdensome and would be routinely excluded. Secondly, the scope and operation of such discretions would be difficult to define. Thirdly, even if new discretions were tightly defined, such recommendations would be unlikely to appeal to HMRC for the reasons outlined above. Finally, in particular in relation to the rule in *Re Earl of Chesterfield's Trusts*, it is questionable whether trust law should unravel the outcomes of trustee investment decisions where trustees are subject to the requirements of

[71] The Powers and Duties of Trustees (1982) 23rd Report of the Law Reform Committee, Cmnd 8733, para 3.36.

[72] Capital and Income of Trusts (1999) Trust Law Committee Consultation Paper, paras 6.1 to 6.7 and 6.15.

[73] Apportionment of Trust Receipts and Outgoings (2003) Scottish Law Commission Discussion Paper No 214, para 2.33.

the Trustee Act 2000 when selecting investments. Trustees are under a duty to balance at the pre-investment stage; trustees who purchase reversionary interests should make balancing investments to compensate the income beneficiary if that is desired.[74]

6.64 Accordingly, we take the view that the equitable rules of apportionment should be abolished in relation to trusts created or arising in the future; it would remain open to future settlors to incorporate express provision in the trust deed if they wished to replicate the rules.

Recommendation

6.65 **We recommend that the equitable rules of apportionment shall not apply to any future trusts, subject to any contrary provision in the trust instrument.**[75]

The statutory time apportionment rule

6.66 The CP took the view that while the statutory apportionment rule was inconvenient and unfair, there may be circumstances in which trustees consider that apportionment is necessary to maintain a balance between beneficiaries in circumstances currently covered by section 2 of the 1870 Act, for which the power of allocation would not be available.[76] On this basis, the CP provisionally proposed a statutory power in place of section 2. On further reflection, and taking into account consultees' concerns, the Commission does not consider it desirable to recommend the introduction of such a power. We accept that a statutory power of this sort would be excessively wide and would therefore increase the likelihood of disputes between trustees and beneficiaries and would lead to higher trust management expenses.

6.67 However, a significant majority of consultees supported the abolition of section 2 in its application to trusts (except in so far as the terms of the trust express a contrary intention). As with the equitable apportionment rules, time apportionment is routinely excluded in professionally drafted trust deeds, and when not excluded it is likely that trustees are either unaware of the rule or simply ignore it. The Commission therefore recommends section 2 of the Apportionment Act 1870 should not apply to trusts created after the commencement of the Act implementing the recommendations, unless the terms of the trust expressly state that the section should apply.

6.68 After the disapplication of the section to trusts, periodic payments such as dividends will accrue to the income beneficiary at the date when they arise.

6.69 We do not think that this will cause hardship between successive income beneficiaries. In circumstances where it is important, settlors and testators can include a duty to apportion on a time basis. Indeed, it has been pointed out that

[74] Alternatively, if the trust contains a power to advance capital (see para 3.25 above), and where there are sufficient liquid funds to do so, the disadvantage to the life tenant of the reversionary interest could be compensated by an advancement from another part of the trust fund.

[75] Draft Bill, cl 1(2)(b) to (e) and (4).

[76] CP, para 5.88.

the abolition of the rule may be of great assistance to a life beneficiary, typically a widow or widower, who would otherwise lose income as a result of the application of the rule. Consequently, the proposed change would establish a default position more likely to accord with the wishes of the testator and the needs of the beneficiaries.

Recommendation

6.70 **We recommend that section 2 of the Apportionment Act 1870 shall not apply to any future trusts, subject to any contrary provision in the trust instrument.**[77]

[77] Draft Bill, cl 1(1) and (4).

PART 7
TRUST EXPENSES

INTRODUCTION

7.1 A settlor or testator may make express provision for the incidence of trust expenses, or may provide the trustees with a discretion to allocate them between the beneficiaries. Where express provision has not been made, expenses are to be classified as capital or income in accordance with the general law of trusts.

7.2 This Part is concerned with the general law of trust expenses. The question is: when the trust incurs an expense, such as accountancy fees or the cost of repairing buildings, are the trustees to charge that expense to income or to capital?

7.3 An instinctive response is to say that the income and capital beneficiaries should bear the expenses that benefit them, respectively, and share those that benefit both. But sharing is not simple. In what proportions should they share? Would it be the same proportion for each expense or would that proportion vary depending upon an assessment of the relative benefit to each beneficiary? And how would such an assessment be made objectively? How can we say how much each beneficiary benefits from an expense such as investment management, since the income beneficiary receives the income, while capital growth is important to the capital beneficiary?

7.4 A different way of looking at sharing is to observe that if an expense is paid from capital, both beneficiaries pay, because less capital remains to generate income. That method of sharing has the advantage of certainty – trustees do not have to take a view about relative benefit – but it can be unfair if the benefit to the remainderman is relatively small while that to the income beneficiary is disproportionately large. Accordingly, in a range of cases a more proportionate sharing might be achieved by apportioning the expense between income and capital in proportion to the benefit to each.

7.5 Whatever method of sharing is chosen has tax implications, because an expense that is properly chargeable to income reduces the income tax payable; and in contrast to the treatment of trust receipts,[1] tax law currently follows trust law for the purposes of the classification of expenses. In a discretionary trust, the trustees are relieved of the difference between the basic rate of tax and the trust rate to the extent of the income expense; any provisions of the trust deed as to what is an income expense are disregarded for that purpose, and the general law of classification is applied.[2] In an interest in possession trust[3] the income beneficiary's taxable income is reduced by the amount of any expenses incurred by the trustees that are chargeable to income either under the general law or

[1] See Parts 3 to 5.

[2] Income Tax Act 2007, ss 484 to 486 (formerly s 686(2AA) Income and Corporation Taxes Act 1988).

[3] See Part 5, n 4 above.

under the terms of the settlement.[4] The classification of expenses has, therefore, a direct impact upon tax liability. As Mr Justice Lindsay recently put it:

> It can thus behove trustees to claim that their expenses are regarded as income expenses whilst, conversely, it suits HM Revenue and Customs to see them as outgoings of a capital nature.[5]

THE CONSULTATION PAPER

7.6 The CP's discussion of the classification of trust expenses centred on the leading authority, the House of Lords' decision in *Carver v Duncan.*[6] That case concerned the proper classification of various expenses, including insurance premiums and investment advisers' fees, for the purposes of the precursor to section 484 of the Income Tax Act 2007.[7] Their Lordships held that in this case the insurance premiums and investment advisers' fees were for the benefit of the whole estate and therefore properly chargeable to capital. Lord Templeman stated the following general principles:

> Trustees are entitled to be indemnified out of the capital and income of their trust fund against all obligations incurred by the trustees in the due performance of their duties and the due exercise of their powers. The trustees must then debit each item of expenditure either against income or against capital. The general rule is that income must bear all ordinary outgoings of a recurrent nature, such as rates and taxes, and interest on charges and encumbrances. Capital must bear all costs, charges and expenses incurred for the benefit of the whole estate.[8]

7.7 The CP expressed the view that "the classification of trust expenses should depend on the purpose for which they were incurred".[9] It recognised that "there is some uncertainty in the application of the rule" in *Carver v* Duncan, but argued that it "achieves a broadly impartial balance between the interests of competing beneficiaries" and noted the difficulty of identifying a sensible alternative.[10] The CP concluded that the law regarding the classification of trust expenses should remain unchanged. However, that classification would operate only by way of default if the proposed power of allocation were available.[11]

7.8 The CP invited the views of consultees on whether the rule in *Carver v Duncan* should be placed on a statutory footing. It also provisionally proposed that the rules of classification for trust expenses should be subject to any contrary provision in the terms of the trust.

[4] Income Tax Act 2007, s 500.

[5] *Revenue and Customs Commissioners v Trustees of the Peter Clay Discretionary Trust* [2007] EWHC 2661 (Ch), [2008] Ch 291 at [1].

[6] See CP, paras 2.51 to 2.54.

[7] Finance Act 1973, s 16, subsequently the Income and Corporation Taxes Act 1988, s 686.

[8] [1985] AC 1082, 1120. See CP, para 2.51 and following.

[9] CP, para 5.16.

[10] CP, para 5.16.

[11] CP, para 5.16.

CONSULTATION RESPONSES

The rule in *Carver v Duncan*

7.9 The majority of consultees who answered the question thought that the rule laid down in *Carver v Duncan* should continue to apply. For example, the Association of District Judges argued that "the treatment of trustee expenses is reasonably understood to be classified in the way explained in *Carver v Duncan* … and, although we accept that there will always be anomalies, the rule is fair and provides an appropriate balance between income and capital beneficiaries".

7.10 Those who disagreed generally did so on the basis of a lack of clarity as to the proper application of the rule, leading to uncertainty. A number of consultees commented on the apparent overlap between Lord Templeman's categories: the judgment appears to describe mutually exclusive alternatives (namely "outgoings of a recurrent nature" or "costs etc incurred for the benefit of the whole estate"), but those two forms of expense are obviously not mutually exclusive. Simon Gardner[12] observed that

> [*Carver v Duncan*] depends on the two categories of expenditure it uses being both mutually exclusive and exhaustive. The two categories are "all ordinary outgoings of a recurrent nature" and expenses incurred "for the benefit of the whole estate". But surely one could have ordinary, recurrent expenditure that benefited the whole estate (eg the annual insurance premiums on the estate's commercial property investments); and also one-off expenditure that did not (eg payment for professional advice towards raising the rents on those investments).

7.11 Consultees also commented on the perceived unfairness and illogicality of allocating some expenses wholly to capital. For example, the Law Reform Committee of the General Council of the Bar said that it "disagree[d] with Lord Templeman's view that annual premiums on insurance policies to protect the capital value of the trust fund should be paid out of capital. Protection of the capital also protects income." They also disagreed with his classification of investment advisers' annual fees as capital, as such advice will clearly benefit both income and capital.

7.12 A number of consultees stressed the close relationship between trust classification and tax law in this area. STEP stated that it is "fundamentally important to ensure there [is] a proper alignment from a fiscal perspective in allowing proper deductibility of appropriate income expenses".

Placing the rule on a statutory footing

7.13 A majority of the consultees who answered this question considered that the rule in *Carver v Duncan* should not be placed on a statutory footing. Some favoured an approach whereby HMRC (in consultation with the relevant professional bodies) would provide non-statutory guidance on the incidence of trust expenses. Others argued for limited legislation confirming the status of certain important expenses, for example, the special case of recurrent trustee remuneration.

[12] University of Oxford.

7.14 The minority who thought that the rule in *Carver v Duncan* should be placed on a statutory footing suggested that legislation would clarify the law and so reduce the scope for dispute between trustees and HMRC, and that it would also increase transparency.

Classification of expenses subject to contrary provision in terms of the trust

7.15 Nearly all consultees who answered this question agreed that the general rule ought to be subject to any contrary provision in the terms of the trust.

SUBSEQUENT DEVELOPMENTS

7.16 Since the publication of the CP there have been a number of developments in this area. In particular, HMRC has published detailed Guidance on the classification of trust management expenses, and the Court of Appeal has recently considered the trust law classification rules in *Revenue and Customs Commissioners v Trustees of the Peter Clay Discretionary Trust*.[13]

HMRC Guidance on trust management expenses

7.17 In January 2006, after the publication of the CP, HMRC issued guidance on Trust Management Expenses ("TMEs") setting out its interpretation of trust law,[14] which it subsequently also issued in the form of a Help Sheet.[15] The Guidance listed TMEs as allowable or not allowable for income tax purposes.[16] In that Guidance HMRC interpreted *Carver v Duncan* to mean that only expenses that benefit the income beneficiary alone can be charged to income (and so are "allowable TMEs" for the purposes described at paragraph 7.5 above). All other TMEs must be charged to capital. According to the Guidance, "there is no suggestion in case law that there is any basis for apportioning expenses that are incurred for the benefit of the whole estate into income and capital costs".[17] Nevertheless, the Guidance went on to concede that apportionment may be appropriate in certain circumstances (see paragraph 7.18 below).

7.18 The 2006 Guidance provided HMRC's views on the proper trust law classification of particular types of expense. The treatment of some TMEs was presented as straightforward. Investment advice, and the costs of distributing income, for example, were said not to be allowable. Travel and subsistence costs might exceptionally be allowable when they were associated solely with securing the trust's income, but otherwise they were not allowable. However, other expenses were presented as rather more complex, and the Guidance suggested that some TMEs could be apportioned:

> Generally, apportionment of TMEs between income and capital is not

[13] [2008] EWCA Civ 1441, [2009] STC 469.

[14] In a series TSEM8000 to TSEM8900, available at www.hmrc.gov.uk.

[15] Help Sheet IR392.

[16] That is, in the calculation of income tax as explained in para 7.5 above; note that, so far as interest in possession trusts are concerned, expenses are not technically deductions, but sums used in the initial calculation of taxable income; see the general explanation at TSEM8020 and comment at TSEM8230.

[17] TSEM8140.

appropriate. In a few situations it is appropriate to consider apportioning what is, after applying the principle [that capital must bear all costs, charges and expenses incurred for the benefit of the whole estate], apparently an expense of capital, between income and capital. The governing principle here is that when what is procured for the trust can properly be said to be for the income fund as distinct from the capital fund, rather than the two matters being inextricably bound together, then apportionment is reasonable.[18]

7.19 Thus the costs of accounting for the trust's income were said to be allowable, but the costs of accounting for the trust's capital were not. As to the costs of preparation of a tax return, the Guidance listed as allowable "those that relate to income, apportioned on a just and reasonable basis, most easily done by excluding the costs of preparing the Capital Gains Pages of the Return".[19] As to audit, HMRC regarded as allowable "the costs of auditing the trust's income, on the basis of a just and reasonable apportionment, best made by the person who carries out the audit".[20]

7.20 Accordingly, where apportionment was permitted, it was to be achieved by demonstrating that a specific proportion of an expense (for example, of a particular professional's services) was incurred exclusively for the benefit of income, such as by itemising the invoice or producing two separate invoices. What was not permitted was the apportionment of an expense where the benefit to income and capital was inextricably bound together; an example might be the salary of the trustees' secretary, where it is not possible to say precisely the extent to which the secretary's services benefit the income and capital beneficiaries respectively.

7.21 The status of trustees' fees has been a vexed source of dispute between HMRC and the trust industry, to the extent that HMRC's 2006 Guidance referred explicitly to the disagreement and stated that it was likely to be the subject of litigation.[21] HMRC's position in its Guidance was that "trustees' fees represent payment for work done by the trustee in carrying out the terms of the trust as a whole" and that, on general principles, are therefore properly payable out of capital.[22] The trust industry's position, as outlined in HMRC's Guidance, was that trustees' fees are annual recurrent expenses which represent work done on behalf of both income and capital, and that there is therefore a case for apportioning the fees partly to income.[23] This disagreement came to a head in the *Peter Clay* litigation.

The *Peter Clay* litigation

7.22 The *Peter Clay* litigation provided the Court of Appeal with the opportunity to

[18] TSEM8815.

[19] Help Sheet IR392, p 2.

[20] The full catalogue of expenses is best viewed in Help Sheet IR392 at www.hmrc.gov.uk/helpsheets/hs392.pdf.

[21] See TSEM8880.

[22] TSEM8883.

[23] TSEM8882.

clarify the law relating to the treatment of trust receipts. The action was brought by the trustees of a large discretionary trust, who were in dispute with HMRC over two issues. One was the status of the fees charged by the trustees, which HMRC were not willing to treat as a TME at all, in accordance with the position stated in the Guidance. The other was the proper allocation of a range of expenses: investment management fees, bank charges, custodian charges, accountancy and administration fees, and executive and non-executive trustees' remuneration.[24]

7.23 The case was heard initially by the Special Commissioners,[25] appealed to the High Court and heard by Mr Justice Lindsay,[26] and finally appealed to the Court of Appeal.[27] We examine the two issues in turn.

The status of trustees' fees

7.24 Where a trust has professional trustees, a charging clause in the trust deed will normally allow the trustees to charge a fee. From the beneficiaries' point of view this is an expense that the trust fund bears. However, HMRC argued that, as a matter of trust law, trustees' fees are not an expense, but a gift of the settlor to the trustees; and that even if it was such an expense in trust law, as a matter of tax law trustees' remuneration is not an "expense of the trustees", the language used in the statutory provisions.[28]

7.25 The Special Commissioners and Mr Justice Lindsay held that trustees' fees were an expense of the trust, for tax purposes as well as in trust law; Mr Justice Lindsay discussed the wording of the statute and concluded that "in the context of an inept section it would, in my judgment, be wrong to treat the expression 'the expenses of the trustees' as excluding their remuneration". The point was not appealed further.

The classification of trust expenses

7.26 The expenses in issue were calculated in a number of different ways. Some, such as the executive trustees' remuneration, were calculated in accordance with time spent; the non-executive trustees charged a fixed fee for preparing for and attending meetings; the investment managers charged a fee calculated by reference to the capital value of the fund.

7.27 Sir John Chadwick, in the Court of Appeal, summarised the trustees' and HMRC's positions as follows:

> Put shortly, the trustees contended that, where a particular expense of managing the trust related partly to income, that expense could and should be apportioned fairly between income and capital; so that

[24] There was a further issue as to the timing of allowable expenses, which does not concern us here.

[25] [2007] STC (SCD) 362.

[26] [2007] EWHC 2661 (Ch), [2008] Ch 291.

[27] [2008] EWCA Civ 1441, [2009] STC 469.

[28] The relevant provision was s 686(2AA) Income and Corporation Taxes Act 1988; see nn 2 and 7 above.

> part was attributed to income. The Revenue contended that apportionment between capital and income was not permissible in such a case: it was only those expenses which related wholly and exclusively to income that could be attributed to income: an expense which related partly to income and partly to capital was to be charged wholly to capital.[29]

7.28 A way of describing the issue about classification in the *Peter Clay* case is to say that it was a question about the relationship between the two kinds of expense described in *Carver v Duncan*: the "income limb" ("ordinary outgoings of a recurrent nature") and the "capital limb" ("expenses incurred for the benefit of the whole estate"). There is an ambiguity here, as discussed above:[30] how are expenses to be attributed when they are ordinary and recurrent but benefit both income and capital?

7.29 For HMRC, the income limb was qualified by the capital limb, so that only expenses incurred exclusively for the benefit of income were properly chargeable to income, and all the rest were capital. Their initial position was that this was the case for all the expenses in issue, including the trustees' fees if they were indeed expenses. The trustees argued that the capital limb was not a general rule without qualification, and therefore that some ordinary and recurrent outgoings which benefit the whole estate could be apportioned between capital and income. In other words, for the trustees the income limb of the rule in *Carver v Duncan* provided a general rule qualifying the capital limb. Accordingly, they claimed that it was proper to allocate the various expenses between income and capital.

THE SPECIAL COMMISSIONERS

7.30 At first instance the Special Commissioners took the view that there was very little authority on the classification of expenses that comprised both income and capital elements. They considered that

> … in the light of the general principle of fairness "expenses incurred for the benefit of the whole estate" should not be understood widely as meaning anything that is for the benefit of both the income and capital beneficiaries should be charged to capital and should not be attributed. We therefore prefer the approach that one should attribute unless the expense really is a capital expense where the interest of the income beneficiary is merely the consequential loss of income on the capital that goes to pay the expense.[31]

7.31 Consequently, in accordance with the requirement to achieve a fair balance between income and capital beneficiaries, the Special Commissioners held that a proportion of the accountancy fees, bank charges and custodian fees should be apportioned between income and capital, and those attributed to income are properly chargeable to income within the tax provisions.[32] The same was said of the executive trustee's remuneration. However, the investment management fees

[29] [2008] EWCA Civ 1441, [2009] STC 469 at [4].

[30] See para 7.10 above.

[31] [2007] STC (SCD) 362 at [17].

[32] Above at [23].

were held to be wholly attributable to capital on the facts. While the Special Commissioners accepted that the work undertaken by investment managers was wider than that described in *Carver v Duncan* (and that therefore *Carver v Duncan* is not conclusive as to the classification of such fees), they noted that since most of their work related to the accumulation of income such fees were "predominantly attributable to capital, particularly when, as here, the custodian does the bulk of the work relating to income".[33]

7.32 The Special Commissioners also held that a fixed trustee fee such as that charged by the non-executive trustees should not be shared between income and capital on the basis that the fee does not change according to the amount of work undertaken for the benefit of income or capital.

CHANCERY DIVISION OF THE HIGH COURT

7.33 Cross appeals were made to the High Court. Mr Justice Lindsay held that the Special Commissioners had erred in law.[34] He distinguished the income and capital limbs of the rule in *Carver v Duncan*, noting that the income limb provides that income must bear all ordinary outgoings of a recurrent nature although "it is not difficult to find instances where [this] 'general rule' … would be unclear in its applicability".[35] He also noted that the scope of the word "ordinary" in "ordinary outgoings of a recurrent nature" is far from clear. For example, the annual fee for a firm of investment advisers while plainly recurrent was held in *Carver* not to be an "ordinary outgoing".[36] Mr Justice Lindsay concluded that "it is possible to point to real doubts as to the applicability of Lord Templeman's 'general rule' as to ordinary outgoings of a recurrent nature", and that although described as general Lord Templeman "none the less contemplated [it] as likely to require many exceptions".[37]

7.34 However, Mr Justice Lindsay held that the capital limb of *Carver v Duncan* was beyond doubt and took precedence over the income limb.[38] For this reason the Special Commissioners "were wrong to resist that 'all costs, charges and expenses incurred for the benefit of the whole estate' were inescapably to be treated as of a capital nature for the purposes of section 686(2AA)".[39] The key question, he said, is whether particular expenses are or are not for the benefit of the whole estate.[40] He was not persuaded that this principle can be qualified by considerations of fairness, and rejected the arguments that had convinced the Special Commissioners that it could.

7.35 By the time of the hearing, HMRC had agreed an apportionment with the trustees in respect of the custodian, accountancy and other professional fees, narrowing the expenses in dispute to investment management fees and trustee

33 Above at [19].

34 [2007] EWHC 2661 (Ch), [2008] Ch 291.

35 Above at [28].

36 Above at [30].

37 Above at [31]

38 Above at [31] to [36].

39 Above at [36].

40 Above at [37].

remuneration. As to investment management fees, Mr Justice Lindsay upheld the Special Commissioners' decision that these were properly chargeable to capital; as the trustees accumulated income the expense related to "advice as to how best to make income into capital, advice which surely, redounded for the benefit of the estate as a whole".[41] As to the fees of the executive and non-executive trustees, Mr Justice Lindsay held that while trustee remuneration was an expense of the trustees, both sets of fees were chargeable to capital because they benefited the whole estate.

COURT OF APPEAL

7.36 The trustees appealed to the Court of Appeal in relation to the fees paid to the executive and non-executive trustees and to the investment management fees; HMRC accepted the apportionment of bank charges, accountancy and other professional fees, and custodian fees.[42] Importantly, before the hearing HMRC accepted that "a proportion of the fees paid to the executive trustee [were] properly chargeable to income".[43]

7.37 Sir John Chadwick, with whom Lady Justice Arden and Lord Justice Lloyd agreed, upheld Mr Justice Lindsay's decision that the Special Commissioners had erred in law:

> It is … beyond argument that an expense is incurred "for the benefit of the whole estate" in the present context when the purpose or object for which that expense is incurred is to confer benefit both on the income beneficiaries and on those entitled to capital on the determination of the income trusts. The expression "expenses incurred for the benefit of the whole estate" must be understood in that sense. It is common ground … that expenses which are of that nature are to be charged against capital.[44]
>
> … Under the general law, expenses incurred for the benefit of both the income and capital beneficiaries must be charged against capital. It is only those expenses which are incurred exclusively for the benefit of the income beneficiaries that may be charged against income.[45]

7.38 However, the Court of Appeal held that a single fee may be apportioned where an element of it can be demonstrated to relate exclusively to income. On this point the Court of Appeal accepted HMRC's statement of the general law in its skeleton argument:

> HMRC do not contend that the rule [in *Carver v Duncan*] is all or nothing, precluding apportionment of a single expense. But apportionment is not based upon the general principle of achieving fairness between beneficiaries. Instead it is based upon the ability to demonstrate that part of the expense relates to the trustee's duties to

41 Above at [38]

42 [2008] EWCA Civ 1441, [2009] STC 469 at [17].

43 Above at [8].

44 Above at [28].

> the income beneficiaries alone. That is, if it can be shown that an identified or identifiable part of an expense is for work carried out for the benefit of the income beneficiaries alone, then that part is properly chargeable to income.[46]

7.39 HMRC conceded that where the fee is charged on the basis of the amount of time undertaking work relating to the income and capital beneficiaries respectively, trustees may apportion such fees as appropriate. For this reason the Court of Appeal allowed the appeal in relation to the executive trustees' fees; Sir John Chadwick noted that given that professional fees incurred for accountancy services had been apportioned between capital and income on a time basis, "then it is impossible to see why the fees charged by the executive trustee for time spent in applying his professional judgment to the matters in relation to which those accountancy services are required should not also be capable of a proper apportionment".[47]

7.40 What HMRC continued to dispute was the apportionment of fixed fees which did not change according to how much work was undertaken for the income or capital beneficiaries. The Court of Appeal rejected HMRC's argument and allowed the trustees' appeal in relation to the non-executive trustees' fee:

> The nature of a fixed fee is that it does not vary with the amount of work actually done to earn it: whether that work be attributable solely to income, solely to capital or to both income and capital. But the fact that the fee is fixed does not of itself prevent the fee from being apportioned into two or more parts. The amount of each part is ascertained by applying the appropriate proportion to the whole. So, if it could be established (say, by the keeping of time records) that the non-executive trustees spent one half of their time addressing matters which were exclusively for the benefit of the income beneficiaries, there would be no difficulty in principle in making an attribution of one half of the fixed fee to income. The hurdle which faces the trustees' claim to charge part of the fixed fee against income does not arise because the fee is fixed: it arises because, in the absence of time records, it will be difficult for trustees to establish whether any (and, if any, what proportion) of the time of the non-executive trustees was spent addressing matters which were exclusively for the benefit of income.[48]

7.41 The effect of the decision is that the ability to apportion a single expense is now clear as a matter of principle – trustees may apportion to income any part of an expense relating solely to discharging the trustees' duties in relation to the income beneficiary, even if the invoice itself is not itemised. The fact that an expense is a fixed expense does not in itself prevent apportionment; rather, the difficulty facing trustees is one of proof. As Lady Justice Arden stated, "the non-

[45] Above at [29].

[46] Above at [31].

[47] Above at [32].

[48] Above at [37].

executive trustees can be called on within their retainer to give advice exclusively for the benefit of income beneficiaries".[49] However, as with all fees, where an expense is fixed the onus of showing that the fees were for the exclusive benefit of the income beneficiaries rests on the trustees.[50] Importantly, Sir John Chadwick noted that in this case the absence of time records will necessarily make the estimation of the proportion of the work done for income and capital imprecise, but that does not prevent apportionment provided "a realistic estimate can be made".[51] In the context of a discretionary trust of income, Sir John Chadwick considered it self-evident that "the trustees may be expected to spend part of their time in addressing matters which are exclusively for the benefit of income beneficiaries".[52]

7.42 Applying these principles to the investment management fees, the Court of Appeal upheld the decision of the Special Commissioners:

> The first question is whether the expenses incurred in connection with the investment of income were incurred before or after the trustees had made the decision to accumulate that income. If the expenses were incurred after the trustees had made the decision to accumulate, they cannot, as it seems to me, be said to be expenses incurred exclusively for the benefit of the income beneficiaries. They must be charged against the capital of the accumulated funds.[53]

7.43 If the trustees had been able to show that the expenses were incurred for the temporary investment of income then the expenses "could be said to have been incurred exclusively for the benefit of the income beneficiaries".[54] However, on the facts this was not the case.

Current law: summary

7.44 The *Peter Clay* litigation clarified three points on the classification of trust expenses.

7.45 The first is that trustees' fees are an expense of the trust and therefore a TME for tax purposes.

7.46 The second is that the "capital limb" of the rule in *Carver v Duncan* is not to be regarded as qualified by the "income limb". If an expense is incurred for the benefit of the whole estate, it is to be charged to capital.

7.47 The third is that where the trustees can show that part of a single fee relates to work done for income alone (whether or not the invoice is itemised), then the trustees can apportion the expense, detaching the income element and charging it to income. In other words, while the Court of Appeal was very clear that

[49] Above at [45].

[50] Above at [46].

[51] Above at [38].

[52] Above at [38].

[53] Above at [41].

[54] Above at [41].

apportionment could not be carried out simply on the basis of fairness, there can be an apportionment on the basis of evidence. Accordingly, the classification of particular expenses will be heavily dependent upon the facts of the case.

7.48 To what extent does that principle entail a practical difference from the position for which the trustees were arguing, or indeed from a simple rule of fairness that expenses are to be apportioned in accordance with the trustees' views as to who benefits? There may be very little difference in practice. We have been offered considerable anecdotal evidence to the effect that, before the *Peter Clay* litigation, it was accepted professional practice that expenses could be apportioned and invoices were itemised to reflect this. That practice has now been validated by the Court of Appeal. In addition, the Court of Appeal has validated trustees' ability to make an apportionment based on evidence of proportions of work done.

7.49 The one form of apportionment that is not permitted is an apportionment without evidence. Where the trustees simply cannot tell how much of a particular invoice relates to income and how much to capital, then they may not apportion. If they cannot produce evidence of the proportionate benefits, then the expense is to be regarded as incurred for the benefit of the whole estate and charged to capital.

CONCLUSIONS

7.50 This is an area in which it is particularly difficult to weigh the comments of consultees. It remains significant that the majority of consultees were satisfied with the law as stated in *Carver v Duncan*, and agreed with the CP's provisional proposal not to place it on a statutory footing. But this agreement was premised on the law as it stood before HMRC issued its Guidance and before the *Peter Clay* litigation.[55] In one sense the law has stayed the same – the leading authority remains that of the House of Lords in *Carver v Duncan*. But of course in another sense things have moved on a great deal, and whereas there have been divergent views of the meaning of that authority we now have the Court of Appeal's authoritative interpretation.

7.51 As outlined above, the CP concluded that the classification of expenses should depend on whether they are incurred for the benefit of income or capital, and that "*Carver v Duncan* achieves a broadly impartial balance between the interests of competing beneficiaries".[56] The decision in *Peter Clay* confirms that the principle underlying the classification of trust expenses is that the burden of the expense should be borne by the beneficiary who receives the benefit.

7.52 In the *Peter Clay* litigation, the trustees argued that expenses should be classified in accordance with the general equitable duty to hold an even hand between competing beneficiaries,[57] which would have required the trustees to make an

[55] Consultees' support was also premised on the availability of a power of allocation which would have operated in relation to both receipts and expenses, although we cannot tell how far this weighed with consultees in their assessment of *Carver v Duncan*. We have explained at para 5.72 why we cannot recommend a power of allocation.

[56] CP, para 5.16.

[57] See para 4.10 and following above.

assessment of what was "fair" as between the beneficiaries.[58] The Court of Appeal, agreeing with HMRC, rejected this argument and held that in this context "apportionment is not based upon the general principle of achieving fairness between beneficiaries".[59]

7.53 However, we do not consider these two positions to be entirely incompatible; it can be said that a fair apportionment of a single expense is achieved by the principle that the burden of an expense is borne by the beneficiary who benefits from that expense.

7.54 We noted in paragraph 7.4 above that although it is possible to share an expense by attributing it to capital, because there is as a result less capital to generate income for the future, that way of sharing will not achieve a fair balance in a situation where the income beneficiary gets a great deal more benefit from an expense than does the capital of the trust fund. The decision in *Peter Clay* narrows the circumstances in which that is likely to arise. It is now clearly open to trustees to apportion expenses between income and capital on the basis, not of fairness as such, but of evidence; and they are free to do so even in cases where (as with the non-executive trustees' fees) in *Peter Clay* itself, the invoice is not itemised, although in doing so they must have an evidential basis for their decision rather than merely an impression. There will of course remain cases where proportionate sharing cannot be achieved because although both beneficiaries benefit, that sort of evidential support is simply not available; and in that case the expense must be attributed, for both trust and tax purposes, to capital. But such cases should be very few. If settlors or testators desire a finer balance to be achieved between income and capital beneficiaries where an expense is for the benefit of the whole estate, it is of course open to them to make express provision to this effect in the trust instrument.[60]

7.55 The decision in *Peter Clay* has also settled the status of trustees' fees, making it clear that they are to be regarded as expenses of the trust, in the context of the tax legislation.[61] As to the classification of trust expenses, in *Peter Clay* the Court of Appeal not only clarified the ambiguity in *Carver v Duncan*[62] but went a long way towards ensuring that, so far as possible, the burden of an expense should rest with the beneficiary who benefits from it.

7.56 Accordingly, we consider that the current trust law on the classification of trust expenses is both acceptable in principle and sufficiently clear, and make no recommendation for its reform.

[58] See [2008] EWCA Civ 1441, [2009] STC 469 at [4] and [2007] EWHC 2661 (Ch), [2008] Ch 291 at [9] and [10].

[59] [2008] EWCA Civ 1441, [2009] STC 469 at [31].

[60] Such a provision will affect the tax classification in the case of an interest in possession trust, but not for a discretionary trust; see para 7.5 above.

[61] See para 7.21 and 7.25 above.

[62] See para 7.10 above.

PART 8
CHARITIES

BACKGROUND: CHARITIES WITH PERMANENT ENDOWMENT

8.1 The rules for the classification of investment returns apply to charitable trusts as they do to private trusts. The impact of the distinction between capital and income returns upon private trusts for interests in succession is relatively easy to see, because different beneficiaries are entitled to capital and income respectively; but the beneficiary of a charity is the public, and so the distinction might be thought to be less crucial. For private trusts, total return investment, in which the distinction is disregarded in selecting investments, generates difficult taxation consequences, whereas for charitable trusts – which are exempt from income tax and inheritance tax – such consequences cannot arise.

8.2 So why are the classification rules a problem for charities? The answer is that the rules cause difficulties for a particular type of charity: charities set up with permanent endowment. A charitable trust has a permanent endowment where its terms impose restrictions upon the expenditure of some or all of its capital.[1] Where a charitable trust has a permanent endowment the trustees may spend the income produced by the trust on charitable purposes. The trustees are not, however, freely entitled to convert capital into income for expenditure. This creates a distinction between income available for current use and capital held to produce future income, and consequently a tension between the interests of the current recipients of charitable assistance and the future recipients. This tension is analogous to – albeit distinct from – that between beneficiaries interested in income and capital under private trusts.

8.3 Most charity trust deeds do not include express restrictions on the distribution of a charity's property; the existence of permanent endowment is usually a matter of inference.[2] And not all charities have permanent endowment. For the sake of convenience many modern charitable trusts are created without one.

8.4 However, it was with regard to charities that concerns were first raised in Parliament about the distinction between capital and income in trust law. During the debates on the Trustee Bill in 2000, Lord Dahrendorf asked:

> Above all, will it be possible for trustees to adopt what are called "total return policies" in which the rigid and often quite inadvisable distinction between capital and income is abandoned and to look at the total return of investments and thereby have even more freedom to benefit the purposes for which trusts are set up?[3]

8.5 The difficulty of which Lord Dahrendorf and others complained in 2000 was the practical consequence of the inability of charities with permanent endowment to

[1] A statutory definition of permanent endowment is provided by the Charities Act 1993, s 96(3): see para 8.12 and following below.

[2] See J Dutton, "Endowed Charities: A Total Return Approach to Investment?" (2001) 7(2) *The Charity Law and Practice Review* 131.

[3] *Hansard* (HL) 14 April 2000, vol 612, col 385.

spend capital freely. If income alone can be spent on the charity's purposes, the charity's trustees must invest to produce enough income for a reasonable level of expenditure, while maintaining capital growth, and so would be unable to invest on a total return basis.

8.6 However, as is the case with private trusts, total return investment is not for all. It may require trustees to make more sophisticated judgements about the construction of investment portfolios than they currently have to make; it will certainly require them to make decisions about the division of the total return, which under the current law is determined by the form that the receipts take. Trustees who invest on a traditional basis, selecting investments with a view to producing a balanced return, will continue to be subject to the classification rules. That means that where an investment return takes an unexpected or inappropriate form, the charity's capital or income will benefit or lose out disproportionately, and the trustees will be unable to redress the balance.

8.7 Accordingly, the reforms to classification that we would have wished to recommend, set out in Part 5, would have benefited charities not operating on a total return basis by rationalising their investment returns.[4] As it is, however, charities will benefit from the implementation of our recommendation as to the classification of shares distributed in the course of demergers.

DEVELOPMENTS SINCE THE TRUSTEE ACT 2000

8.8 The CP identified two main areas of difficulty for charities:

(1) the circumstances in which permanent endowment may be spent; and

(2) total return investment by charity trustees.

8.9 Since the debates on the Trustee Bill, a number of important developments have taken place affecting these issues. The first was the Charity Commission's publication in 2000 of a consultation document on investment by endowed charities. This was followed in 2001 by Operational Guidance[5] setting out the circumstances in which the Charity Commission would authorise total return investment for charities with permanent endowment. Accordingly, the concerns about total return investment aired in Parliament have to some extent been remedied, although only within the confines of the Charity Commission's sanctioned total return investment scheme.

8.10 The second development was the Cabinet Office Strategy Unit's consultation on charity law reform in 2002.[6] This led to the publication, shortly before the publication of the CP, of a draft Charities Bill. The Bill was implemented as the Charities Act 2006 which, among other things, introduces new provisions as to

[4] We take the view, and consultees agreed, that it would be undesirable for the classification rules for charities to differ from those for private trusts.

[5] Charity Commission, Operational Guidance 83 Endowed Charities: A Total Return Approach to Investment (available at http://www.charitycommission.gov.uk/supportingcharities/ogs/index083.asp), hereafter "OG 83".

[6] Cabinet Office Strategy Unit Report, *Private Action, Public Benefit – A Review of Charities and the Wider Not-For-Profit-Sector* (September 2002).

the circumstances in which a charity's capital may be freed from restrictions by way of amendment to the Charities Act 1993.

8.11 We now go on to examine the current law relating to the expenditure of permanent endowment and then to discuss total return investment for charities. In both cases, we explain the current state of the law, outline the issues raised in the CP and consultees' comments on the CP's provisional proposals, and finally describe the recommendations that we now make.

PERMANENT ENDOWMENT

The current law

8.12 Section 96(3) of the Charities Act 1993 defines permanent endowment as follows:

> A charity shall be deemed for the purposes of this Act to have a permanent endowment unless all property held for the purposes of the charity may be expended for those purposes without distinction between capital and income, and in this Act "permanent endowment" means, in relation to any charity, property held subject to a restriction on its being expended for the purposes of the charity.

8.13 Permanent endowment can in certain circumstances be spent as income, pursuant either to section 43 of the Charities Act 2006 or to the Charity Commission's more general powers.

Statutory provisions

8.14 The CP commented on the proposals to widen the circumstances in which statute authorised charity trustees to expend permanent endowment set out in the Strategy Unit's consultation document and the draft Charities Bill. These changes were put into effect by section 43 of the Charities Act 2006.

8.15 Section 43 substitutes new sections 75 and 75A of the Charities Act 1993 under the heading "Power of unincorporated charities to spend capital: general". The old section 75 had allowed small charities, following public advertisement and with Charity Commission approval, to distribute their permanent endowment where they considered the charity's assets to be too small "in relation to its purposes, for any useful purpose to be achieved by expenditure of income alone". The power was available only where the gross income of the charity in the previous financial year was £1,000 or less, and was not effective in respect of permanent endowment that included land.

8.16 In broad terms, the new powers brought in by the Charities Act 2006 allow small charities[7] to expend capital without Charity Commission authorisation (new section 75) and enable the Charity Commission to authorise the expenditure of capital by larger charities (new section 75A). The two sections are mutually exclusive; section 75 does not apply if section 75A does.

[7] Defined as having gross income in the last financial year of £1,000 or less or a market value of the permanent endowment fund of £10,000 or less.

8.17 Specifically, section 75 authorises the trustees to resolve that the endowment fund, or a portion of it, ought to be freed from restrictions with respect to expenditure of capital, where they are satisfied that their charitable purposes could thus be carried out more effectively. Section 75A enables the trustees of a larger charity to make the same resolution, subject to the same condition as to satisfaction about the effective carrying out of the charity's purposes, and subject also to the Charity Commission's concurrence. The Charity Commission has power to request further information and to require the trustees to give public notice of the resolution. In deciding whether or not to concur, the Charity Commission must take into account: any available evidence as to the wishes of the donor(s); any changes in circumstances relating to the charity since the making of the gift(s); and any representations by interested persons where public notice has been given. The Charity Commission must not concur with the resolution unless it is satisfied that the charity trustees have complied with their obligations in making it and that its implementation would accord with the "spirit of the gift".[8]

General powers of the Charity Commission

8.18 In addition to the specific statutory powers to expend endowment outlined above, it has long been the Charity Commission's practice to use its general powers to authorise the expenditure of part of a charity's permanent endowment. The Charity Commission remains willing to consider doing so in cases where the section 75 and 75A statutory powers are either unavailable or inappropriate.[9]

8.19 The powers in question are sections 26 and 16 of the Charities Act 1993. Section 26 gives the Charity Commission power to authorise any action in the administration of a charity which it considers expedient in the interests of the charity. Section 26(4) enables the Commission to make an order giving directions for "meeting any expenditure out of a specified fund, for charging any expenditure to capital or to income, for requiring expenditure charged to capital to be recouped out of income within a specified period, for restricting the costs to be incurred at the expense of the charity, or for the investment of moneys arising from any transaction". Section 26 cannot be used to authorise any action expressly prohibited in the charity's governing document; nor can it be used to change the purposes of the charity. The latter restriction is relevant where the property in question is "functional permanent endowment": capital held on express terms that it be used for a specific purpose of the charity (for example, a village hall).

8.20 Section 16 gives the Charity Commission power by Order to exercise the same jurisdiction and powers as are exercisable by the High Court in charity proceedings for various purposes. These include establishing a scheme for the administration of a charity. The Charity Commission will use section 16 where section 26 is unavailable.

[8] Charities Act 1993, s 75A(9)(a).

[9] Charity Commission, Operational Guidance 44 Permanent Endowment (available at http://www.charitycommission.gov.uk/supportingcharities/ogs/index044.asp), hereafter "OG 44". OG 44 A1 replicates the Charity Commission Information Sheet CSD-1347A, "Permanent Endowment – What is it and when can it be spent?" (May 2008) (available at http://www.charity-commission.gov.uk/supportingcharities/csd1347a.asp).

8.21 The Charity Commission's section 16 and section 26 powers may in theory be employed to authorise the use of permanent endowment for any purpose, if this is in the interests of the charity. However, the Charity Commission's guidance suggests "we expect that in most cases where we authorise trustees to spend permanent endowment it will be used for repairing, improving or extending buildings belonging to the charity".[10] The Charity Commission will usually require that the expenditure be replaced ("recouped" is the term used) out of future income.[11] But recoupment may not be required where the expenditure will provide long-term value or if the charity cannot afford it.

Consultees' comments

8.22 Because the Charities Bill was in draft form at the date of the CP, no specific question was asked about permanent endowment. However, a number of consultees made helpful comments in response to the CP's discussion of the meaning of permanent endowment and of the law, as it then stood, as to when it might be spent. A variety of views was expressed as to whether the powers set out in what was to become section 43 of the Charities Act 2006 were too wide or too narrow. There was a suggestion from the Charity Law Association that the definition itself might be re-examined; and argument that the Charity Commission's requirements for recoupment were not always appropriate.

8.23 The definition of permanent endowment, and the Charity Commission's requirements for recoupment, were the subject of debate in the course of the passage of the Charities Bill, and we do not think it appropriate at this point to re-open matters that have been considered so recently by Parliament. Since those debates the Charity Commission has conducted a review of its recoupment requirements, the results of which are set out in its Operational Guidance on permanent endowment.[12]

8.24 As to section 43 itself, we have in the course of 2008 sought the views of the Charity Commission and the Charity Law Association on the new powers introduced by this section. Representatives of both bodies have told us that the 2006 Act reforms make further Law Commission consideration of this area unnecessary. We agree with that conclusion.

TOTAL RETURN INVESTMENT FOR CHARITIES

8.25 We have referred above to the Operational Guidance on total return investment which was published by the Charity Commission in May 2001.[13] This stated that

[10] OG 44, para C4.1.

[11] Recoupment currently involves simple pound-for-pound repayment by regular instalments – no interest is involved and so no account is taken of inflation, even if repayment is made over, for example, 20 years. Annual payments are invested and the income produced is then available for the charity's purposes. However, the Operational Guidance notes the need to "protect the charity's capital and the purchasing power of the income it produces against the effects of inflation. This normally involves choosing a form of investment that offers a good prospect of capital growth" (OG 44, para C5.8). Also see Charity Commission CSD-1347A, "Permanent Endowment – What is it and when can it be spent?" (May 2008), para C5.7.

[12] OG 44 B2 (Expenditure and Recoupment Orders).

[13] OG 83.

the Charity Commission would offer, on an individual basis, authority to undertake total return investment using its power under section 26(1) of the Charities Act 1993.

8.26 The Charity Commission's section 26 authorisation is for the operation of a specific total return investment scheme. The scheme is available where:

(1) a charity holds endowed gift;[14]

(2) it is possible to distinguish the original gift and its accretions from unapplied investment returns; and

(3) the power is in the charity's interests.

Where granted, the authorisation will include directions that impose duties on the trustees in operating the scheme.[15]

8.27 The Charity Commission's scheme requires trustees to identify the "total return", that is, the investment return from the charity's endowed gift. This is made up of income receipts and capital gains. They must then divide it between the "trust for application" and the "unapplied total return".

8.28 The trust for application is the portion of total return that has been allocated for spending to meet present charitable needs. It must be spent within a reasonable period on the charity's purposes and (absent a separate power to accumulate) may not be added back to the endowed gift or the unapplied total return.

8.29 The unapplied total return is the remainder of current and past total return. Unapplied total return can be allocated to the trust for application at any time. In deciding whether to allocate total return to the trust for application, the trustees must have regard to their underlying duty to take account of the present and future needs of the charity and to be even-handed in their treatment of present and future beneficiaries. The CP commented that this will require the trustees to establish a rational policy taking account of the factors such as fluctuations in the value of trust assets, investment risks, changes in the charity's service provision, past patterns of expenditure and anticipated demand for the charity's support.

8.30 The Charity Commission's scheme thus abolishes the distinction between capital gains and income for the purposes of distributing investment returns. It enables the trustees of charities with permanent endowment, where appropriate, to expend capital gains as well as income on the charity's purposes. It also allows the trustees to withhold income (for example, income from a large special dividend) within the unapplied total return.

8.31 The scheme does not, however, authorise trustees to expend what the Charity Commission refers to as the "trust for investment" (that is, the endowed gift and the part of the unapplied total return which, under the duty of even-handedness,

[14] We use the term "endowed gift" to describe the original gift to the charity, and any future gifts, where these are subject to restrictions on expenditure and therefore cannot be spent.

[15] These include a duty to identify the total return, a duty to take advice and a duty to publicise the use of the power (including providing information in the annual report and the notes to the charity's accounts).

may not properly be allocated to the trust for application). The scheme does not include an express requirement that the value of the endowed gift be maintained in real terms; capital gain may, subject to the duty to balance the present and future needs of the charity, be allocated to the trust for application. But the endowed gift itself may not be touched. That is the case even in periods of negative return where there is no remaining unapplied total return.

8.32 The relationship between the various funds is described pictorially in the Charity Commission's Operational Guidance, a copy of which is reproduced as Appendix E to this Report.

8.33 The Charity Commission's Operational Guidance concludes its summary of the policy of its scheme by stating that "it is therefore clear that the concept of permanent endowment … is not affected by the power we propose to give trustees. We recognise a donor's right to create a charity that will have future as well as present beneficiaries".[16]

The CP's provisional proposals

8.34 The CP was written against the background of the Charity Commission's scheme for total return investment. Accordingly, it first assessed the suitability for charities of its own proposals to facilitate total return investment for private trusts, and then considered the Charity Commission scheme.

The duty to balance and the power of allocation

8.35 The CP's proposed power of allocation, its favoured total return investment vehicle for private trusts, was based upon a duty to balance, which we discussed in Part 4 above.[17] The CP took the provisional view that this duty to balance should not extend to charitable trusts, on the basis of the difference between the duties of trustees of private trusts for interests in succession and the duty of charity trustees to consider the present and future needs of the charity. The CP therefore concluded that the power of allocation proposed for private trusts would not be appropriate for charities; if that duty to balance was not to apply to charities, neither could the power of allocation.

8.36 The CP asked consultees whether they agreed with this conclusion. It also asked whether the duty of charity trustees to consider the present and future needs of the charity should be placed on a statutory footing.

8.37 In response to the question whether the private trust duty to balance should extend to charitable trusts, some consultees warned against drawing too sharp a distinction between that duty and the duty to consider present and future needs for charitable trusts. However, a majority agreed that charity trustees should not be subject to the duty to balance provisionally proposed in the CP for private trusts.

8.38 Despite that, a majority of consultees who answered the question took the view that the power of allocation proposed for private trusts ought to be equally available to charity trustees. There may have been some misunderstanding of the

[16] OG 83 A2, para 1.5.

nature of our proposal; some took it to represent a principled rejection of total return investment for charities, which of course it was not. However, some may have seen it as a route to total return investment that did not involve the constraints of the Charity Commission's scheme; while others may have regarded the power as enabling them to deal flexibly with receipts when not operating total return investment.

8.39 As discussed in Part 5, we cannot recommend a power of allocation for private trusts, and therefore the extension of that facility to charitable trusts does not arise. In any event, we continue to take the view, as we did in the CP, that it is desirable for charitable trusts operating total return investment to follow a scheme specifically designed for that purpose by the Charity Commission.

8.40 We move on to the CP's proposals for total return investment, and our recommendations, below. Before doing so, we briefly address the question of whether or not the duty of charity trustees to consider the present and future needs of the charity should be placed on a statutory footing. A number of consultees were in favour of putting the duty on a statutory footing. But the majority were not in favour; they included the Charity Commission, who did not consider there to be anything to be gained from the statutory codification of the duty.

8.41 We have explained why, in the light of consultation and our other recommendations, we do not consider there to be a case for a general statutory statement of the general trust law duty to balance.[18] We do not think that there is any need to place the duty of charity trustees on a statutory footing. The Charity Commission has issued detailed guidance on the duty of trustees of charitable trusts with permanent endowment, and we do not consider that a statutory statement of the duty would offer significant benefits.

Classification

8.42 The CP provisionally proposed that the rules governing the classification of receipts from corporate entities should be conclusive for charities, rather than default. This was on the basis that the default nature of the classification proposed for private trusts was intrinsically linked to the operation of the power of allocation proposed for private trusts.

8.43 A narrow majority of consultees agreed with that proposal, although some noted that the rules could be displaced by express wording in the trust and by the court or by the Charity Commission in the exercise of their powers. The minority who did not agree with the provisional proposal generally did so on the basis that they wanted the CP's power of allocation to extend to charitable trusts, with the result that the classification rules would give rise to default classifications.

8.44 Although the overall shape of our proposals for private trusts has changed since the CP, we still take the view that the classification rules should apply to charities as they do to private trusts. Accordingly, corporate receipts by charities will

[17] See paras 4.10 to 4.23 above.

[18] See paras 5.24 to 5.29 above.

continue to be classified in accordance with the rule in *Bouch v Sproule*, subject to the reform we propose with respect to demergers.

8.45 The application of the equitable and statutory apportionment rules to charitable trusts was not directly considered in the CP and there is some dispute as to the current law. Again, however, we see no reason why our proposals for private trusts should not extend to charitable trusts, to the extent that they can do so.

Total return investment for charities: the options in the CP

8.46 Having rejected the power of allocation as a suitable mechanism for charity trustees to conduct total return investment, the CP went on to consider how total return investment should be facilitated, in the context of the availability of the Charity Commission's scheme. It proposed three alternative mechanisms:

(1) The current system of individual Charity Commission authorisations could be retained, possibly with legislative confirmation of the scope of the Charity Commission's powers to authorise such schemes.

(2) A general statutory power could be granted to all permanently endowed charities on similar terms to the Charity Commission's current scheme.

(3) As (2) but with additional reporting and accounting requirements.

8.47 The CP considered the advantages of Option 1 to be that it gave the Charity Commission notice of the trustees' intentions and gave the trustees access to the Charity Commission's Operational Guidance. The "obvious disadvantage" was said to be that the application might be relatively costly, time-consuming and inconvenient for the charity and had operational implications for the Charity Commission. The advantage of Option 2 was that it would allow for total return investment for all, and so would overcome any problematic results generated by the classification rules. The CP discussed the question whether trustees would, in effect, have to use the power and concluded "we do not think that charity trustees would necessarily commit a breach of trust by failing to make use of this general power. Trustees would be under a duty to consider using the power but we believe that a properly considered decision not to use the power would discharge this duty".[19]

8.48 The CP considered Option 3 to be the best in that it would reduce the burden on the Charity Commission, while enabling it to retain some control over the activities of charity trustees.[20]

8.49 The CP did not consult on the option of giving charity trustees an entirely unfettered power to distribute capital or accumulate income. It noted the Charity Commission's comment in its 2000 consultation document on investment by endowed charities that such an approach would "effectively eliminate" the duty to consider the present and future needs of the charity, and that it would not "keep

[19] CP, para 6.60.

[20] CP, para 6.61.

faith with those that set up charities with capital funds".[21]

Responses to the CP's proposals about total return investment for charities

8.50 Most consultees agreed with our preference for Option 3, above, although some expressed concern about the need for "safeguards" or about the administrative burden on charities, particularly small organisations. Some, including the Charity Law Association and the Wills and Equity Committee of the Law Society, also took the view that, failing a provision to make the Charity Commission's scheme available without individual authorisation, Option 1 should be pursued, to place the current system on a statutory footing.[22]

8.51 Of those who were unhappy with Options 2 and 3, some were concerned that total return investment was too complex or too risky for charitable trusts. Others expressed disagreement in the opposite direction, arguing in favour of total return investment but criticising the Charity Commission's scheme. Those criticisms fall broadly under three heads.

RESTRICTIONS ON THE EXPENDITURE OF ENDOWED GIFT

8.52 First, consultees criticised the absence of any ability under the Charity Commission's scheme to have any access to the original gift (or the investments representing it) in order to fund charitable activity where the unapplied total return has been exhausted. That ability is seen as an important means of facilitating prudent long-term total return investment; if there is no absolute bar on the expenditure of endowed gift, short-term very low yields can be endured in the interests of longer-term gain, and spending is not paralysed.

8.53 To explain this concern, we have to go back to the model of percentage trust explained in Part 3.[23] It will be recalled that in a percentage trust the trustees distribute as income every year a proportion of the total assets of the trust – income or capital – without regard to their source. In a bad year when investment returns are very low, or during a planned period of low returns where the trustees have invested with a view to later capital growth, the funds distributed may not constitute investment *returns* at all, but may be part of the original capital of the fund. Trustees may at times need to do this to tide the trust over difficult periods or indeed to facilitate sophisticated financial planning.

8.54 However, the Charity Commission's scheme makes this form of total return investment impossible, because it does not make any provision for the

[21] CP, para 6.41 referring to *Endowed Charities – A Fresh Approach to Investment Returns?* (July 2000).

[22] One reason why some consultees supported this was a doubt, expressed in an article published in 2001, about the Charity Commission's power to use the section 26 power to authorise total return investment. See J Hill and J Smith, "Permanent Endowment and Total Return" (2001) 7(2) *The Charity Law and Practice Review* 125 and J Dutton, "Endowed Charities: A Total Return Approach to Investment?" (2001) 7(2) *The Charity Law and Practice Review* 131. We do not agree with Hill and Smith's argument. It was not raised during the passing of the Charities Act 2006 and does not appear to have been picked up in other published works. There is no evidence that charities have been deterred by it from applying under section 26, nor that the Charity Law Association regards it as a live issue today. In the light of our recommendation there is in any event no need for us to consider it further: see para 8.80 below.

distribution of any part of the charity's endowed gift – that is, the original fund and any further gifts. Clearly distribution of endowed gift would not be undertaken lightly. But there might be circumstances where the inability to access that fund could cripple a charity in the short term, where there is no "unapplied total return".[24]

8.55 It is this inability to distribute the endowed gift that lies at the heart of the criticisms of the Charity Commission's scheme expressed in the responses to our 2004 CP.

NO REQUIREMENT TO CONSERVE THE ENDOWMENT

8.56 A second criticism of the Charity Commission's total return investment scheme, made by a number of consultees, is the absence of an absolute requirement to retain the real value of the endowed gift. The ability of trustees to expend capital gains arising on the endowed gift means that its value can shrink over time. It was suggested that this makes the scheme's prohibition on expending the endowed gift artificial.

8.57 The Charity Commission does not accept this criticism. Its view is that the duty to keep a balance between current and future charitable purposes, which underpins the scheme, makes an express requirement to maintain the value of the endowed gift unnecessary. Moreover, it considers that it would be arbitrary to limit expenditure by, say, a compulsory percentage increase in the value of the retained fund or to a defined percentage of total return or of the value of the trust. Any form of prescription would produce irrational results in some of the wide variety of circumstances which would arise.

INFLEXIBLE PROCEDURE

8.58 Finally, there is the issue of structural rigidity. The London Endowed Charities Forum summed up the views of several consultees when it stated that the current system "is not in practice seen as terribly workable or attractive". Trustees are obliged to operate on the basis of the Charity Commission's categories (endowed gift, total return, unapplied total return and trust for application). They are subject to various reporting and accounting requirements which many find cumbersome and inappropriate. We have sympathy with this concern, although we recognise the need for accounting safeguards.

OUR RECOMMENDATIONS FOR TOTAL RETURN INVESTMENT FOR CHARITIES

Making total return investment more widely available

8.59 In recommencing work on this project in 2008, we endeavoured to ascertain, in

[23] See paras 3.17 to 3.22 above.

[24] Edward Nugee QC contrasted the Charity Commission's scheme with the type of total return investment policy drafted by him and adopted by a number of Oxford and Cambridge colleges. In these trusts the total value of the fund's assets is ascertained at the end of the relevant accounting period, and the trustees then determine what proportion can properly be spent. These are exempt charities, not currently subject to Charity Commission control.

discussion with organisations and with individuals, whether the range of views on total return investment expressed in 2004 is still held. We found that it is. We have had very constructive discussions with representatives of the Charity Commission and of the Charity Law Association. We agree with them that total return investment holds significant advantages for charity trustees. It enables flexible investment which can maximise returns, and overcomes the problems caused by the rules of trust classification, such as the receipts of large and unexpected income returns which erode capital. Such receipts are a particular problem for charities as the income must be spent within a reasonable period.

8.60 Total return investment may be unsuitable for smaller trusts where the administrative burden of running a total return investment scheme would outweigh the benefits. Such charities might invest more effectively on a conventional basis; and the very small ones might reasonably choose to place their endowed gift in a single income-producing investment which offers predictable, if unspectacular, returns.

8.61 Accordingly, we favour a reform making total return investment available to all charities, at the discretion of the trustees; it will be for trustees to decide, in the light of the charity's size and the nature of its investment portfolio – and indeed of their own investment competence – whether or not to do so. The trustees' properly considered decision would discharge their duty to consider exercising the power. It should be noted that, in a sense, introducing the power would not alter charity trustees' responsibilities in this regard; charity trustees currently have power to apply to the Charity Commission for authorisation to conduct total return investment, and so are under a duty to consider the exercise of that power. It should also be borne in mind that there is precedent for introducing facilitative powers of this sort. The Trustee Act 2000 widened investment powers for all existing trusts. In doing so it enabled more effective trustee investment. It did so notwithstanding that some elements of the Act's "package" are potentially burdensome.

Which total return investment scheme for charities?

8.62 There are clearly many different possible forms of total return investment. As to the appropriate scheme for charities, we have heard two very clear messages in discussions held in 2008.

8.63 The first is that the Charity Commission considers that its scheme is now tried and tested and should be made more widely available. Consequently, it considers that where its section 26 scheme can apply, it generally should do, on the grounds of public benefit. It remains confident in the terms of its scheme, and has stressed to us that it consulted stakeholders before settling on its total return investment policy, and that a range of prescriptive schemes were put forward and considered. The Charity Commission would therefore favour the extension of its scheme to all charitable trusts: Option 2 of those put forward by the CP. It does not favour Option 3, involving additional reporting and accounting requirements.

8.64 The second message is that there is still significant disquiet about the Charity Commission's scheme among charities, focused still on the restrictions on endowed gift, the lack of requirement to retain the value of endowed gift, and structural rigidity. That disquiet is now expressed against a different statutory background, because section 43 of the Charities Act 2006 is now in force, so that

charities now have much wider powers to spend their permanent endowment, as discussed above.

8.65 Those wider powers have a potential impact – perhaps an unexpected one - upon the operation of the Charity Commission's total return investment scheme.[25] They may make it unnecessary for charities who wish to operate total return investment to follow the route of obtaining section 26 authority to do so; instead, it would appear to be open to charity trustees to exercise the power in section 75 or to make an application under section 75A to remove the restriction on the expenditure of capital and thereafter invest on a total return basis. The grounds for the exercise of the power or for making the application would be that the charity would be able to carry out its charitable purposes more flexibly on this basis. Such trustees would, of course, remain subject to the duty to be even-handed in their treatment of present and future charitable purposes. But they would be free to devise their own scheme for total return investment, including for example the facility to expend endowed gift in a period of negative total return; they might impose their own restrictions to prevent the erosion of capital, and they might devise simpler accounting requirements than those imposed within the section 26 scheme.

8.66 This proposition has not been tested because the relevant sections have only recently come into force. Larger charities would require Charity Commission concurrence with their plans under section 75A, and in the current investment market it may be that many would be able to present a strong application under section 75A on the basis that the Charity Commission's section 26 total return scheme would not be effective. The Charity Commission's decision could, of course, be appealed to the Charity Tribunal.

8.67 It therefore appears that the changes made by the Charities Act 2006 to the rules of expenditure of permanent endowment may have opened the way for charity trustees to bypass the Charity Commission's total return investment scheme and to undertake a different sort of total return investment.

8.68 We take the view that that, where appropriate, charities should be able to take advantage of the section 75 and 75A powers to conduct total return investment in the manner of their own choosing, provided that it can be demonstrated that this is in the interests of the charity. Those that do so will remain subject to the duty to balance the present and future needs of the charity and to the oversight of the Charity Commission.

8.69 However, we think that for many charitable trusts the Charity Commission's scheme remains the most appropriate form of total return investment. We would not favour the widespread use of sections 75 and 75A as a mechanism of bypassing the Charity Commission's carefully designed scheme. Nor do we think that all applications under section 75A would be successful, for the reasons outlined above. We therefore do not think that the availability of sections 75 and 75A negates the argument that there should be a general statutory power to operate the Charity Commission's total return investment scheme.

8.70 We understand the criticisms of that scheme, but we do not consider its

[25] We are grateful to the Charity Law Association for drawing this point to our attention.

prescriptive requirements to be a disadvantage. The Charity Commission's role is to regulate and assist charities, in order to increase their efficiency and effectiveness and to promote public confidence and trust in them. Although the concept of total return investment is relatively straightforward, the mechanics of operating it are not. We consider that it is appropriate, and indeed necessary, that the Charity Commission design and provide support for a detailed total return investment scheme for charity trustees. The fact that the scheme spells out what the trustees need to do may irritate some sophisticated charity trustees. But the structure of the scheme, together with the Charity Commission's voluminous Operational Guidance, is extremely valuable for less experienced trustees. The duties that the Charity Commission has put in place spell out to charity trustees what is expected of them and allows the Commission to police the scheme's effective implementation.

8.71 We therefore do not accept that it would be appropriate to recommend a less structured total return investment scheme for charities. The Charity Commission may be able better to present the scheme in a way which makes clear the flexibility that it does offer.

8.72 We have concluded, therefore, that there should be a general statutory power which would enable all charities to operate total return investment in accordance with regulations made by the Charity Commission.[26] We do not consider that there is any need to impose more onerous reporting requirements[27] on charities taking advantage of a new general statutory total return investment power. Various duties are already imposed on charities taking advantage of the Charity Commission's scheme.[28] The Charity Commission and other consultees have made it clear that they do not think that the adoption of a total return investment approach to investment requires the imposition of additional obligations on charity trustees.

Remaining concerns about the Charity Commission's scheme

8.73 Nevertheless, we are aware of the claims that the scheme is unpopular and we have discussed with the Charity Commission the concerns that our consultees have raised with us. We commented above on structural and accounting requirements, and the benefits we see in these; but it is undesirable that they be expressed in a way that charities find burdensome. We think that, in itself, the absence of any formal mechanism to retain the real value of the endowed gift is not problematic, provided that trustees who operate the scheme appreciate the need to keep in mind the effect of inflation on the value in real terms of the endowed gift. The Charity Commission should consider amplifying its guidance on this issue and remain open to the concerns of charities on this point and to the possibility of imposing further safeguards. Finally, the concern of charities about the restrictions on the endowed gift are persistent, and it seems inappropriate that there should be an automatic bar that prevents charities from operating a model for total return investment that many private trusts in other jurisdictions

[26] See Draft Bill, cl 4 which sets out the Charity Commission's power to make regulations and gives examples of the provisions such regulations may contain.

[27] As envisaged in the CP's Option 3: see para 8.46, above.

[28] See OG 83 B2 ("Directions relating to the use of the power") and B5 ("Accounting for Total Return").

have found useful and workable, particularly in falling markets.

8.74 We think that while the passage of time is a reason for widening the availability of the Charity Commission's scheme, on the basis that fundamental flaws have not become apparent, the passage of time also indicates that it would be appropriate for the Charity Commission to consult afresh about the details of the scheme.

8.75 We would like that consultation to focus particularly upon endowed gift and the circumstances in which it might be spent. The Charity Commission might usefully give consideration to setting up a procedure, within its total return investment scheme, whereby trustees might apply for authority to spend it, and for the Commission to consider such applications with an unfettered discretion but in the light of relevant criteria. These might include:

(1) the interests of the charity, taking into account the charity's past, present and future investment policy and the past, present and future calls on its funds;

(2) the intentions of the donor of the gift; and

(3) whether or not provision is to be made to recoup the gift from future investment.

8.76 Other criteria might be suggested in consultation, and no doubt more flexibility might be available where the authorisation is to spend endowed gift on condition that it must be recouped from future investment returns. We anticipate that such authorisation would be required only for larger charities that cannot use the procedure under section 75 of the Charities Act, since smaller charities may use that section to free their capital from restrictions by resolution in any event.

8.77 The additional ability for charities to apply for authorisation for the expenditure of the original gift, within the Charity Commission's own total return investment scheme, would enable the Charity Commission to control and provide targeted operational and policy guidance on the circumstances in which expenditure of endowed gift would be appropriate.

8.78 The Charity Commission clearly values the preservation of permanent endowment, but equally wishes charities to conduct total return investment. We believe that a consultation about the detail of the scheme would lay the foundations for improvements to it, which would make it more attractive to charities; and that, in turn, would reduce the necessity for charities to apply to operate schemes of their own devising under section 75A.

8.79 Accordingly, with the agreement of the Charity Commission, we make two recommendations.

Recommendation

8.80 **We recommend that there should be a general statutory power which would enable all charities to resolve that the endowment fund, or a portion of it, ought to be freed from restrictions with respect to expenditure of capital in order that they might operate total return investment in accordance with regulations made by the Charity Commission without seeking authorisation**

under section 26 of the Charities Act 1993.[29]

Recommendation

8.81 **We recommend that the Charity Commission should conduct a consultation about the details and rules of its current scheme, with a view to amending the terms on which it authorises total return investment in the future.**

[29] Draft Bill, cl 4.

PART 9
SUMMARY OF RECOMMENDATIONS

9.1 We recommend that all distributions falling within sections 213(2) or 213A of the Income and Corporation Taxes Act 1988 (defined as exempt distributions in section 218) should be classified as capital for trust law purposes.[1] When such a distribution is made, the trustees should have a power to make a payment of capital to beneficiaries interested in income where otherwise there would be prejudice to those beneficiaries.[2]

[paragraph 5.95]

9.2 We recommend that the Secretary of State should be given power by statutory instrument to provide, with HM Treasury consent, for similar amendments to trust classification in the event that developments in tax legislation create new exempt distributions.[3]

[paragraph 5.97]

9.3 We recommend that HMRC and HM Treasury in the longer term enter into discussions with the trust industry as to the feasibility and mechanics for total return investment for trusts within the parameters of current tax policy, to the extent that is possible, or in the event of future developments in policy.

[paragraph 5.104]

9.4 We recommend that the first part of the rule known as the rule in *Howe v Earl of Dartmouth* shall not apply to any future trusts.[4]

[paragraph 6.53]

9.5 We recommend that the equitable rules of apportionment shall not apply to any future trusts, subject to any contrary provision in the trust instrument.[5]

[paragraph 6.65]

9.6 We recommend that section 2 of the Apportionment Act 1870 shall not apply to any future trusts, subject to any contrary provision in the trust instrument.[6]

[paragraph 6.70]

9.7 We recommend that there should be a general statutory power which would enable all charities to resolve that the endowment fund, or a portion of it, ought to be freed from restrictions with respect to expenditure of capital in order that they

[1] Draft Bill, cl 2(1) and (3)(a).

[2] Draft Bill, cl 3.

[3] Draft Bill, cl 2(1) and (3)(b).

[4] Draft Bill, cl 1(2)(a) and (4).

[5] Draft Bill, cl 1(2)(b) to (e) and (4).

might operate total return investment in accordance with regulations made by the Charity Commission without seeking authorisation under section 26 of the Charities Act 1993.[7]

[paragraph 8.80]

9.8 We recommend that the Charity Commission should conduct a consultation about the details and rules of its current scheme, with a view to amending the terms on which it authorises total return investment in the future.

[paragraph 8.81]

(*Signed)* TERENCE ETHERTON, *Chairman*
ELIZABETH COOKE
DAVID HERTZELL
JEREMY HORDER
KENNETH PARKER

MARK ORMEROD, *Chief Executive*
3 April 2009

[6] Draft Bill, cl 1(1) and (4).

[7] Draft Bill, cl 4.

APPENDIX A
DRAFT TRUSTS (CAPITAL AND INCOME) BILL AND EXPLANATORY NOTES

The draft Bill begins on the following page.

Turn to page 129 for a background note, summary and commentary on the clauses.

DRAFT

OF A

BILL

TO

Amend the law relating to capital and income in trusts.

BE IT ENACTED by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:—

1 Disapplication of apportionment etc. rules

(1) Any entitlement to income under a trust created or arising after this section comes into force is to income as it arises (and accordingly section 2 of the Apportionment Act 1870 (c. 35), which provides for income to accrue from day to day, does not apply in relation to the trust). 5

(2) The following do not apply in relation to a trust created or arising after this section comes into force—

(a) the first part of the rule known as the rule in *Howe* v. *Earl of Dartmouth* (which requires certain residuary personal estate to be sold);

(b) the second part of that rule (which withholds from a life tenant income arising from certain investments and compensates the life tenant with payments of interest); 10

(c) the rule known as the rule in *Re Earl of Chesterfield's Trusts* (which requires the proceeds of the conversion of certain investments to be apportioned between capital and income); 15

(d) the rule known as the rule in *Allhusen* v. *Whittell* (which requires a contribution to be made from income for the purpose of paying a deceased person's debts, legacies and annuities);

(e) the rules known as the rule in *Re Atkinson* and the rule in *Re Bird* (which require losses on certain investments to be apportioned between capital and income). 20

(3) Trustees have power to sell any property which (but for subsection (2)(a)) they would have been under a duty to sell.

(4) In a case where there is a trust instrument, subsections (1) to (3) have effect subject to any contrary provision in the instrument. 25

2 Classification of certain corporate distributions as capital

(1) A receipt consisting of a tax-exempt corporate distribution is to be treated for the purposes of any trust, whether created or arising before or after this section comes into force, as a receipt of capital (even if it would otherwise be treated for those purposes as a receipt of income). 5

(2) In a case where there is a trust instrument, subsection (1) has effect subject to any contrary provision in the instrument.

(3) The following are tax-exempt corporate distributions for the purposes of this section and section 3—

(a) a distribution that is an exempt distribution by virtue of section 213(2) or 213A of the Income and Corporation Taxes Act 1988 (c. 1), and 10

(b) any other distribution of assets (in any form) by a body corporate, where the distribution is of a description specified by an order made by the Secretary of State by statutory instrument.

(4) An order under subsection (3)(b) may specify a description of distribution only if neither income tax nor capital gains tax is chargeable in respect of a distribution of that description. 15

(5) The making of an order under subsection (3)(b) requires the consent of the Treasury.

(6) A statutory instrument containing an order under subsection (3)(b) is subject to annulment in pursuance of a resolution of either House of Parliament. 20

3 Power to compensate income beneficiary

(1) Subsection (2) applies in any case where—

(a) by virtue of section 2 a tax-exempt corporate distribution made by a body corporate is treated for the purposes of a trust as a receipt of capital, and 25

(b) the trustees are satisfied that it is likely that, but for the distribution, there would have been a receipt from the body corporate that would have been a receipt of income for the purposes of the trust.

(2) Where this subsection applies, the trustees may make a payment out of the capital funds of the trust, or transfer any property of the trust, to an income beneficiary with a view to placing the beneficiary (so far as practicable) in the position in which the beneficiary would have been had there been the receipt of income mentioned in subsection (1)(b). 30

(3) In subsection (2) "income beneficiary", in relation to a trust, means a person entitled to income arising under the trust, or for whose benefit such income may be applied. 35

4 Total return investment by charities

After section 75B of the Charities Act 1993 (c. 10) insert—

"75BA Investment of endowment fund on total return basis 40

(1) This section applies to any available endowment fund of a charity which is not a company or other body corporate.

(2) Where the following conditions are met, the charity trustees may resolve for the purposes of this section that the fund, or a portion of it, ought to be freed from the restrictions with respect to expenditure of capital that apply to it.

(3) The first condition is that the charity trustees are satisfied that it is likely that the total return from the fund or portion would be greater if it could be invested without the need to maintain a balance between capital and income returns. 5

(4) The second condition is that the charity trustees are satisfied that it is in the interests of the charity that the fund or portion, and income arising from it, should be subject to regulations under section 75BB(1)(b). 10

(5) While a resolution under subsection (2) has effect—
- (a) the fund or portion is not subject to the restrictions mentioned in that subsection, but
- (b) the fund or portion, and income arising from it, is subject to regulations under section 75BB(1)(b). 15

(6) In this section "available endowment fund" has the same meaning as in section 75.

75BB Total return investment: regulations

(1) The Commission may by regulations make provision about— 20
- (a) resolutions under section 75BA(2), and
- (b) the investment of a relevant fund without the need to maintain a balance between capital and income returns, and expenditure from such a fund.

(2) Regulations under subsection (1)(a) may, in particular— 25
- (a) specify steps that must be taken by charity trustees before passing a resolution under section 75BA(2),
- (b) make provision about the variation and revocation of such a resolution,
- (c) require charity trustees to notify the Commission of the passing, variation or revocation of such a resolution, and 30
- (d) specify circumstances in which such a resolution is to cease to have effect.

(3) Regulations under subsection (1)(b) may, in particular—
- (a) make provision about the taking of advice by charity trustees in connection with the investment of, and expenditure from, a relevant fund, 35
- (b) specify circumstances in which expenditure from a relevant fund requires the Commission's consent, and
- (c) require charity trustees to report to the Commission on the investment of, and expenditure from, a relevant fund. 40

(4) Any regulations made by the Commission under this section must be published by the Commission in such manner as it thinks fit.

(5) In this section—
- (a) "relevant fund" means a fund, or portion of a fund, in respect of which a resolution under section 75BA(2) has effect, and 45

(b) references to expenditure from a relevant fund include references to expenditure of income arising from such a fund.”

5 Short title, commencement and extent

(1) This Act may be cited as the Trusts (Capital and Income) Act 2009.

(2) This section comes into force on the day on which this Act is passed, but otherwise this Act comes into force on such day as the Secretary of State may by order made by statutory instrument appoint. 5

(3) An order under subsection (2) may—

(a) appoint different days for different purposes;

(b) make such provision as the Secretary of State considers necessary or expedient for transitory, transitional or saving purposes in connection with the coming into force of any provision of this Act. 10

(4) This Act extends to England and Wales only.

DRAFT TRUSTS (CAPITAL AND INCOME) BILL: EXPLANATORY NOTES

BACKGROUND AND SUMMARY

Capital and income in trusts

A.1 This Bill will give effect to the recommendations made in the Law Commission's Report *Capital and Income in Trusts: Classification and Apportionment*,[1] which examined: the rules classifying receipts and expenses, in the hands of trustees, as income and capital; the rules apportioning receipts and outgoings of trustees between income and capital; and the rights and duties of charity trustees in relation to investment returns on a charity's permanent endowment. The Bill makes changes to a number of those rules.

A.2 The Bill is relevant to those trusts that have to distinguish between capital and income in the management of their property. Such trusts fall into two groups:

(1) private trusts for interests in succession; and

(2) charitable trusts with a permanent endowment.

A.3 The trustees of these trusts have to distinguish between capital and income investment receipts. In the case of private trusts for interests in succession, income receipts must be paid to the life tenant while capital receipts must be held for the remainderman; in the case of charitable trusts with permanent endowment, capital receipts must generally be held as part of the permanent endowment.

A.4 The Bill makes three changes. First, it disapplies, for new trusts, the rules known as the equitable rules of apportionment, which require adjustments to be made to the entitlement to income and capital receipts, and to liabilities for income and capital expenses, in certain instances. It also disapplies the statutory time apportionment rule imposed by the Apportionment Act 1870 in so far as it relates to trusts. Secondly, it changes the classification of shares received by trustees by way of investment receipts when the company in which they hold shares undergoes a demerger. Finally, the Bill makes an amendment to the Charities Act 1993 in order to facilitate total return investment for charitable trusts that have a permanent endowment.

The rules of apportionment

A.5 The rules of apportionment require the sharing of certain returns and outgoings of a trust between capital and income, and in some cases impose a duty to sell certain investments. Most derive from case law, and are often known as the "equitable rules of apportionment"; one derives from statute. The rules can be summarised as follows:

(1) Section 2 of the Apportionment Act 1870 is a rule of time apportionment. The effect of the section is that income beneficiaries are entitled only to

[1] Law Com No 315.

the proportion of income that is deemed to have accrued during their period of entitlement.

(2) The first part of the rule known as the rule in *Howe v Earl of Dartmouth* creates an implied trust for sale, putting the trustees under a duty to convert residuary personal estate, held on trust for persons in succession, if it is an unauthorised investment and of a wasting or hazardous nature.

(3) The second part of the rule known as the rule in *Howe v Earl of Dartmouth* compensates the capital beneficiary for loss pending conversion of trust investments.

(4) The rule in *Re Earl of Chesterfield's Trusts* compensates the income beneficiary for loss of present income from future property where trustees have exercised a power to defer sale.

(5) The rule in *Allhusen v Whittell* apportions debts, liabilities, legacies and other charges payable out of the residuary estate between capital and income beneficiaries.

(6) The rule in *Re Atkinson* apportions the loss caused to the trust by authorised investments in loan stock where the borrower is unable to meet his or her obligations and there is insufficient security to make up the shortfall.

(7) The rule in *Re Bird* apportions the loss caused to the trust by unauthorised investments in loan stock where the borrower is unable to meet his or her obligations and there is insufficient security to make up the shortfall.

A.6 The rules apply to private trusts for interests in succession; the extent to which they apply to charitable trusts is unclear. Professionally drafted trust instruments generally exclude them. In most trusts where they have not been excluded they are either ignored or cause considerable inconvenience by requiring complex calculations in relation to very small sums of money.

A.7 The Bill abolishes the rules for trusts coming into existence after commencement. But settlors and testators who wish any or all of the rules to apply to the trust can make express provision to that effect in the trust instrument.

The classification of shares received in the course of a demerger

A.8 The trust law classification of investment receipts from companies as income or capital is determined, in most instances, by the rule known as the rule in *Bouch v Sproule.*[2] It was stated in its modern form in *Rae v Lazard Investment Co Ltd*:

> There is no doubt that every distribution of money or money's worth by an English company must be treated as income in the hands of the shareholders unless it is either a distribution in a liquidation, a repayment in respect of reduction of capital (or a payment out of a

[2] (1887) LR 12 App Cas 385.

special premium account) or an issue of bonus shares (or it may be bonus debentures).[3]

A.9 Among the effects of the rule is that any dividend paid by a company in which trustees hold shares is classified as income.

A.10 The Bill changes that classification, for the purposes of trustee shareholders, in the case where the dividend is a distribution made in the course of a corporate demerger. Such demergers can be of two kinds: direct and indirect. A demerger involves the transfer of part of Company A's business to a new Company B, with the shareholders of the demerged company (Company A) receiving shares in the new company by way of a declaration of dividend. In a direct demerger the dividend is satisfied by Company A issuing to its shareholders shares in Company B. In an indirect demerger the shares in Company B are transferred to a separate holding company, Company C, whose shares are owned by Company A. Company A satisfies the dividend by transferring to its shareholders the shares in Company C.

A.11 Under the rule in *Bouch v Sproule*, shares distributed in the course of a direct demerger are classified as income. Shares distributed in the course of an indirect demerger, on the other hand, constitute an exception to the rule in *Bouch v Sproule* and are classified as capital, following the decision in *Sinclair v Lee*.[4] The Bill provides that the shares distributed in defined direct and indirect demergers will for the future be treated as capital for the purposes of the trust. This reform affects both private and charitable trusts.

A.12 The classification of such receipts may, in some circumstances, prejudice the income beneficiary. The Bill provides a power to compensate the income beneficiary by way of a payment from trust capital in these circumstances.

Total return investment for charitable trusts

A.13 The trustees of charitable trusts with permanent endowment must keep separate income available for current use and capital held to produce future income, and consequently must maintain a balance between the interests of the current recipients of charitable assistance and the future recipients.

A.14 Those duties to balance have an influence upon the selection of investments by the trustees of these trusts. They must invest with a view to the likely form of the receipt – as income or capital – in an endeavour to ensure that future investment receipts do not favour income or capital disproportionately. As the classification of investment receipts is governed by rules, the trustees cannot take any corrective action in the event that the eventual return on the investments does not produce the requisite balance.

A.15 The selection of investments in this way prevents trustees from operating total return investment, whereby investments are selected with a view to the level of return without being constrained by the likely form of the return.

[3] [1963] 1 WLR 555 at 565.

[4] [1993] Ch 497.

A.16 Trustees of charitable trusts with permanent endowment can operate total return investment if they apply to the Charity Commission for an order enabling them to do so, in accordance with the Charity Commission's scheme for total return investment set out in its Operational Guidance.[5] The Bill enables trustees by resolution to operate total return investment in accordance with Charity Commission regulations, without having to approach the Charity Commission for an order.

COMMENTARY ON CLAUSES

Clause 1: Disapplication of apportionment etc rules

A.17 Clause 1 disapplies the statutory and equitable rules of apportionment and the first part of the rule known as the rule in *Howe v Earl of Dartmouth* for trusts created or arising after the clause comes into force.

A.18 Subsection (1) disapplies the time apportionment imposed on trustees by section 2 of the Apportionment Act 1870. The effect of section 2 is that income is deemed to accrue at a constant rate from day to day, and apportioned accordingly when the entitlement to income changes during the period before income was received by the trustees. Thus where shares are held in trust for A for life, then to B in remainder, A dies on 1 January, and a dividend is declared on 1 February on shares that last yielded a dividend on 1 December, half the dividend is payable to B and half accrues to A's estate. The effect of subsection (1) is that the whole dividend is payable to B.

A.19 A further effect of subsection (1) is that the rule known as the rule in *Re Joel* will not apply to trusts created or arising after the subsection comes into force. This rule is simply a consequence of section 2 of the Apportionment Act. The rule in *Re Joel* is that trustees are only permitted to maintain an individual member of a beneficial class out of the income which can be apportioned to a period when the member was alive and therefore eligible to receive the benefit of the income. Accordingly, where a fund is held upon trust for the children of X, and the trustees have power to maintain the children out of income to which they are not yet absolutely entitled, then, where a child is born, an apportionment calculation must be carried out to ascertain the income from which that child can be maintained. Without the rule in *Re Joel*, income as it arises is available in equal proportions for the maintenance of all the beneficiaries entitled to be maintained from it.

A.20 Subsection (2)(a) disapplies the first part of the rule known as the rule in *Howe v Earl of Dartmouth*, which imposes a trust for sale upon residuary personalty where it consists of an unauthorised investment of a wasting and hazardous nature. The effect of subsection (2)(a) is that trustees will not be under an immediate obligation to sell such an investment. Normally, of course, they would choose to do so in any event. But in some circumstances immediate sale would be unwise, and without the rule the trustees can exercise their discretion in the context of their general duty of care. Subsection (3) confirms that the trustees have power to sell where previously they had a duty to sell.

[5] Charity Commission, *Operational Guidance 83 Endowed Charities: A Total Return Approach to Investment* (available at http://www.charitycommission.gov.uk/supportingcharities/ogs/index083.asp).

A.21 Subsection (2)(b) disapplies the second part of the rule known as the rule in *Howe v Earl of Dartmouth*, which applies to all trusts for sale, express or implied, where hazardous or wasting property is held for persons in succession. Its scope is therefore wider than that of the first branch of the rule. It states that the life tenant is not to be paid the actual income that arises before sale; instead the life tenant is to receive a sum calculated by applying a specified level of interest (usually 4 per cent) to the estimated value of the property. This sum is intended to reflect a fair income from the property, leaving the excessive income actually produced by such an investment to be treated as capital. The effect of the disapplication of the rule is that the income beneficiary will be entitled to income from such investments as it arises.

A.22 Subsection (2)(c) disapplies the rule known as the rule in *Re Earl of Chesterfield's Trusts*, which complements the apportionment rule in *Howe v Earl of Dartmouth*. It ensures that the income beneficiary receives income from property that does not in fact produce any income until it falls into possession. An example would be where the trust fund includes property held in reversion, that is, property that will fall into the possession of the trust (and will start producing income for it) on the death of a life tenant. The rule provides that where such an interest is retained until it falls into possession, part of it is to be treated as arrears of income and paid to the life tenant. The amount to be treated as capital is that which, if invested at 4 per cent compound interest (and subject to deduction of income tax), would have produced the sum actually received. The difference between those two amounts is to be treated as the arrears of income. The effect of the disapplication of the rule is that such property will be treated as capital when it comes into the possession of the trustees.

A.23 Subsection (2)(d) disapplies the rule known as the rule in *Allhusen v Whittell*. Where a testator's residuary estate is left to persons in succession, the rule in *Allhusen v Whittell* apportions debts, legacies, annuities and other charges payable out of the residuary estate between the income and capital beneficiaries. The purpose of the rule is to place the beneficiaries in the same position as they would have been in had the debts been paid at the moment of the testator's death, so as to prevent the life tenant from benefiting from the portion of capital required for discharging debts. The effect of the disapplication of the rule is that such debts, legacies, annuities and other charges will only be payable out of capital.

A.24 Subsection (2)(e) disapplies the rules known as the rule in *Re Atkinson* and the rule in *Re Bird.* These rules apportion between capital and income beneficiaries the loss suffered when the trust fund includes loan stock, the borrower defaults, and the security taken on the loan is insufficient to meet the shortfall. Such loans may be either authorised or unauthorised investments, and the rules in *Re Atkinson* and in *Re Bird* apply to the two cases respectively. The effect of subsection (2)(e) is that if there is a shortfall in the interest payments due to the trust, that loss will be borne only by the income beneficiary, and that the sum received on the sale of such loan stock will be treated as capital. However, where the investment was in fact unauthorised a beneficiary who suffers loss as a result may have a remedy for breach of trust.

A.25 Subsection (4) provides that subsections (1) to (3) are subject to contrary provision in the trust instrument. The effect of this subsection is that settlors or

testators who wish to include any of the rules disapplied in subsections (1) and (2) may do so by excluding the clause or by expressly invoking the rule by name in the trust instrument.

Clause 2: Classification of certain corporate distributions as capital

A.26 Subsection (1) provides that where a trust receives a tax-exempt corporate distribution it is to be treated as a receipt of capital. Subsection (3) defines a tax-exempt corporate distribution for the purposes of subsection (1). Subsections (1) and (3)(a) change the classification of shares distributed to a trust by way of dividend in the course of a demerger. They do so by reference to the definition of an "exempt distribution" in sections 213(2) and 213A of the Income and Corporation Taxes Act 1988. The effect of those sections is that shares distributed in the course of certain direct or indirect demergers are exempt from income tax. The effect of subsections (1) and (3)(a) of the clause is that such shares are to be regarded as capital in the hands of a trustee shareholder.

A.27 So far as private trusts for interests in succession are concerned, that means that the shares will be held as capital (producing income for the future), rather than being paid out to the income beneficiary. Where the shareholders are the trustees of a charity with permanent endowment, the shares will be held as capital by the trustees and dealt with in accordance with the terms of the trust instrument.

A.28 Subsection (1) makes it clear that the change made by subsection (3)(a) applies in relation to all trusts, including trusts created or arising before the commencement of the clause. However, under subsection (2) this is subject to contrary provision in the trust instrument as to the classification of such receipts. This clause will not affect the classification of receipts received prior to its commencement.

A.29 The clause also provides for future developments. Subsection (3)(b) gives the Secretary of State a power to specify by order other distributions by corporate bodies which are to be treated as a receipt of capital by trustees; it does not allow the Secretary of State to specify that certain tax-exempt corporate distributions are to be treated as income. "Body corporate" includes all Companies Act companies and limited liability partnerships and will also cover foreign companies where they are corporate bodies, but it will not cover unincorporated associations. "Distribution" here includes a distribution of assets, whether in cash or otherwise, and whether by dividend or otherwise.

A.30 Subsections (4) and (5) limit the Secretary of State's power to make such an order. Subsection (4) provides that such an order can only be made where the distribution is not subject to income tax or capital gains tax, for example where a similar exemption from tax is extended to other corporate receipts. Subsection (5) requires the consent of HM Treasury in the making of such an order.

A.31 As with subsection (3)(a), an order under subsection (3)(b) will apply in relation to all trusts, including trusts created or arising before the commencement of the clause (subsection (1)) and is subject to contrary provision in the trust instrument (subsection (2)).

Clause 3: Power to compensate income beneficiary

A.32 Clause 3 provides trustees with a power to compensate income beneficiaries where there has been a tax-exempt distribution classified as capital by virtue of clause 2.

A.33 Subsection (1)(b) makes it clear that the power can only be exercised where the trustees are satisfied that, but for the tax-exempt distribution, the body corporate would have, for example, paid a dividend or a larger dividend.

A.34 Subsection (2) enables trustees to make a payment out of capital, or to transfer trust property (such as shares) to the income beneficiary, to the extent necessary to place the income beneficiary in the position that the trustees consider they would have been in under section (1)(b). Trustees are only expected to do this to the extent that it is practicable.

A.35 Subsection (3) defines "income beneficiary" and includes a class of income beneficiaries. It is not limited to beneficiaries who have an interest in possession.

Clause 4: Total return investment by charities

A.36 Clause 4 enables the trustees of a charitable trust with permanent endowment to adopt, by resolution, the Charity Commission's scheme for total return investment.

A.37 It does this by inserting two new sections in the Charities Act 1993. New section 75BA sets out the procedure for adopting the Charity Commission's scheme and some of the consequences of adopting it. New section 75BB allows the Charity Commission to make regulations setting out the details of its total return investment scheme, and procedural provisions regarding charity trustees' resolutions to adopt the scheme.

A.38 Section 75BA is based on sections 75 and 75A of the 1993 Act (as substituted by the Charities Act 2006). Those sections allow the trustees of a charitable trust with permanent endowment to pass a resolution freeing that endowment from restrictions. Smaller charities do not need to involve the Charity Commission in this process (see section 75); larger charities do (see section 75A).

A.39 Section 75BA(2) enables the trustees of a charitable trust with permanent endowment to pass a resolution where they are satisfied that the conditions in section 75BA(3) and (4) are met. The conditions are, first, that the total return on an available endowment fund of the charity, or a portion of such a fund, would be greater if it were invested without regard to the form of the receipts as income and capital. Secondly, that it is in the interests of the charity that the fund or portion, and any income arising therefrom, should be subject to the Charity Commission's total return investment regulations. Section 75BA(5) provides that the effect of such a resolution is to free the available endowment fund of the charity from restrictions on the expenditure of capital that would otherwise apply, while subjecting it and income arising from it to the Charity Commission's total return investment regulations (which, as mentioned below, may include restrictions on the expenditure of capital). It will not be possible for any charity to pass such a resolution until the Charity Commission has made regulations under section 75BB.

A.40 Section 75BA(1) makes it clear that such a resolution may be passed only in the case of a charity which is a trust (and not a charity which is a company or other body corporate).

A.41 Under section 75BA(6) "available endowment fund" has the same meaning in section 75BA as in section 75. Subsection (7) of section 75 defines a charity's "available endowment fund" as "(a) the whole of the charity's permanent endowment if it is all subject to the same trusts, and (b) any part of its permanent endowment which is subject to any particular trusts that are different from those to which any other part is subject". The effect of this definition is that section 75BA will apply separately to each part of a charity's permanent endowment which is subject to separate trusts. A charitable trust which has more than one available endowment fund and which wishes to operate total return investment on all of its funds will need a separate resolution for each fund.

A.42 Section 75BB(1)(a) and (2) allow the Charity Commission by regulations to make procedural provision about resolutions under section 75BA, and about the variation and revocation of such resolutions.

A.43 Section 75BB(1)(b) and (3) allow the Charity Commission to make regulations setting out the investment of the relevant fund on a total return basis, and the expenditure from such a fund. Charities will be subject to the regulations once they have adopted the scheme by a resolution under section 75BA. Section 75BB(3) contains an illustrative list of requirements and restrictions that may be included in the regulations; the list is permissive rather than mandatory and it will be for the Charity Commission to decide on the specific provisions. For example, the Charity Commission may make regulations concerning recoupment. Nothing in this clause affects the general duties of charity trustees, for example to have regard to both present and future needs of the charity.

Clause 5: Short title, commencement and extent

A.44 Subsection (4) provides that the Bill extends only to England and Wales.

Glossary

Beneficiary	A legal person (that is, an individual or a corporation) entitled to the benefit of a trust.
Capital	Trust property that constitutes a pool or fund of assets, to which a particular class of beneficiaries under the trust in question may be entitled. Capital is to be distinguished from the income earned on those assets, to which a different class of beneficiaries may be entitled. For example, A may settle £10,000 on trust to be held first for the benefit of his sister, B, during her lifetime, and then absolutely for the benefit of his son, C. In this situation, B is entitled only to the income earned on the £10,000 (for example, the interest

	earned by its investment in a bank) during her lifetime, while C will not be entitled to that income but will be entitled to the capital sum of £10,000 after B's death.
Charitable trust	A trust set up for a charitable purpose. Trustees of charitable trusts do not hold the trust property for, or on behalf of, beneficiaries but rather for the public benefit. A charitable purpose must be for the public benefit and fall within one of the descriptions of charitable purposes provided in the Charities Act 2006. Such purposes include the prevention or relief of poverty, the advancement of education, the advancement of religion and all purposes which were recognised as charitable immediately prior to the coming into force of the Charities Act 2006.
Charitable trust with permanent endowment	Defined by section 96(3) of the Charities Act 1993 as follows: A charity shall be deemed for the purposes of this Act to have a permanent endowment unless all property held for the purposes of the charity may be expended for those purposes without distinction between capital and income, and in this Act "permanent endowment" means, in relation to any charity, property held subject to a restriction on its being expended for the purposes of the charity.
Charity Commission	The non-ministerial Government department which acts as the regulator and registrar of charities, governed by Schedule 1A of the Charities Act 1993. The Commission can provide advice and guidance to charities, and has various legal powers, including the ability to investigate cases of dishonesty and fraud, as well as to transfer trust property and replace trustees.
Duty to convert	A duty to sell an investment and reinvest the proceeds or to invest cash.

Income	Assets that represent the earnings on trust property, to which a particular class of beneficiaries under the trust in question may be entitled. Income may be contrasted with capital and capital gains.
Interest in possession trust	A trust in relation to which one or more beneficiaries have an immediate entitlement to the income of the trust as it arises.
Investment receipt or investment return	Money, shares, or other property received from an investment; for example, a dividend from a shareholding, or rent from property.
Life tenant	Where property is held for A for life, with remainder to B, A is said to be the life tenant or life beneficiary.
Permanent endowment	See “charitable trust with permanent endowment”, above.
Personal estate	The property left by a deceased person, other than land (land is classified as real property). Personal property may include physical objects such as books and money, and intangible rights such as debts and patent rights.
Private trust	A trust that is not charitable, such as a will trust.
Remainderman	Where property is held for A for life, with remainder to B, B is said to be the remainderman.
Residuary estate	That part of the estate of a deceased person that is left once debts have been paid and specific legacies have been satisfied.
Settlor	A person who sets up a trust which is to take effect during his or her lifetime.
Testator	A person who makes a will.
Total return investment	The practice of investing with a view to maximising the return on the investment, without regard to the likely form (as capital or income) of investment receipts.

Trust	An arrangement for the holding and administration of property. Trustees will usually hold the legal title to the property for, or on behalf of, the beneficiaries, who are said to hold the equitable title to the property. In the case of charitable trusts, trustees may hold the legal title of the property to use it for charitable purposes that they are obliged by law to promote. A trust can be created by deed, by will, by statute, by declaration or by operation of law.
Trust for interests in succession	A trust where property is shared over time; for example, a trust of shares held for A for life with remainder to B. In such a trust A enjoys the investment returns during his or her lifetime, and then the shares pass to B.
Trust instrument	An instrument is a formal legal document that is effective in creating legal rights and liabilities. A trust instrument is a document that establishes the trust and sets out its terms.
Trustee	A person who has the legal title to trust property. A trustee can be a natural person or corporate body (or the Public Trustee) and must hold the trust property and deal with it, according to the terms of the trust, entirely for the benefit of the beneficiaries of the trust.

APPENDIX B
ADVISORY GROUP MEMBERS

Rupert Allen (Fountain Court)

John Battersby (KPMG, representing the Institute of Chartered Accountants in England and Wales)

James Dutton (representing the Charity Commission)

Murray Hallam (Withers, representing the Law Society)

The Hon Mr Justice Henderson (representing the Judges of the Chancery Division)

Simon Jennings (Rawlinson and Hunter, representing the Trust Law Committee)

Christopher McCall QC (Maitland Chambers, representing the Trust Law Committee)

Francesca Quint (Radcliffe Chambers, representing the Charity Law Association)

Nigel Reid (Linklaters)

Paul Saunders (Barclays Bank Trust Company Limited)

Jeffrey Sultoon (Ashursts)

Emma-Jane Weider (Allen and Overy, representing the Financial Markets Law Committee)

Arthur Weir (representing the City of Westminster & Holborn Law Society)

John Wood (representing the Association of Contentious Trust and Probate Specialists)

APPENDIX C
RESPONDENTS TO CONSULTATION PAPER NO 175

Association of Contentious Trust and Probate Specialists

Association of Corporate Trustees

Association of District Judges

Barclays Bank Trust Company

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British Bankers' Association

Professor Catherine Brown, University of Calgary

Charity Commission

Charles Russell, solicitors

City of Westminster and Holborn Law Society

Charity Law Association

The Hon Mr Justice Etherton

Mr Simon Gardner, University of Oxford

Mr Toby Harris

The Hon Mr Justice David Hayton

Her Majesty's Revenue and Customs

Herbert Smith, solicitors

HSBC

Mr Ed Kisby

Professor John Langbein, Yale University

Law Reform Committee of the General Council of the Bar

Mr W A Lee

The Hon Mr Justice Lloyd

London Endowed Charities Forum

Mr John Ross Martyn

Mr Christopher McCall QC

Moore & Blatch, solicitors

Mr Richard Nolan, University of Cambridge

Notaries Society

Mr Edward Nugee QC

Mr David Palfreyman

Mr Hubert Picarda QC

Richards Butler, solicitors

Mr Paul Saunders

Mr Geoffrey Shindler

Mr Tim Smith

Society of Pension Consultants

Society of Trust and Estates Practitioners UK Technical Committee

Trust Law Committee

The Rt Hon Lord Walker of Gestingthorpe

Wills and Equity Committee of the Law Society

Wrigleys, solicitors

APPENDIX D
US UNIFORM PRINCIPAL AND INCOME ACT

D.1 In the following pages we reproduce the relevant provisions from the US Uniform Principal and Income Act 1997.

D.2 We are grateful to the National Conference of Commissioners on Uniform State Laws for permission to reproduce these provisions. A full copy of the revised text of the Act, with detailed commentary, is available at http://www.law.upenn.edu/bll/archives/ulc/upaia/2008_final.pdf.

SECTION 103. FIDUCIARY DUTIES; GENERAL PRINCIPLES[1]

(a) In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:

(1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];

(2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];

(3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

(4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

(b) In exercising the power to adjust under Section 104(a) or a discretionary power of administration regarding a matter within the scope of this [Act], whether granted by the terms of a trust, a will, or this [Act], a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this [Act] is presumed to be fair and reasonable to all of the beneficiaries.

SECTION 104. TRUSTEE'S POWER TO ADJUST

(a) A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in Section 103(a), that the trustee is unable to comply with Section 103(b).

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(b) In deciding whether and to what extent to exercise the power conferred by subsection (a), a trustee shall consider all factors relevant to the trust and its beneficiaries, including the following factors to the extent they are relevant:

(1) the nature, purpose, and expected duration of the trust;

(2) the intent of the settlor;

(3) the identity and circumstances of the beneficiaries;

(4) the needs for liquidity, regularity of income, and preservation and appreciation of capital;

(5) the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;

(6) the net amount allocated to income under the other sections of this [Act] and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;

(7) whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;

(8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and

(9) the anticipated tax consequences of an adjustment.

(c) A trustee may not make an adjustment:

(1) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment;

(2) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;

(3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;

(4) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;

(5) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment;

(6) if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment;

(7) if the trustee is a beneficiary of the trust; or

(8) if the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly.

(d) If subsection (c)(5), (6), (7), or (8) applies to a trustee and there is more than one trustee, a cotrustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is not permitted by the terms of the trust.

(e) A trustee may release the entire power conferred by subsection (a) or may release only the power to adjust from income to principal or the power to adjust from principal to income if the trustee is uncertain about whether possessing or exercising the power will cause a result described in subsection (c)(1) through (6) or (c)(8) or if the trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (c). The release may be permanent or for a specified period, including a period measured by the life of an individual.

(f) Terms of a trust that limit the power of a trustee to make an adjustment between principal and income do not affect the application of this section unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power of adjustment conferred by subsection (a).

SECTION 105. JUDICIAL CONTROL OF DISCRETIONARY POWER

(a) The court may not order a fiduciary to change a decision to exercise or not to exercise a discretionary power conferred by this [Act] unless it determines that the decision was an abuse of the fiduciary's discretion. A fiduciary’s decision is not an abuse of discretion merely because the court would have exercised the power in a different manner or would not have exercised the power.

(b) The decisions to which subsection (a) applies include:

(1) a decision under Section 104(a) as to whether and to what extent an amount should be transferred from principal to income or from income to principal.

(2) a decision regarding the factors that are relevant to the trust and its beneficiaries, the extent to which the factors are relevant, and the weight, if any, to be given to those factors, in deciding whether and to what extent to exercise the discretionary power conferred by Section 104(a).

(c) If the court determines that a fiduciary has abused the fiduciary's discretion, the court may place the income and remainder beneficiaries in the positions they would have occupied if the discretion had not been abused, according to the following rules:

(1) To the extent that the abuse of discretion has resulted in no distribution to a beneficiary or in a distribution that is too small, the court shall order the fiduciary to distribute from the trust to the beneficiary an amount that the court determines will restore the beneficiary, in whole or in part, to the beneficiary's appropriate position.

(2) To the extent that the abuse of discretion has resulted in a distribution to a beneficiary which is too large, the court shall place the beneficiaries, the trust, or both, in whole or in part, in their appropriate positions by ordering the fiduciary to withhold an amount from one or more future distributions to the beneficiary who received the distribution that was too large or ordering that beneficiary to return some or all of the distribution to the trust.

(3) To the extent that the court is unable, after applying paragraphs (1) and (2), to place the beneficiaries, the trust, or both, in the positions they would have occupied if the discretion had not been abused, the court may order the fiduciary to pay an appropriate amount from its own funds to one or more of the beneficiaries or the trust or both.

(d) Upon [petition] by the fiduciary, the court having jurisdiction over a trust or estate shall determine whether a proposed exercise or nonexercise by the fiduciary of a discretionary power conferred by this [Act] will result in an abuse of the fiduciary's discretion. If the petition describes the proposed exercise or nonexercise of the power and contains sufficient information to inform the beneficiaries of the reasons for the proposal, the facts upon which the fiduciary relies, and an explanation of how the income and remainder beneficiaries will be affected by the proposed exercise or nonexercise of the power, a beneficiary who challenges the proposed exercise or nonexercise has the burden of establishing that it will result in an abuse of discretion.

SECTION 401. CHARACTER OF RECEIPTS

(a) In this section, "entity" means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or estate to which Section 402 applies, a business or activity to which Section 403 applies, or an asset-backed security to which Section 415 applies.

(b) Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.

(c) A trustee shall allocate the following receipts from an entity to principal:

(1) property other than money;

(2) money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;

(3) money received in total or partial liquidation of the entity; and

(4) money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

(d) Money is received in partial liquidation:

(1) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or

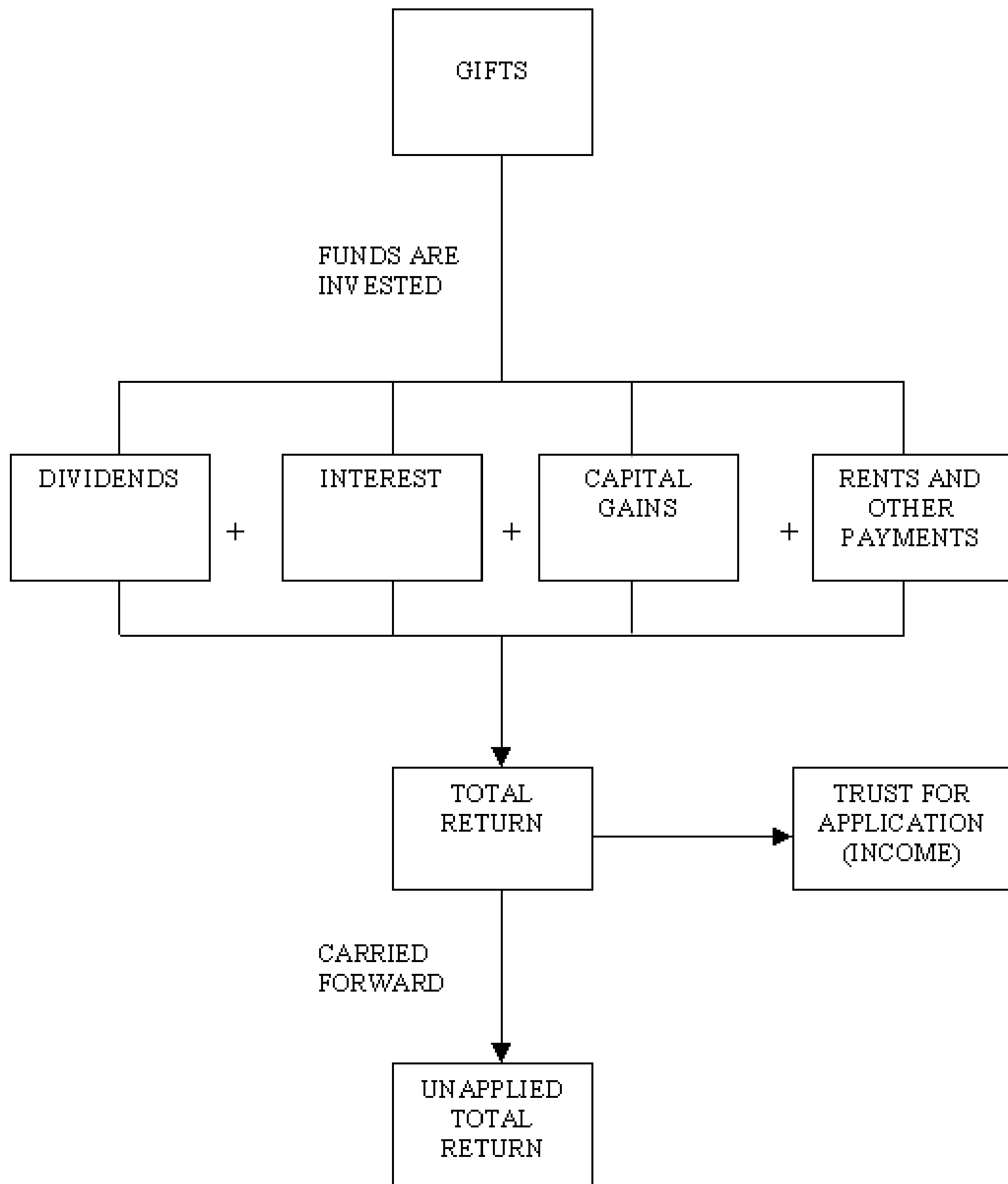
(2) if the total amount of money and property received in a distribution or series of related distributions is greater than 20 percent of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt.

(e) Money is not received in partial liquidation, nor may it be taken into account under subsection (d)(2), to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.

(f) A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

APPENDIX E
CHARITY COMMISSION TOTAL RETURN INVESTMENT SCHEME

E.1 This appendix reproduces the Charity Commission's pictorial representation of the relationship between a charitable trust's funds when operating its total return investment scheme from Operational Guidance 83 C2.



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