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CAPITAL AND INCOME IN TRUSTS: CLASSIFICATION AND APPORTIONMENT

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This consultation paper, completed on 12 July 2004, is circulated for comment and criticism only. It does not represent the final views of the Law Commission.

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THE LAW COMMISSION

CAPITAL AND INCOME IN TRUSTS: CLASSIFICATION AND APPORTIONMENT

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PART I
INTRODUCTION

THE TRUSTEE ACT 2000

1.1 The Trustee Act 2000 came into force on 1 February 2001. Based on earlier work of the Law Commission,[1] it imposed a statutory duty of care on trustees in relation to the exercise of certain powers and duties, and made important reforms to the law affecting the delegation of trusteeship and the remuneration of trustees. It was particularly significant in its repeal of the Trustee Investments Act 1961 and its conferment of wide investment powers on trustees.

1.2 The Trustee Investments Act 1961 had been the subject of serious criticism for many years.[2] It was considered unduly rigid in its demand that the trust fund be divided into two parts for investment purposes in order to regulate risk-taking, and overly restrictive in its prescription of the range of permissible investments. The Act was routinely excluded in modern trust instruments so that its application was more the exception than the rule.

1.3 The 2000 Act heralded a new approach to trustee investment, abandoning the restrictive "statutory list" of authorised investments characteristic of the 1961 Act. This approach confers on trustees a "general power of investment", which means that they are now entitled to make any kind of investment they could make if they were absolutely entitled to the assets of the trust.[3] In the exercise of this power, trustees are required to have regard to the "standard investment criteria", namely the suitability to the trust of the particular investment and the need for diversification of investments (insofar as is appropriate to the circumstances of the trust).[4] The 2000 Act embraces modern portfolio investment theory in which the main concern of the investor is to balance overall growth and overall risk.

1.4 The 2000 Act regulates investment decisions regarding the retention, as well as the conversion, of existing investments. In deciding whether to retain investments trustees are required to discharge the statutory duty of care imposed by section 1 of the Act, having regard to the standard investment criteria. [5] They must also

[1] See, in particular, Trustees' Powers and Duties (1999) Law Com No 260; Scot Law Com No 172.

[2] Trustees' Powers and Duties (1999) Law Com No 260, Scot Law Com No 172; paras 2.16 - 2.18.

[3] Trustee Act 2000, s 3. Investment in land is excluded from the scope of the general power, although trustees do have statutory power to acquire freehold or leasehold land in the UK: Trustee Act 2000, s 8. The investment power is itself subject to restriction or exclusion in the trust instrument or by any enactment or any provision of subordinate legislation: Trustee Act 2000, s 6(1)(b).

[4] Trustee Act 2000, s 4.

[5] The statutory duty of care is to "exercise such care and skill as is reasonable in the circumstances". The extent to which this and other duties of trustees should be capable of exclusion or restriction is the subject another consultation paper of the Law Commission: see Trustee Exemption Clauses (2003) Law Com No 171.

take and consider advice, unless they reasonably conclude that it is unnecessary and inappropriate to do so,[6] and discharge their duties under the general law, such as the duty of even-handedness[7] and the fiduciary duties of good faith and loyalty.[8]

THE REFERENCE TO THE LAW COMMISSION

1.5 On the passage of the Trustee Bill, now the Trustee Act 2000, through Parliament, concerns were expressed as to whether the Act would tackle the difficulties caused in the management of trust estates by the distinction which trust law draws between income and capital.

1.6 There was particular concern over the impact of the rules preventing the expenditure of the capital of permanently endowed charitable trusts. As Lord Phillips of Sudbury explained:

> Endowments are basically investments that can never be sold and the proceeds distributed to their charitable purposes; they must always be retained so that only the income arising from the endowment can be used for beneficial purposes. For most charities they have become a severe encumbrance.[9]

1.7 Under the current law the trustees of charitable trusts which have permanent endowments are ordinarily unable to convert any of that capital into income even when this would be to the advantage of the charity's objects. Permanently endowed charities are therefore reliant on income investment returns to fund their charitable activities. During debates in the House of Lords, Lord Dahrendorf suggested that there should be consideration of the possibility of trustees adopting "total return policies" in which the rigid distinction between capital and income receipts is abandoned in favour of attempting to achieve the maximum total return on investments.[10] This would allow trustees to make investment decisions for the overall economic benefit of the charity without regard to the legal form of the investment returns.

1.8 Replying to the above concerns, the Lord Chancellor acknowledged that the law of apportionment is in "some disarray" but proposed that this issue should be dealt with as a whole rather than piecemeal as an amendment to the Trustee Bill.[11] He gave an undertaking to refer the matter to the Law Commission for examination. The terms of the formal reference to the Law Commission are:

6 Trustee Act 2000, s 5.

7 See below, paras 5.19 – 5.26.

8 See, for example, *Boardman v Phipps* [1967] 2 AC 46 (HL).

9 Hansard (HL) 14 April 2000, vol 612, col 389.

10 For discussion of "total return policies" see below, paras 5.32 – 5.40 and paras 6.39 – 6.61.

11 Hansard (HL) 14 April 2000, vol 612, col 389.

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.

It can be seen from these terms of reference that the scope of the current project is by no means restricted to charitable trusts. Indeed, the majority of the issues under consideration are of primary importance to private (non-charitable) trusts.

1.9 The law affecting classification of trust receipts as income or capital and the rules of apportionment are of course inter-linked. Although the Trustee Act 2000 has now advanced the cause of portfolio investment theory, the current law as it appertains to classification and apportionment makes it impossible to realise all the potential benefits of that theory. Trustees are compelled to sacrifice larger economic returns which might have been achieved had there been no restrictions on the form which those returns could take. It is strongly arguable that this is not in the interests of beneficiaries or the economy as a whole.

PRINCIPAL ISSUES

1.10 The principal issues for consideration in this Consultation Paper can broadly be divided into three categories:

(1) The rules governing the classification of trust receipts as income or capital;

(2) The rules, both equitable and statutory, requiring conversion of the original trust property or apportionment between the capital and income accounts;

(3) The impact of these rules on charities, with particular reference to permanent endowments.

Classification of investment returns as income or capital

1.11 The significance of classification as income or capital is most clearly seen in the context of a private trust for the benefit of persons in succession. The life tenant is entitled to the income for the duration of his or her life. The beneficiary entitled in remainder, the remainderman, has no current entitlement to income, but is interested in the capital. This impacts on the trustees' duties of investment:

> 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.[12]

1.12 Usually it will be fairly obvious whether an investment return should be classified as income, payable to the life tenant (the income beneficiary), or capital, to be held for the remainderman (the capital beneficiary). If trust property is leased out, the rent received by the trustees will clearly be income. If trust money is invested in a bank account, the interest payable on the original sum will also be income. There are, however, a number of circumstances in which receipts that would instinctively be considered capital are in fact classified as income.

1.13 Particular difficulties have been identified where the courts have sought to classify trust receipts from companies by way of distribution to their shareholders. The general rule, laid down by the House of Lords in *Bouch v Sproule*,[13] and developed by the Privy Council in *Hill v Permanent Trustee Company of New South Wales*,[14] is of uncertain extent, and where it does apply can be notoriously difficult to construe. It has been criticised judicially. In an important decision concerning the classification of trust receipts following an indirect demerger, Sir Donald Nicholls VC (as he then was) stated:

> I am mindful of the need for certainty in this area of the law. I am acutely conscious of the danger of doing more harm than good by an apparent departure from established principles so as to reach a fair conclusion in a particular case. Nevertheless, in my view an application of existing principles in their full width would produce a result in this case which would, frankly, be nothing short of absurd.[15]

Rules of apportionment

1.14 In theory, rules of apportionment fairly attribute the assets and liabilities of the trust between the income and capital beneficiaries in circumstances where no proper balance would otherwise be struck. The principle behind such rules is to give effect to the duty of trustees, in the exercise of their functions, to maintain a balance, so far as it is possible, between those interested in capital and those interested in income. This important point, which is often overlooked, is central to our consideration of the subject, and will in due course form a central component in our provisional proposals.

1.15 In practice, the current law of apportionment comprises a number of rigid and technical equitable rules, most of which were judicially laid down in the eighteenth and nineteenth centuries, and which now give rise to considerable practical difficulties. They often require complex calculations to be made, yet affect very small sums of money. Consequently the rules are routinely excluded in well-

[12] *Re Whiteley* (1886) 33 Ch D 347, 350, *per* Cotton LJ.

[13] (1885) 12 App Cas 385.

[14] [1930] AC 720.

[15] *Sinclair v Lee* [1993] Ch 497, 515.

drafted trust instruments or wills; they apply more often by accident than design. It is also unsatisfactory that the rules of apportionment only apply in certain specific circumstances. There are situations in which no rule applies but where justice would require apportionment between income and capital.[16] The equitable rules of apportionment are widely acknowledged to be unsatisfactory. Reform is required to ensure that the law keeps pace with modern trust practice.

1.16 Rules of apportionment can also be found in statute. By section 2 of the Apportionment Act 1870, all "rents, annuities, dividends, and other periodical payments in the nature of the income" are deemed to accrue from day to day over the period in respect of which they are made rather than being allocated to the person who is entitled to income on the date on which they become due. The income must therefore be apportioned between those entitled to the income over that period in proportion to the duration (in days) of their respective entitlements. It should be noted that this provision is of more general application than the equitable apportionment rules. It is potentially applicable whenever there is a change in the entitlement to receive income and therefore its application is not limited to trusts.[17]

1.17 In the trusts context the operation of the Apportionment Act has been described as "inconvenient" and "unfair".[18] Where a life tenant is the spouse of a testator it is unlikely to reflect the testator's intention if, for example, dividends declared in respect of a period before death are apportioned to remainder rather than income. The operation of the Act also places an onerous obligation on trustees to make complex enquiries about the precise source of and reason for the payment. The Act can produce uncertainty; it is unclear, for example, how trustees should deal with interim dividends.[19] A strict application of the Act also leads to the complexities of the rule in *Re Joel*[20] if there is a settlement for the maintenance of a class of minors who are contingently entitled to the fund on attaining a specified age.[21] As a result of these difficulties the operation of the Apportionment Act is, much like the equitable rules of apportionment, routinely excluded in well-drafted trust instruments and wills.

Impact on charities

1.18 Issues involving apportionment arise in quite different circumstances where charities are concerned. Private trusts in succession benefit identified individuals (or classes) with distinct interests; usually a life tenant entitled to income and a

[16] Some of these circumstances are considered below (paras 3.64 – 3.74) alongside the equitable rules of apportionment.

[17] It is, for example, relevant to the calculation of an employee's accrued holiday pay on termination of employment: *Thames Water Utilities Ltd v Reynolds* [1996] IRLR 186.

[18] The Powers and Duties of Trustees (1982) 23rd Report of the Law Reform Committee, Cmnd 8733, para 3.39.

[19] Interim dividends are declared in respect of a period which has not come to an end, whereas final dividends only arise when the period has been finally concluded.

[20] [1967] Ch 14 (Goff J).

[21] The implications of the rule in *Re Joel* are considered below, paras 3.79, 3.85 – 3.87.

remainderman interested in capital. Charitable trusts on the other hand always further the same charitable purpose. The same individuals may benefit from a charitable trust now and in the future; the "beneficiary" of a charitable trust is the public at large. The main tension is therefore between supporting the current charitable purposes of the trust and ensuring that sufficient value remains in the trust to allow it to further its charitable purposes in the future. Whether a charitable trust can fulfil its purposes by expending capital and income or income alone depends on the terms of the trust. Some trusts have expendable capital endowments which can be dissipated in furtherance of the charitable purposes. Many, however, have a permanent endowment which cannot be distributed. In these circumstances the classification of returns as income or capital is of crucial importance.

LAW REFORM INITIATIVES TO DATE

1.19 The rules of apportionment have been critically examined in the 23rd Report of the Law Reform Committee,[22] the Trust Law Committee's 1999 Consultation Paper[23] and the Scottish Law Commission's Discussion Paper in 2003.[24] All three law reform bodies recommended the abolition and replacement of the rules. The rules of classification of trust receipts as income or capital have also been considered at length by the Trust Law Committee and the Scottish Law Commission, and again recommendations for reform have been made.

1.20 Following receipt of this reference by the Law Commission, there have been significant developments in relation to charity law reform. Total return investment policies have been the subject of operational guidance from the Charity Commission, and in response to a consultation process initiated by the Strategy Unit of the Cabinet Office a draft Charities Bill has been published.

SUMMARY OF OUR PROVISIONAL PROPOSALS

1.21 We consider that the case for some reform of the current law is overwhelming, and we are provisionally proposing a new approach to the classification and apportionment of income and capital in trusts. In overview we propose to:

> (1) Replace, in the absence of contrary provision in the terms of the trust, the rules for classification of corporate receipts by trustee-shareholders as income or capital with a simpler alternative based on the form of receipts. The rules of classification for other receipts and expenses will remain unaltered.
>
> (2) Make available a new power for trustees to allocate investment returns and trust expenses as income or capital insofar as is necessary to maintain a balance between income and capital ("the power of allocation").

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

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

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

(3) Abrogate all existing equitable rules of apportionment.

(4) Replace the provisions of the Apportionment Act 1870 (only insofar as they relate to trusts) with a discretion to apportion periodic payments which accrue from day to day when it is just and expedient to do so (unless contrary intention is shown in the terms of the trust).

(5) Abolish the implied trust for sale of unauthorised hazardous or wasting assets under the first branch of the rule in *Howe v Earl of Dartmouth*. Express and statutory trusts for sale would be unaffected.

(6) Clarify the mechanism by which trustees of permanently endowed charities may invest on a "total return" basis.[25]

THIS CONSULTATION PAPER

1.22 This Paper sets out the reasoning behind our provisional proposals. In **Part II** we state the current law concerning classification of trust receipts, and in **Part III** we state the current law of apportionment. In each case, we make criticisms of the existing law. In **Part IV** we briefly summarise the views and recommendations of the law reform bodies which have already considered the case for reform of the law in the United Kingdom. In **Part V** we explain the reforms which we are provisionally proposing, setting out the details of a new approach to classification and apportionment. In **Part VI** we give specific consideration to the problems facing charities.

1.23 The provisional proposals, and those issues on which we invite the views of consultees, are brought together in **Part VII** of the Paper for convenience.

HUMAN RIGHTS

1.24 We do not consider that the provisional proposals for reform described in this Paper would contravene any rights contained in the European Convention on Human Rights. We would, however, be interested to hear the views of consultees on this issue.

We would welcome the views of consultees on the human rights implications of the provisional proposals described in this Paper.

REGULATORY IMPACT

1.25 Current Government practice is to consider the impact of changes to regulatory structures on businesses, particularly small businesses, charities and other voluntary organisations by means of a regulatory impact assessment. While the Law Commission does not provide its own regulatory impact assessments, it

[25] Following the Government's recent review of charity law we consider that the question of whether charity trustees should be permitted to distribute a permanent endowment as if it were income lies outside the scope of the project. See below, paras 6.31 – 6.34.

does seek to collect information and views which may be of assistance to Government in this regard.

1.26 Any legislative regulation of the areas of law discussed in this Paper is likely to confer benefits and to impose costs on businesses, organisations and individuals. We believe that the expected benefits to beneficiaries are likely to outweigh the potential administrative costs of the new scheme. We do, however, invite the views of consultees on, in particular, the likely impact of our proposals on small trusts. We do not foresee a significant amount of litigation flowing from the introduction of our provisional proposals.[26]

We would welcome any information or views from consultees about the regulatory impact of our provisional proposals.

ACKNOWLEDGEMENTS

1.27 We would like to take this opportunity to thank the members of the Trust Law Committee, in particular Sir John Vinelott, Mr John Dilger, Professor David Hayton, Mr Michael Jacobs and Mr Geoffrey Shindler, for their assistance and advice. We are very grateful to Mrs Francesca Quint of 11 Old Square and Mr James Dutton of the Charity Commission with whom we have discussed the impact of the current law and our provisional proposals on charities. We are particularly indebted to the Honourable Mr Justice Etherton for soliciting the views of the judges of the Chancery Division, on the initiative of the Right Honourable Sir Andrew Morritt VC, on the outline of the scheme provisionally proposed in Part V of this Paper. They should not, however, necessarily be taken to agree with the provisional proposals outlined in this Paper and any errors which remain are our own.

[26] See below, paras 5.78 – 5.82.

PART II
CLASSIFICATION OF TRUST RECEIPTS AND EXPENSES

INTRODUCTION

2.1 In English trust law the classification of investment returns as income or capital is rule-based. In most circumstances, the classification is straightforward and accords with common sense. The courts often draw on the metaphor of a tree and its fruit. Property which can be characterised as the "tree" is usually treated as capital whereas the "fruit" which it produces is classified as income. In simple cases the metaphor can be useful for "getting across in graphic form the basic idea of the distinction [between income and capital]".[1] The "fruit-tree" analogy indicates that, for instance, rents received from the letting of trust property[2] and interest received on loans of trust property[3] are clearly income. It is equally clear that, for example, the return of the principal of a loan of trust property[4] should be classified as capital.

RULES GOVERNING CLASSIFICATION OF CORPORATE RECEIPTS

2.2 Much of the judicial consideration of the classification of trust receipts concerns distributions by companies to trustee shareholders. In contrast to the relatively clear cases described above, the rules governing the treatment of receipts by trustees from corporate entities are complicated and, in some cases, give rise to unfairness.

The rule in *Bouch v Sproule*

2.3 The directors of a company which makes a profit (whether a trading profit or a capital profit[5]) generally have two courses of action available to them. They may choose to distribute the profit to the company's shareholders in the form of a

1 *Inland Revenue Commissioners v John Lewis Properties Ltd* [2002] EWCA Civ 1869 [2003] Ch 513, 546, para [89], *per* Dyson LJ. Although this case concerned the classification of receipts for tax purposes the principle of the "fruit-tree" analogy remains the same. Dyson LJ noted that in more complicated cases the analogy is markedly less useful and "merely begs the question: what is tree and what is fruit?"

2 *Sinclair v Lee* [1993] Ch 497, 506*, per* Sir Donald Nicholls VC.

3 *Re Atkinson* [1904] 2 Ch 160, 165, *per* Vaughan Williams LJ.

4 *Ibid*.

5 A trading profit is the excess of a company's trading receipts over its costs. A capital profit is realised where a company sells an asset in excess of its balance sheet value. Both sorts of profit are available for distribution to shareholders; there is no distinction in company law between divisible profits of different kinds. The only important line to draw is between capital (which can only be distributed in a winding up or by way of an authorised reduction of capital) and undistributed divisible profits.

dividend. Alternatively they may elect to capitalise the profit by issuing more shares to the shareholders.[6]

2.4 In *Bouch v Sproule*,[7] the House of Lords laid down what has become the general rule for classifying receipts from companies as capital or income. The rule is that the trust classification follows company law principles. Profits which are distributed to trustee-shareholders by way of dividend are accordingly received as income. Shares allotted following capitalisation are received as capital. Lord Herschell quoted with approval the following passage from Fry LJ's judgment 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 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 of the concern, enures to the benefit of all who are interested in capital.[8]

2.5 The case concerned the bequest of a residuary estate to the testator's wife for life, with remainder to a third party absolutely. Part of the residuary estate consisted of shares in a company. For several years the company had transferred profits to reserve. After the testator's death the company issued partly paid up bonus shares to its shareholders of a value equivalent to that reserve. The question for the court was whether these shares should be treated as income or capital. The Court of Appeal and the House of Lords reached different conclusions on the facts as a result of divergent judicial interpretations of the roundabout route by which the bonus shares were distributed.

2.6 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. It was thought necessary to declare a dividend because of the rule that a company may not use its own funds to pay up its shares;[9] as shareholders have no legal right to a company's profits unless and until a dividend is declared no consideration would have passed from the shareholders to the company in respect of the issue if the shares had been issued without the prior declaration of a dividend. The Court of Appeal considered that this procedure did not disclose a clear intention to capitalise the profits. Although no rational shareholder would

6 Thus increasing the issued share capital of the company by the amount of profit capitalised.

7 (1885) 12 App Cas 385.

8 *Ibid*, 397-398.

9 The phrase "pay up" refers to the purchase of shares in a company. The purchaser of *fully* paid up shares has contributed the full nominal amount of those shares (i.e. the value of those shares as recorded in the company's Memorandum of Association). In the case of *partly* paid up shares the shareholder has contributed less than this amount and a call may be made for the sums required to fully pay up his or her shareholding.

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.

2.7 Although the application of the rule in *Bouch v Sproule* can be complicated, ordinarily much can be learnt from the form which the distribution takes. If a company distributes shares instead of cash to members it is likely that the shares will be received as capital. Conversely a distribution of profits in cash is likely to represent trust income. Of course, this is only a rule of thumb, and cannot be conclusive. Everything turns on the application of the clear legal principles to the precise facts of the case.

2.8 When a company capitalises its profits (whether they be trading or capital profits), the classification produced by the rule in *Bouch v Sproule* does at least reflect reality as far as the company is concerned. The capitalised profits remain within the company so that the sum total of the company's assets remains unchanged. As the overall number of issued shares increases so the value of each individual share decreases. In these circumstances it would be very unfair on the beneficiary interested in capital to attribute the additional allotted shares to income. It is similarly self-evident that current trading profits, distributed to shareholders as dividends, should be considered income; what the company received as income is distributed as income.

2.9 The result may be less appropriate where a company is deemed to have distributed accumulated profits to shareholders by way of dividend. The rule in *Bouch v Sproule* classifies these dividends as income in the hands of trustee-shareholders. This is the case even though the capital value of the company has fallen as a result of the distribution, to the detriment of beneficiaries with an interest in the trust capital. Where a trustee has purchased shares in the company after the profit has arisen, but before it is distributed, the value of the reserves is likely to have been reflected in the price paid. It can then be contended that any subsequent income distribution may unfairly favour the income beneficiary over the remainderman.

2.10 On occasion, the accumulated trading profits may represent a large proportion of the value of a company. The distribution of these profits has a potentially significant impact on the share price and can thereby drastically reduce the value of the trust's capital holding. Treating such distributions as income, payable to the income beneficiary, can operate to the serious disadvantage of those beneficiaries entitled to capital.

2.11 Where the distribution is of capital profits, rigid application of *Bouch v Sproule* has the potential to cause even greater unfairness. This difficulty is illustrated neatly by *Re Sechiari*,[10] which is one of several cases concerning the nationalisation of the interests of Thomas Tilling & Co Ltd ("Tilling Ltd"). A testatrix had bequeathed shares in Tilling Ltd to her children for life, with remainder to her children's issue. Under the Transport Act 1947, Tilling Ltd was obliged to sell its

[10] [1950] 1 All ER 417 (Romer J).

road transport interests to the British Transport Commission in return for British Transport stock. The company distributed this stock among its shareholders as a capital profits dividend. Each shareholder received £5 of British Transport stock for each £1 of ordinary stock they held in Tilling Ltd. As a result of this distribution the value of shares in Tilling Ltd fell from £6 4s to £1 8s. Although the value of the trust capital fell by over 75 per cent the distribution was held to be income.

2.12 In *Re Bates,*[11] a testator bequeathed shares in a company which owned and operated steam trawlers to his wife for life with remainder to a third party. The company sold some of its vessels for sums in excess of their balance sheet values thereby realising a capital profit. After the testator's death the company's directors resolved to distribute these profits to shareholders as cash dividends and sent a circular to shareholders explaining that the payments were made out of capital and were not in the nature of a dividend or bonus upon the shares.[12]

2.13 Eve J held that on the facts the capital profits had not been capitalised and so remained distributable. Applying the rule in *Bouch v Sproule*, any payment made to shareholders from that profit was, for trust purposes, income notwithstanding that the profits themselves were of a capital (rather than trading) nature.

2.14 Companies' statements that distributions are not to be treated as dividends are therefore irrelevant to their proper classification. The court looks to the intention of the company as manifested by its actions (i.e. resolutions) rather than its words. As Lord Russell of Killowen said[13] in *Hill v Permanent Trustee Company of New South Wales Ltd*,[14] "the essence of the case" was what the company showed "not by its statements, but by its acts".[15]

2.15 In the *Hill* case[16] a corporate trustee held shares in a pastoral company. The pastoral company sold almost all of its land, livestock and other assets, and ceased to carry on business. Subsequently the company declared a dividend of these capital profits and stated that "the dividend is being paid out of profits arising from the sale of breeding stock, being assets of the company not required for resale at a profit, and that is free of income tax". Perhaps influenced by the fact that distribution had taken place immediately prior to liquidation,[17] the Supreme Court of New South Wales held that the dividend should be treated as capital of the trust.

[11] [1928] Ch 682 (Eve J).

[12] The company's express intention in making this statement was to protect the shareholders from liability for income tax.

[13] Referring to the decision of the House of Lords in *Bouch v Sproule*.

[14] [1930] AC 720 (PC).

[15] *Ibid*, 732.

[16] Although *Hill* is a decision of the Privy Council it is now viewed as the leading case on the classification for trust purposes of receipts from corporate entities. It was applied by the Court of Appeal in *Re Doughty* [1947] Ch 263.

[17] If the distribution had taken place on liquidation then it would have constituted capital: see now Companies Act 1985, s 263(2)(d) and *Sinclair v Lee* [1993] Ch 497, 507, *per* Sir Donald Nicholls VC.

2.16 On appeal the Privy Council reversed this decision and held that the dividend should be treated as income of the trust estate. Lord Russell set out five principles as a fundamental restatement of the rules governing the classification of corporate receipts:

> (1) A limited company when it parts with money available for distribution among its shareholders is not concerned with the fate of those moneys in the hands of any shareholder. The company does not know and does not care whether a shareholder is a trustee of his shares or not. It is of no concern to a company which is parting with money to a shareholder whether that shareholder (if he is a trustee) will hold them as a trustee for A absolutely or as trustee for A for life only.
>
> (2) 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.
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> (3) Moneys so paid to a shareholder will (if he be a trustee) 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 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.
>
> (4) 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.
>
> (5) The result of such a dealing is obviously wholly different from the result of paying away the profits to 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.[18]

2.17 Since Lord Russell found the rationale for the default rule in company law principles it is unsurprising that he reached the conclusion that capital profits should be treated in the same way as trading profits.[19]

Exceptions to the rule in *Bouch v Sproule*

2.18 The following circumstances have been judicially recognised as exceptions to the normal application of the rule in *Bouch v Sproule*:

(1) A distribution will be treated as capital 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.[20]

(2) When a distribution is made after the testator's death but relates to a transaction completed before the testator's death, income must be treated as accruing before death.[21] Accordingly the distribution of a dividend relating to a period which ended before the testator's death should be treated as trust capital.

(3) Where a company purports to accumulate profits as capital although it has no power to increase its capital, such profits when distributed by way of dividend are received by trustee-shareholders as capital.[22]

Applying and extending the rule in *Bouch v Sproule*

2.19 The general rule has been affirmed and applied on numerous subsequent occasions in circumstances falling outside the facts of *Bouch v Sproule*. It is not limited to money or shares, and may apply to distributions of any assets.[23] Particular difficulties of construction have been experienced in relation to debenture stock which is, by definition, subject to redemption on repayment of the debt at some time in the future. If the period during which redemption is postponed is short the capitalisation transaction begins to resemble the distribution of income. Despite this, the current state of the authorities is to the

[18] [1930] AC 720, 730–732.

[19] The rule in *Bouch v Sproule* has been applied to capital profits dividends on several other occasions: *Re Doughty* [1947] Ch 263 (CA); *Re Harrison's Will Trusts* [1949] Ch 678 (Roxburgh J); *Re Sechiari* [1950] 1 All ER 417 (Romer J); *Re Kleinwort's Settlements* [1951] Ch 860 (Vaisey J).

[20] *Re Maclaren's Settlement Trusts* [1951] 2 All ER 414 (Harman J).

[21] *Re Winder's Will Trust* [1951] Ch 916 (Romer J). The same principle applies *mutatis mutandis* to *inter vivos* trusts.

[22] *Irving v Houston* (1803) 4 Paton Sc App 521 (HL), distinguished in *Bouch v Sproule* on the basis that the company in the earlier case (the Bank of Scotland) had no power to increase its capital.

[23] *Re Outen's Will Trusts* [1963] Ch 291, 314, *per* Plowman J.

effect that issued debenture stock is treated as capital,[24] even if it has already been redeemed.[25] The rule has also been extended to cover unsecured loan stock.[26]

2.20 A company's share premium account consists of the amount by which its issued shares are paid up in excess of their value. In *Re Duff's Settlements*,[27] the Court of Appeal held that any distribution made from a company's share premium account will constitute capital in the hands of shareholders. The court held that such a distribution is tantamount to an authorised reduction of capital.[28]

Emergence of a judicial discretion to apportion

2.21 As we have noted above,[29] in *Re Sechiari* a distribution of shares was deemed to be income even though it caused a dramatic fall in the value of the trust capital. Romer J stated that the order of the court was "without prejudice to any question whether, in the circumstances, in the administration of the trust, the court has, or would exercise, any jurisdiction to apportion the dividend on equitable principles between income and capital."[30]

2.22 In *Re Kleinwort's Settlements*[31] (the facts of which were for all material purposes identical to those of *Re Sechiari*) the question arose whether the court had a jurisdiction to apportion the dividend between income and capital. Vaisey J held that while there was no general rule requiring apportionment of distributed profits for the benefit of capital, the court may, in "suitable special circumstances", have jurisdiction to order apportionment.[32] This jurisdiction was however limited to cases where there had been a breach of trust. If, for example, a trustee had acquired the shares on the initiative of the life tenant, or with the object of benefiting the life tenant, apportionment to capital might be appropriate.

2.23 *Re Maclaren's Settlement Trusts*[33] appears to support to a broader interpretation of "special circumstances":

> The jurisdiction [to apportion], however, exercised in special circumstances seems to be only the exercise of a right to make a more exact distinction of income from capital. As a matter of

[24] *Commissioners of Inland Revenue v Fisher's Executors* [1926] AC 395 (HL).

[25] *Commissioner of Income-Tax, Bengal v Mercantile Bank of India Ltd* [1936] AC 478 (PC).

[26] *Re Outen's Will Trusts* [1963] Ch 291 (Plowman J). The probability of redemption of the stock was held to be irrelevant provided that capitalisation had taken place.

[27] [1951] Ch 923 (CA).

[28] *Ibid*, 929, *per* Jenkins LJ.

[29] See above, para 2.11.

[30] *Ibid*, 419.

[31] [1951] Ch 860 (Vaisey J).

[32] *Ibid*, 863.

[33] [1951] 2 All ER 414 (Harman J). This was another case in the litigation arising out of the nationalisation of Tilling Ltd.

> convenience, the practice is in the ordinary case that no apportionments are made, with the result that capital sometimes gets what, on a more exact scrutiny, would prove to be income and vice versa. Where this produces a glaring error, the court will cause a more exact calculation to be made but it does not treat as income that which is capital, or as capital that which is income.[34]

2.24 The requirement of a breach of trust to constitute "special circumstances" was re-affirmed by *Re Rudd's Will Trusts*.[35] As in *Re Sechiari*, trustees held shares in Tilling Ltd. Despite an announcement by Tilling Ltd that they had sold off significant parts of their business the trustees failed to consider whether they should sell any part of the trust's shareholding cum dividend.[36] It was found that the trustees had not even contemplated that the British Transport Stock might be distributable as income. The capital beneficiaries contended that this constituted a breach of trust and, as a result, that there should be an apportionment between the capital and income of the trust. Upjohn J accepted that the jurisdiction of the court to apportion dividends between capital and income was limited to cases of breach of trust.[37] It was, however, insufficient that the trustees ought to have considered a sale or that they had misunderstood the legal implications of the company's announcement. "Special circumstances" did not exist because it had not been established that the trustees ought to have sold the stock (or part of it) cum dividend.[38]

Problem situations

Demergers

2.25 A demerger involves the transfer by a company ("Company A") of part of its business to a new company ("Company B"). The shareholders of Company A receive shares in Company B. The mechanism of demerger can take two forms:

(1) Direct demerger

(2) Indirect demerger

2.26 In each case the original company transfers the appropriate parts of its business to a new subsidiary company (wholly owned by it at the time of the transfer) and then declares a dividend to its shareholders. The difference between the two types of demerger lies in the way that the dividend is satisfied.

[34] [1951] 2 All ER 414, 420, *per* Harman J.

[35] [1952] 1 All ER 254 (Upjohn J).

[36] "Sale cum dividend" means a sale before an expected dividend has been declared. The price of shares sold at this time is generally higher to reflect the value of the contemplated dividend.

[37] Following *Re Kleinwort's Settlement Trusts* [1951] Ch 860 (Vaisey J).

[38] [1952] 1 All ER 254, 260*, per* Upjohn J.

DIRECT DEMERGERS

2.27 In a direct demerger the dividend is satisfied by Company A issuing to its shareholders the entire share capital of Company B. It is well settled that these shares are received by shareholders as income.[39] This rule applies notwithstanding the fact that a demerger inevitably results in a fall in the value of the trust's shares in Company A. The operation of the rule in *Bouch v Sproule* therefore adversely affects the capital beneficiary.

INDIRECT DEMERGERS

2.28 An indirect demerger includes a further step absent from a direct demerger; at the same time as declaring a dividend, Company A transfers all its shares in Company B to another (wholly separate) holding company ("Company C"). In consideration for this transfer of shares Company C satisfies Company A's dividend by issuing its own shares to the shareholders of Company A.

2.29 The classification of shares received by shareholders as a result of an indirect demerger was the subject of litigation in *Sinclair v Lee*.[40] In that case a testatrix bequeathed shares in ICI plc ("ICI") to her husband for life with the remainder to her son. After her death, ICI resolved to demerge its bioscience activities. In preparation it consolidated its bioscience activities into a wholly owned subsidiary company. ICI proposed to transfer the shares of this subsidiary company to a newly created holding company called Zeneca Group plc ("Zeneca"). Zeneca was then to issue its own paid up shares to ICI shareholders.

2.30 Understandably the "instinctive reaction" of Sir Donald Nicholls VC, as he then was, when asked to consider the nature of the Zeneca shares in the hands of the trustees, was that the shares were received as trust capital. This result would accord with the economic realities of the situation, as 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.[41]

2.31 Sir Donald Nicholls VC conceded that the line of cases developing the rule in *Bouch v Sproule* ran directly against his instincts.[42] These authorities suggested

[39] *Re Sechiari* [1950] 1 All ER 417 (Romer J).

[40] [1993] Ch 497 (Sir Donald Nicholls VC).

[41] *Ibid*, 504.

[42] *Ibid*, 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).

that the Zeneca shares should be treated as income but none of them dealt with the precise situation of an indirect demerger. The Vice-Chancellor therefore felt able to distinguish *Bouch v Sproule* and held that the Zeneca shares would be received by the trustee-shareholders as capital.

2.32 There seems no principled ground for drawing a distinction between direct demergers and indirect demergers for the application of the rule in *Bouch v Sproule*, especially in the light of the wide interpretation which has been given to the rule.[43] The formalistic distinction was adopted by the Vice-Chancellor solely in order to avoid what his Lordship considered to be an "absurd" result. The clear inference from this is that the wide application of the rule in *Bouch v Sproule* continues to give rise to unfortunate consequences in other cases.

Scrip dividends

2.33 Scrip dividends are dividends which offer shareholders the choice of being paid in the form of cash or shares. When a company declares a conventional scrip dividend each shareholder has the option to take the dividend in cash or in additional shares of equal value. Such dividends will almost always be treated as income in the hands of the shareholder whichever option is chosen.[44]

2.34 The situation is more complicated when the company declares an "enhanced" scrip dividend. Enhanced scrip dividends give shareholders the option of taking the distribution either in cash or in additional shares of greater value than the cash alternative. If (unusually) the shareholder opts for cash the receipt will clearly be income under the rule in *Bouch v Sproule*. The position is more difficult if the shareholder takes the option of receiving shares. 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.

2.35 However, on occasion, the courts have retreated from the strict dichotomy of the general rule and ordered an apportionment of receipts from scrip dividends between income and capital. In *Re Malam*[45] a testator bequeathed shares on trust for his widow for life and for a third party thereafter. After the testator's death, the company resolved to increase its capital by the issue of new shares. The directors were empowered to offer new shares to existing shareholders in satisfaction of a dividend. The company declared a dividend. The company would have been able to meet its obligations to shareholders in cash. In respect of half the declared dividend shareholders were offered the option of shares or cash. The trustees accepted the allotment of shares.

2.36 It was held by Stirling J that the company intended to distribute its accumulated profits as a dividend and not to capitalise them. Prima facie the rule in *Bouch v*

[43] See above, paras 2.19 – 2.20.

[44] The dividend will be classified in accordance with the general rule in *Bouch v Sproule*.

[45] [1894] 3 Ch 578 (Stirling J).

Sproule would demand that such receipts be treated as income. However following the distribution there had been a sharp fall in the value of the shares as a result of the distribution of the accumulated profits. The court decided that in these circumstances the tenant for life should only be entitled to a lien in respect of the amount of cash dividend foregone. The balance was attributable to capital. Stirling J proceeded on the basis that the shares had been bought partly by the cash dividend foregone and partly by the fall in the value of the original shares.

2.37 The classification of scrip dividends is therefore uncertain. It is unclear whether the solution adopted by Stirling J will always be correct or whether it is limited to the precise facts of that case. The *Re Malam* decision also raises the issue of how tax will be levied in such circumstances, although the Inland Revenue have stated that they will accept all reasonable decisions by trustees.[46] Identifying the intention of the company is not always easy since there are competing considerations. Shareholders can usually be expected to opt for the share option in an enhanced scrip situation. This suggests that the company intended to capitalise.[47] In the past, however, enhanced scrip dividends have been declared in order to avoid the payment of advance corporation tax on cash dividends.[48] This would point towards a distribution of income.

Criticisms of the current law

Perceived illogicality of rule in Bouch v Sproule

2.38 The operation of the rule in *Bouch v Sproule* appears to be illogical and capricious in many ways. Take, for example, the case of a company which declares a dividend and distributes its profits. These profits will be received by shareholders as income and, if a shareholder is a trustee, will be paid to the life tenant. If the company offers to issue new shares the life tenant could elect to apply the income received to purchase some of those shares in which case the life tenant will own them absolutely. Contrast this with the position if the company had declared a dividend and simultaneously resolved to capitalise its profits. The issued shares would be received as capital and the life tenant would have no right to them.

2.39 It should be borne in mind, however, that the convoluted process of declaring a dividend coupled with the issue of paid-up shares is, in corporate law, necessary. A company cannot purchase its own shares or issue shares by way of gift and a shareholder has no legal right to the company's assets until a dividend is

[46] Statement of Practice 4/94, para 6.

[47] On the basis that the terms of the offer make it so unrealistic that any shareholder would take the cash option, this option is in fact illusory. This was the view that the House of Lords took in *Bouch v Sproule* (although technically that distribution did not take the form of an enhanced scrip dividend since only partly paid-up shares were available).

[48] Advance corporation tax has now been abolished but it was stated in "Capital and Income of Trusts" (1999) Trust Law Committee Consultation Paper, para 2.3 that this change "will not make the position any clearer. It and other tax changes may well breed new ways of making distributions to shareholders that will throw up new questions about whether they are capital or income of a trust, to which the existing principles will not prove strong or clear enough to give any certain answers."

declared. Unless a dividend is declared prior to paying up and issuing new share capital no valuable consideration would be transferred from the shareholders to the company. The rule in *Bouch v Sproule* does at least, therefore, have regard to the substance of what the directors are trying to achieve by their actions and in that sense is not illogical.

Questionable relevance of company law principles

2.40 The principles of company law are of doubtful relevance when it comes to determining whether receipts should be classified as income or capital for trust purposes. As Lord Russell noted in the *Hill* case,[49] the fact that a shareholder holds shares for him- or herself or as a trustee is immaterial to the company. No notice of a trust of shares can be entered on the register of companies and so the destination of the distribution is determined by the actions of the company directors who do not know (and do not consider) whether a shareholder is a trustee. It is of no consequence to the company whether the corporate profits are treated as trust income or trust capital. It is therefore not readily apparent why the legal principles which have been developed to regulate companies should be applied without modification to trusts.[50]

2.41 Specifically, the rule in *Bouch v Sproule* conflates the concepts of share capital and trust capital.[51] 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. Where trust property consists of shares the capital value of the fund will be the combined market value of all the shares which are held. The value of those shares is in turn influenced by the total worth of the underlying companies. The total value of a company is not limited to the nominal value of the issued share capital. A company will often accumulate profits which are capable of distribution to use as "working capital". If these accumulated profits are distributed as a dividend the share price of the company is likely to fall significantly with the result that the capital value of the trust fund will be diminished. Under the rule in *Bouch v Sproule* the distribution will nevertheless be treated as income.

2.42 Sir Donald Nicholls VC commented in *Sinclair v Lee*:

> It is unsatisfactory to treat all accumulated profits as earmarked as income to the extent that any distribution of such profits, regardless of the amount or the circumstances, will belong to the tenant for life

[49] [1930] AC 720 (PC).

[50] Lord Russell dismissed this concern summarily on the grounds that a testator or settlor could displace the default rule by careful drafting of the trust instrument to display a contrary intention. In the absence of such an intention the testator or settlor is presumed to have intended corporate receipts to be treated in accordance with the general rule (see, for example, the discussion in *Sinclair v Lee* [1993] Ch 497, 514, *per* Sir Donald Nicholls VC).

[51] *Sinclair v Lee* [1993] Ch 497, 511, *per* Sir Donald Nicholls VC.

> if made outside a winding up. Such a distribution may represent a serious erosion of the trust capital.[52]

2.43 Similarly no distinction is drawn in company law (except for the purposes of taxation) between the distribution of current trading profits and capital profits. This is not surprising because both types of profit are available for distribution to shareholders by way of dividend. This distinction between trading profits and capital profits is, however, hugely relevant to trustees and beneficiaries. It seems appropriate to consider dividends of current trading profits to be income. This is not the case with capital profits; as these represent profits on the realisation of the company's capital assets they are more naturally considered capital.

2.44 The application of company law principles therefore fails to hold a fair balance between the life tenant and remainderman. The courts nevertheless consider themselves to have no jurisdiction to order apportionment to remedy this imbalance except in the "special circumstances" of a breach of trust.[53]

Complexity and uncertainty in application to novel rearrangements of capital

2.45 Whether or not they operate fairly, the legal principles on which the rule in *Bouch v Sproule* is based are at least relatively clear. However, the application of the rule in *Bouch v Sproule* to particular novel factual situations becomes far less certain as corporate law develops new ways of rearranging capital in order to obtain commercial or tax advantages.[54]

2.46 As a result of this uncertainty, trustees may be forced to apply to the court for directions as to the proper classification of corporate receipts in new situations.[55] The expense of such an application, which may be considerable, will usually be borne by the trust fund to the detriment of all beneficiaries. Alternatively, trustees may seek to avoid such difficulties by selling their shareholding before the rearrangement of capital takes place. The upshot of this is that trustees may sell a potentially lucrative investment in order to maintain a fair balance between the life tenant and the remainderman.

Ignorance or disregard of the rule

2.47 Although it is not practical to measure compliance, it is questionable how often in practice trustees allocate corporate receipts in accordance with the strict rules in *Bouch v Sproule*. It seems likely that in many cases trustees (especially those

[52] [1993] Ch 497, 508, *per* Sir Donald Nicholls VC.

[53] See above, paras 2.21 – 2.24.

[54] The decision in *Sinclair v Lee* was based on a narrow ground of distinction with previously decided cases. It is difficult to say whether this distinction will be available for new kinds of capital rearrangement. It is also unclear whether the courts will be prepared to follow the lead of Sir Donald Nicholls VC (as he then was) to destabilise the rule in *Bouch v Sproule* more generally.

[55] As in *Sinclair v Lee*.

who are not legally advised) will, as a matter of practice, allocate in accordance with common sense rather than the technical analysis set out in this Part.

RULES GOVERNING CLASSIFICATION OF NON-CORPORATE RECEIPTS

Rules relating to timber, minerals and copyright

2.48 The Scottish Law Commission, in its Discussion Paper on the Apportionment of Trust Receipts and Outgoings,[56] considered the special rules which apply to investment returns from timber, minerals and intellectual property rights (including copyright).[57] The general Scots law rule on timber is that it belongs to the remainderman. The life tenant is, however, entitled to take timber to meet the needs of the estate and its buildings or to take "ordinary windfalls and normal coppicing".[58] The extent to which this exception to the general rule applies in English law is unclear.

2.49 The general rules on minerals were laid down by the House of Lords (on appeal from Scotland) in *Campbell v Wardlaw*.[59] The starting point for their Lordships was that all returns from minerals should be classified as capital. Minerals are not in the nature of "fruit" because once they have been taken away from the land they are never replaced. The life tenant is, however, entitled to use minerals obtained from trust property for his own needs and those of the trust estate. The life tenant is also entitled to royalties from minerals extracted from mines which were opened before the commencement of the trust (but not those opened after the commencement of the trust). The House of Lords expressly stated that Scots law was the same as the law of England and Wales on this point.[60] Similar principles are applied in Scotland to intellectual property rights, based on the date on which the work to which the property right relates was published.[61]

2.50 Whilst the application of these rules is not entirely straightforward, the difficulties are of lesser significance than those relating to the classification of receipts from corporate entities. Trust funds today are much more likely to be invested in share portfolios than in forests or mines.

RULES GOVERNING CLASSIFICATION OF TRUST EXPENSES

2.51 Where a trustee holds property on trust for persons in succession it is important to determine which expenses should be met by trust income and which expenses should be charged to trust capital. The House of Lords considered the apportionment of expenses incurred in the administration of trusts in *Carver v*

[56] (2003) Scot Law Com Discussion Paper No 124.

[57] *Ibid*, paras 2.8 – 2.10.

[58] *Ibid*, para 2.9.

[59] (1883) 8 App Cas 641.

[60] *Ibid*, 644, *per* Lord Blackburn LC.

[61] *Simpson (Davidson's Trustees) v Ogilvie* (1910) 1 SLT 45 (Second Division). It is unclear whether this states the law in England and Wales as well but, as it applies the principle in *Campbell v Wardlaw* by analogy, it seems likely that it does.

Duncan.[62] Although that case primarily concerned the construction of section 16 of the Finance Act 1973,[63] Lord Templeman considered the general law governing the apportionment of the costs of trust administration:

> 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 incumbrances. Capital must bear all costs, charges and expenses incurred for the benefit of the whole estate.[64]

2.52 On the facts of *Carver v Duncan*, Lord Templeman held that the annual premiums on insurance policies to protect the value of the trust fund were a capital expense.[65] His Lordship also held that the annual fees of investment advisers, although they were recurrent charges, were not "ordinary outgoings" and were "incurred for the benefit of the estate as a whole". Accordingly they should also be deemed a capital expense.

2.53 This last example illustrates the difficulties in applying what seems, in principle, to be a sensible rule. In *Re Bennett*, Lindley LJ said: "by an 'outgoing' [i.e. an ordinary expense chargeable to income] is generally meant some payment which must be made in order to secure the income of the property."[66] Many fees charged by trustees or their advisers will not meet this requirement, although they have "an income character in so far as [they] may be connected with an income benefit."[67] Moreover, when a trust corporation charges an annual fee which is calculated by reference to the level of trust income it should be treated as an income expense, at least in cases where a separate capital charge is made on acceptance and/or withdrawal.[68] Where there is no separate capital fee against which the annual fee can be contrasted the situation is less clear. The irresistible conclusion is that the annual fee reflects work done on behalf of both income and capital. Since the work is for the benefit of the whole estate, the fee should be charged to capital. There is, however, no authority on this question.

2.54 The majority of the House of Lords in *Carver v Duncan* (Lord Diplock dissenting) considered that the express provisions of the trust instrument regarding the

[62] [1985] AC 1082.

[63] Since repealed by the Income and Corporation Taxes Act ("ICTA") 1988, s 844(4) and Schedule 31 and replaced by s 686 of that Act.

[64] [1985] AC 1082, 1120.

[65] *Ibid*, following *Macdonald v Irvine* (1878) 8 Ch D 101 (CA) and *Re Sherry* [1913] 2 Ch 508 (Warrington J).

[66] [1896] 1 Ch 778; approved by Lord Templeman in *Carver v Duncan* [1985] AC 1082, 1121.

[67] Capital and Income of Trusts (1999) Trust Law Committee Consultation Paper, para 4.1.

[68] *Re Hulton* [1936] Ch 536 (Clauson J); *Re Roberts' Will Trusts* [1937] Ch 274 (Crossman J); *Re Godwin* [1938] Ch 341 (Farwell J).

apportionment of expenses were irrelevant to the question of whether certain expenses were "properly chargeable" to income under the statute in question.[69] It is clear, however, that as a matter of general law the settlor may displace the default rule by authorising or directing the trustees to meet certain expenses, otherwise chargeable to income, out of capital or vice versa.

[69] *Carver v Duncan* [1985] AC 1082, 1121, *per* Lord Templeman.

PART III
EQUITABLE AND STATUTORY RULES OF APPORTIONMENT

INTRODUCTION

3.1 The rules of apportionment are to be found partly in case law and partly in statute. The case law dates largely from the nineteenth century and consists of judge-made rules dictating the extent to which trustees of a fixed trust were able to maintain a balance between the interests of income and capital beneficiaries in circumstances where no balance would otherwise be struck. The statute is the Apportionment Act of 1870. In this Part, we outline the scope of these equitable and statutory rules and set out criticisms of their operation.

RULES GOVERNING THE APPORTIONMENT OF TRUST RECEIPTS PENDING CONVERSION OF ORIGINAL TRUST ASSETS

3.2 Whenever there is a trust for sale[1] for the benefit of persons in succession it is inevitable that some investments will favour the life tenant and others will favour the remainderman. Equity has consequently developed technical rules which seek to restore a balance between those interested in trust capital and those interested in trust income. For example, the second branch of the rule in *Howe v Earl of Dartmouth*[2] was originally conceived to ensure that life tenants do not receive too much income at the expense of remaindermen pending conversion of property subject to a trust for sale. The rule in *Re Earl of Chesterfield's Trusts*[3] is a special application of the second branch of the rule in *Howe v Earl of Dartmouth*. It applies where property in remainder not currently yielding income is held on a trust for sale with a power to postpone conversion. Its purpose is to tip the balance away from the remainderman back towards the life tenant.

Trusts for sale

3.3 A trust for sale exists when a trustee is under an obligation to convert (i.e. sell) trust property. A trust for sale may require immediate conversion of the trust property or alternatively may provide the trustee with a power to postpone sale. A trust for sale may be created expressly by settlors (or testators), by statute or by implication under the first branch of the rule in *Howe v Earl of Dartmouth*.

Express trusts for sale

3.4 No precise form of words is necessary to establish an express trust for sale. It is only necessary for the settlor (or testator) to make clear that he requires the trust property to be converted and re-invested.[4]

1 Whether the trust for sale is express, statutory or implied. See below, paras 3.3 – 3.8, for discussion of the circumstances in which a trust for sale will arise.

2 (1802) 7 Ves Jr 137 (Lord Eldon LC).

3 (1883) 24 Ch D 643 (Chitty J).

4 *Gibson v Bott* (1802) 7 Ves Jun 89 (Lord Eldon LC); *Dimes v Scott* (1828) 4 Russ 195 (Lord Lyndhurst LC).

Statutory trusts for sale

3.5 Section 33(1) of the Administration of Estates Act 1925 imposes a trust for sale upon the real or personal estate of a person who dies intestate.[5]

The first branch of the rule in Howe v Earl of Dartmouth

3.6 The first branch of the rule in *Howe v Earl of Dartmouth* states that where residuary personal estate is held on trust for persons in succession, the executors are obliged to convert all unauthorised investments of a wasting or hazardous nature and to invest the proceeds in authorised investments. If the investments are authorised the rule in *Howe v Earl of Dartmouth* is inapplicable even if they are wasting or hazardous.[6] The basis of this rule is the presumed intention of the testator that the residuary beneficiaries should, broadly, "enjoy the same thing".[7] Wasting or hazardous investments have the potential to prejudice the capital beneficiary over time through a dramatic diminution in value. Conversely the income beneficiary is liable to receive an augmented level of return.

3.7 The first branch of the rule in *Howe v Earl of Dartmouth* does not apply to specific (as opposed to residuary) bequests (including *inter vivos* settlements by deed)[8] or realty.[9] There is clearly no need for its application where there is an express or statutory trust for sale. It will also be displaced if it is shown that the testator intended that there should not be a trust for sale.[10] For example, an intention that the life tenant should enjoy the actual income of the residuary estate is necessarily inconsistent with the imposition of a duty to convert the residuary estate and re-invest the proceeds of sale in authorised investments. A power to postpone sale will likewise prevent a trust for sale arising under the rule.[11]

3.8 As we have explained in Part I above,[12] the Trustee Act 2000 has given trustees a general power to invest as if absolutely beneficially entitled to the assets of the trust and so has vastly extended the range of authorised trust investments. The effect of this statutory expansion of investment powers has been significantly to restrict the circumstances in which the first branch of the rule in *Howe v Earl of*

[5] This has been interpreted as conferring on trustees a power of sale subject to a power to postpone conversion: *Re Fisher* [1943] Ch 377 (Bennett J).

[6] *Re Gough* [1957] Ch 323 (Vaisey J).

[7] *Re Van Straubenzee* [1901] 2 Ch 779, 782, *per* Cozens-Hardy J.

[8] *Re Van Straubenzee* [1901] 2 Ch 779.

[9] It appears that the original rationale for the distinction between personal and real property was that "every devise of land, whether in particular or general terms, must of necessity be specific from this circumstance": *Howe v Earl of Dartmouth* (1802) 7 Ves Jun 137, 148, *per* Lord Eldon LC. Since 1837, however, land has been permitted to form part of the residuary estate (Wills Act 1837, ss 3, 24).

[10] This intention may be express or implied. The cases in this area have tended to conflate the issues of excluding an implied trust for sale and excluding the equitable apportionment rules: see below, paras 3.25 – 3.28.

[11] *Re Bates* [1907] 1 Ch 22 (Kekewich J).

[12] See above, paras 1.1 to 1.4.

Dartmouth is engaged.[13] There is little doubt in our view that a new approach is now required in order to cater for the new trust investment regime introduced by the Trustee Act 2000.

3.9 The difficulties with the first branch of the rule in *Howe v Earl of Dartmouth* are brought into focus by the Canadian case of *Re Smith*.[14] In that case a settlor had transferred shares in the Imperial Oil Company (an authorised investment) to a trustee. The life tenant of the trust was the settlor's mother and the remainderman was the settlor himself (or his mother if she should survive him). Over the lifetime of the trust the shares produced a small amount of income relative to alternative investments such as bonds or mortgages. The capital value of the shares increased. The settlor responded to the trustees' enquiries about investment performance by asking them not to sell the shares and the trustees complied with this request.

3.10 The Ontario Court of Appeal upheld the first instance decision of Keith J who decided that the failure of the trustees to sell the shares and make investments which yielded a greater level of income was a breach of their duty to maintain an even hand between the income and capital beneficiaries. This was so despite the shares being authorised investments and the trust being an *inter vivos* settlement. This decision was also reached despite terms of the trust which gave the trustees an absolute discretion to retain the original trust property.

3.11 A possible interpretation of this decision is that it departed from the automatic exclusion of the duty of even-handedness, insofar as it relates to the original trust property, in the case of *inter vivos* settlements of authorised investments. The court was persuaded to impose a duty to convert the original trust property in circumstances where the first branch of the rule in *Howe v Earl of Dartmouth* would traditionally have been excluded. The decision apparently advocates a broader role for the duty of even-handedness in trustees' investment decisions.

3.12 There are, however, problems with this analysis. First, the judgments of Keith J and the Ontario Court of Appeal make no reference to *Howe v Earl of Dartmouth*.[15] Secondly, some commentators have suggested that the decision of

[13] No trust for sale will be implied under the first branch of the rule in *Howe v Earl of Dartmouth* if the relevant investments are authorised. The settlor can, however, make provision in the terms of the trust to limit the range of authorised investments and thereby increase the potential scope of the first branch of the rule in *Howe v Earl of Dartmouth.*

[14] [1971] 2 OR 541, 18 DLR (3d) 405. The first branch of the rule in *Howe v Earl of Dartmouth* forms part of Canadian law: see D.W.M. Waters, *Law of Trusts in Canada* (2nd ed 1984) p 791–803.

[15] If, however, *Re Smith* is viewed as separate from, as opposed to an extension of, the first branch of the rule in *Howe v Earl of Dartmouth* the logic of the decision is, at best, questionable. If the settlor had manifested a sufficient intention to exclude the first branch of the rule in *Howe v Earl of Dartmouth* (and the duty of even-handedness insofar as it relates to the original trust property) it is not clear how the duty of even-handedness can be resurrected to impose an alternative duty to convert the original trust property. The implied trust for sale under the first branch of the rule in *Howe v Earl of Dartmouth* is, after all, based on the same duty of even-handedness.

the Supreme Court of Canada in *Lottman v Stanford*[16] has implicitly overruled *Re Smith*.[17] In *Lottman*, the Supreme Court refused to apply the first branch of the rule in *Howe v Earl of Dartmouth* to realty. On a broad interpretation, *Lottman* can be taken as a reaffirmation of the principle that the duty of even-handedness is excluded in the case of specific gifts at least insofar as it relates to the original trust property. McIntyre J's reasoning focussed on the traditional formulation of the first branch of the rule in *Howe v Earl of Dartmouth*.[18] He concluded that it would be an illegitimate act of judicial legislation to alter the scope of a rule of such long standing.[19]

3.13 We believe that the result in *Re Smith* is right as a matter of principle, although it cannot be reconciled with authority. We consider that a settlor should not necessarily be taken to have excluded the duty of even-handedness insofar as it is applicable to original trust property solely because the original trust property comprises authorised investments or because the settlor has created a trust of land or an *inter vivos* settlement. Indeed, in the case of authorised investments, the inapplicability of the first branch of the rule in *Howe v Earl of Dartmouth* seems to have been based originally on the assumption that authorised investments automatically maintain a fair balance between the competing interests of income and capital beneficiaries. Whilst this assumption may have been accurate in the early nineteenth century (when the very short list of authorised investments was made up of assets considered to achieve such a balance) we believe that it no longer holds true. Section 3(1) of the Trustee Act 2000 has massively enlarged the scope of trustees' investment powers. The definition of authorised investments is now wide enough to include investments which do not necessarily maintain a balance between the income and capital beneficiaries.

3.14 Furthermore the settlor may give authorised investments or specific property to be held on trust in the hope that it will maintain a balance. If, however, the original property fails to maintain a balance the settlor may expect the trustee to exercise his or her powers of sale and reinvestment to rectify the imbalance. Unless the terms of the trust exclude the duty of even-handedness (either expressly or by necessary implication) it is unrealistic to assume that the settlor has anticipated all the possible circumstances in which the original trust property might fail to achieve a balance and accepted such an outcome in those circumstances.

[16] [1980] 1 SCR 1065, 107 DLR (3d) 28.

[17] See, for example, Hogg, "Comment on *Lottman v Stanford*" (1981) 5(3) Estates & Trusts Quarterly 181, 194.

[18] On this interpretation it is odd, however, that the Supreme Court did not cite *Re Smith* since *Lottman* was itself an appeal from a decision of the Ontario Court of Appeal.

[19] It seems that a narrower view (dealing only with the exclusion of realty) was taken in the Ontario Court of Appeal. Wilson JA had imposed a duty to convert realty arguing that in Canada land was not "the sacred cow" that it was in England and thought that no distinction should be drawn "in the current social context" between personalty and realty: *Re Lottman* (1978) 2 ETR 1, 14.

The second branch of the rule in *Howe v Earl of Dartmouth*

3.15 The second branch of the rule in *Howe v Earl of Dartmouth* applies where property is held for persons in succession under a trust for sale and the property has not yet been converted. It provides that, up to the date of actual conversion, the life tenant is only entitled to an amount calculated by applying a specified level of interest to the estimated value of the property, rather than to the actual income that the property produces. The original rationale of this rule was to ensure that life tenants did not unfairly benefit from the high levels of income obtained from hazardous or wasting unauthorised assets at the expense of the remaindermen.

3.16 This general rule applies regardless of the circumstances under which the trust for sale arises.[20] It is immaterial whether the trust for sale is express, statutory or implied under the first branch of the rule in *Howe v Earl of Dartmouth*. The second branch of the rule is therefore, unlike the first branch, not limited to the residuary estates of testators.

3.17 It seems, though, that the rule is limited to personal property. It was well established, prior to 1925, that life tenants were entitled to the actual income received from freehold trust property and not the fixed amount that would arise under the second branch of the rule in *Howe v Earl of Dartmouth*.[21] Section 28(2) of the Law of Property Act 1925[22] made it clear that the rule was similarly inapplicable to leasehold trust property. Section 28(2) was, however, repealed by the Trusts of Land and Appointment of Trustees Act 1996[23] so it would seem that post-1996 trusts for sale of leasehold interests now fall within the scope of the general rule once again.

3.18 The rule only applies to limit the income payable to the life tenant from the original trust assets. On general principles, a trustee would be in breach of trust if the proceeds of sale of the original assets were applied to purchase further unauthorised investments, but if the trustee did so the life tenant would be entitled to the actual income the investments produced.[24] The remainderman

[20] *Gibson v Bott* (1802) 7 Ves Jun 89 (Lord Eldon LC).

[21] *Casamajor v Strode* (1809) 19 Ves Jr 390n; *Hope v D'Hedouville* [1893] 2 Ch 361 (Kekewich J).

[22] The section reads: "Subject to any direction to the contrary in the disposition on trust for sale or in the settlement of the proceeds of sale, the net rents and profits of the land until sale, after keeping down costs of repairs and insurance and other outgoings shall be paid or applied except so far as any part thereof may be liable to be set aside as capital money under the Settled Land Act, 1925, in like manner as the income of investments representing the purchase money would be payable or applicable if a sale had been made and proceeds had been duly invested."

[23] Trusts of Land and Appointment of Trustees Act 1996, s 25(2) and Schedule 4.

[24] *Stroud v Gwyer* (1860) 28 Beav 130 (Sir John Romilly MR); *Slade v Chaine* [1908] 1 Ch 522 (CA). It should be noted, however, that Buckley LJ dealt *obiter* with the situation where a defaulting trustee was unable to meet a judgment against him in respect of the breach of trust. He stated ([1908] 1 Ch 522, 536) that "if the trustee were not solvent the reduced amount which he was able to pay and did pay would no doubt have to be apportioned as between corpus and income."

could seek redress for any loss thereby suffered in an action against the trustees to impose personal liability for breach of trust.

Issues of valuation and payment

DATE OF VALUATION

3.19 For the purposes of calculating the interest due to the life tenant, the date of valuation of the trust fund is obviously important. Where the assets form part of the estate of a testator, they should be valued on the first anniversary of the testator's death unless the trustees have a power to postpone conversion,[25] in which case they should be valued as at the date of the testator's death.[26] The basis for this distinction is as follows. Where trustees are under a duty to sell trust assets the period of a year is taken as that in which the duty could reasonably be expected to be performed. Where trustees have a discretion to postpone conversion, however, there is no reason to assume a notional conversion at any particular time. In the absence of any better date, the value of the investments is ascertained at the date of the testator's death.

3.20 Where the assets do not form part of a testator's estate, but are the subject of an *inter vivos* settlement, it seems likely that the date for valuation would be the date of creation of the settlement even where there is no express power to postpone sale.[27]

APPLICABLE INTEREST RATE[28]

3.21 The level of interest payable to the life tenant should be a "fair equivalent"[29] of the capital value of the unauthorised investments, reflecting the expected return from investment in authorised investments of equivalent value. In the nineteenth century the interest rate applied by the courts fluctuated[30] but in every reported decision since 1920 a rate of 4 per cent has been adopted.[31]

[25] *Re Fawcett* [1940] Ch 402 (Farwell J).

[26] *Re Parry* [1947] Ch 23 (Romer J).

[27] There is no "executor's year" applicable to *inter vivos* settlements. It would be possible to value the property at the end of a "reasonable period" for carrying out the duty of conversion. This would, however, lead to uncertainty since the appropriate period would have to be determined on a case-by-case basis.

[28] The Law Commission expressly refrained from dealing with this issue in its Report on Pre-Judgment Interest on Debts and Damages (2004) Law Com No 287, para 5.49.

[29] This term was adopted by the Trust Law Committee in their 1999 Consultation Paper on Capital and Income of Trusts.

[30] *Meyer v Simonsen* (1852) 5 De G & Sm 723 (Sir James Parker VC); *Brown v Gellatly* (1867) 2 LR Ch App 751 (CA); *Re Goodenough* [1895] 2 Ch 537 (Kekewich J).

[31] *Re Beech* [1920] 1 Ch 40 (Eve J); *Re Fawcett* [1940] Ch 402 (Farwell J); *Re Parry* [1947] Ch 23 (Romer J); *Re Berry* [1962] Ch 97 (Pennycuick J). No relevant case has been reported since 1962.

MANNER OF PAYMENT

3.22 In *Re Fawcett*,[32] Farwell J was required to consider how the income should actually be paid to the life tenant. Where the unauthorised investments yield an actual income which is greater than the "fair equivalent", no problem arises. Surplus income is added to the capital and used to purchase authorised investments. The life tenant is then entitled to the actual income of these additional authorised investments. Where the unauthorised investments fail to produce sufficient actual income to pay the "fair equivalent" to the life tenant, the shortfall cannot be made up out of capital.[33] Similarly surpluses of actual income over the fair equivalent from previous accounting periods (which is attributed to capital) cannot subsequently be apportioned to income to make up for a shortage in a later accounting period. Any shortfall can only be made up from any future surpluses of actual income over the fair equivalent or from the proceeds of the realisation of the unauthorised investments.

3.23 If the trust property comprises several different unauthorised investments the surplus or shortfall of income should be determined by taking the investments together. Individual unauthorised investments should not be treated separately.[34] In *Re Fawcett*, Farwell J concluded that the Apportionment Act 1870 was inapplicable to the income from unauthorised investments. All income should be treated as accruing on the day that it falls in.[35]

Exclusion of the general rule

3.24 The operation of the second branch of the rule in *Howe v Earl of Dartmouth* may be excluded expressly, by implication or by statute.

EXPRESS EXCLUSION

3.25 An express declaration to the effect that the life tenant is to take the actual income of the trust property pending conversion will, regardless of the precise wording, suffice to exclude the general rule.[36]

IMPLIED EXCLUSION

3.26 Whether or not the trust instrument, in the absence of express provision, impliedly excludes the general rule raises more difficult issues of construction. It is necessary to distinguish between cases where the trust for sale is implied (under the first branch of the rule in *Howe v Earl of Dartmouth*) and cases where it is expressly declared.

[32] [1940] Ch 402 (Farwell J).

[33] *Ibid*, 408, *per* Farwell J.

[34] *Ibid*, 408, *per* Farwell J.

[35] *Ibid*, 409, *per* Farwell J.

[36] See, for example, *Re Chancellor* (1884) 26 Ch D 42 (CA); *Re Crowther* [1895] 2 Ch 56 (Chitty J); *Re Elford* [1910] 1 Ch 814 (Eve J).

3.27 Any power to postpone conversion is considered to be necessarily inconsistent with the implication of a trust for sale under the first branch of the rule in *Howe v Earl of Dartmouth*.[37]

3.28 In cases where the trust for sale is expressly declared, and trustees have a power to retain investments, or to postpone sale, the general rule will be excluded if, and only if, it can be said, on a proper construction, that the life tenant was intended to take the actual income of the trust property in the meantime. In the case of a power to postpone sale for the more convenient or advantageous realisation of the estate the second branch of the rule in *Howe v Earl of Dartmouth* will not be excluded[38] in the absence of additional indications that the life tenant was to take the actual income of the trust property pending conversion.[39] An "additional indication" might consist of a direction that, in the event of postponement, the life tenant is to take the actual income of the trust property pending conversion. A power to retain investments or postpone sale for the benefit of the life tenant may also have the effect of excluding the rule.[40] It is necessary, in either case, that the trustees consciously and properly exercise their power. A mere failure to sell will not constitute an exercise of a power to postpone sale.[41]

EXCLUSION BY STATUTE

3.29 The real and personal estate in respect of which a person dies intestate is held on trust "with the power to sell it".[42] By section 33(5) of the Administration of Estates Act 1925:

> The income (including net rents and profits of real estate and chattels real after payment of rates, taxes, rent, costs of insurance, repairs and other outgoings properly attributable to income) of so much of the real and personal estate of the deceased as may not be disposed of by his will, if any, or may not be required for administration purposes aforesaid, may, however such estate is invested, as from the death of the deceased, be treated and applied as income, and for that purpose any necessary apportionment may be made between tenant for life and remainderman.

3.30 The effect of the statute is to impose a trust for sale with a power to postpone sale for the more convenient realisation of the estate, combined with a direction that, in the event of postponement, the life tenant should receive the actual income of the trust property. It was held in *Re Fisher,*[43] however, that the second

[37] *Re Bates* [1907] 1 Ch 22 (Kekewich J).

[38] *Re Chaytor* [1905] 1 Ch 233 (Warrington J); *Re Parry* [1947] Ch 23 (Romer J); *Re Berry* [1962] Ch 97 (Pennycuick J).

[39] *Re Chancellor* (1884) 26 Ch D 42 (CA).

[40] *Re Inman* [1915] 1 Ch 187 (Neville J); *Re Rogers* [1915] 2 Ch 437 (Neville J).

[41] *Rowlls v Bebb* [1900] 2 Ch 107 (CA).

[42] Administration of Estates Act 1925, s 33(1). This section was amended by the Trusts of Land and Appointment of Trustees Act 1996, s 5 and Schedule 2, para 5.

[43] [1943] Ch 377 (Bennett J).

branch of the rule in *Howe v Earl of Dartmouth* was applicable to determine the income payable to the life tenant pending conversion unless the trustees consciously and properly exercised the power of postponement.[44]

The rule in *Re Earl of Chesterfield's Trusts*

3.31 The rule in *Re Earl of Chesterfield's Trusts*[45] is said to be complementary to the second branch of the rule in *Howe v Earl of Dartmouth*.[46] We have already seen that the rule in *Howe v Earl of Dartmouth* ensures that the interests of the remainderman are protected from prejudice pending the conversion of trust investments. The rule in *Re Chesterfield's Trusts* compensates the life tenant for the loss of present income from future property where the trustees have exercised a power to defer sale of the property in the interests of the trust as a whole.[47]

3.32 Under the rule in *Re Earl of Chesterfield's Trusts* the life tenant is compensated by a payment made when the future property is actually converted. The formula by which the trustees calculate the amount of that payment is complicated. They are required to calculate the sum which would, if immediately converted and invested in authorised investments on the date the trust was created, yield the amount actually realised on conversion of the future interest. In their calculations the trustees must use a fixed interest rate (currently four per cent[48]), apply compound interest to the principal at yearly intervals and deduct income tax. The sum which they determine would have been required to be invested to produce the actual future receipt is held as capital; the balance is income, payable to the life tenant.

3.33 Suppose that the trust property includes future property, such as monies payable on a life insurance policy. Although all the trust property is subject to a trust for sale, the trustees decide to exercise their power to postpone the sale in the best interests of the trust as a whole. Suppose then that the life insurance policy falls in three years later and a sum of £30,000 is paid to the trustees under the life insurance policy. Assuming a "fair equivalent" of four per cent, and leaving on one

[44] This is the explanation of *Re Fisher* offered by Cohen J in *Re Hey's Settlement Trusts* [1945] Ch 294, 315. It therefore seems that the principles formulated in the context of implied exclusion of the general rule apply. In *Re Fisher* [1945] Ch 377, 385-386, Bennett J stated: "In the case of a residuary bequest of personalty to trustees on trust for conversion with a power to postpone and a trust to pay the income of the subject of a bequest to a person for life with a gift over, the rule of administration formulated by Lord Eldon in *Howe v Lord Dartmouth* never arises." This wide *obiter* statement can only be justified, however, on the basis that it refers only to the first branch of the rule.

[45] (1883) 24 Ch D 643 (Chitty J).

[46] *Re Woodhouse* [1941] Ch 332, 334–335, *per* Simonds J. In reality it is a specific application of the second branch of the rule in *Howe v Earl of Dartmouth* to property which does not yield income and which has subsequently been realised. Accordingly it only applies in the same limited range of circumstances: see above, paras 3.15 – 3.18.

[47] It will usually be advantageous, in terms of financial value, to delay the sale of future property until if falls in.

[48] This is the same rate as under the second branch of the rule in *Howe v Earl of Dartmouth*.

side the added complication of taking account of tax, the rule in *Re Earl of Chesterfield's Trusts* operates as follows:

$30,000 \div 1.04^3 = £26,699.89$ (capital)

$30,000 – 26,699.89 = £3,330.11$ (income)

3.34 It appears from the *obiter* remarks of Simonds J in *Re Woodhouse*[49] that the rule in *Re Earl of Chesterfield's Trusts* only applies to future property which forms part of a testator's residuary estate. The reason for this is difficult to ascertain since the rationale of the rule applies equally to other trusts for sale for persons in succession which include future property not yielding income. It may be that this position (if it is indeed the position) stems from a confusion between the conditions of operation of the first branch (implied trusts for sale) and the second branch (equitable apportionment) of the rule in *Howe v Earl of Dartmouth*.

3.35 The rule in *Re Earl of Chesterfield's Trusts* can be excluded by an express declaration in the trust instrument or by necessary implication. An express statement that no reversionary (or other) property should be treated as producing income unless it actually does so will be effective. It is also established that a declaration that the life tenant is to take the whole actual income of the trust property pending conversion excludes the rule in *Re Earl of Chesterfield's Trusts*, as well as the second branch of the rule in *Howe v Earl of Dartmouth*.[50] The same problems arise in respect of express trusts for sale with powers to postpone sale as arise under the second branch of the rule in *Howe v Earl of Dartmouth*.[51]

Criticisms of the practical operation of the rules of apportionment pending conversion of original trust assets

Complex calculations affecting small amounts of money

3.36 The apportionments required under the second branch of the rule in *Howe v Earl of Dartmouth* and the rule in *Re Earl of Chesterfield's Trusts* involve complex calculations. Where trustees obtain professional assistance in making the calculations or themselves charge for doing so the trust fund will bear the cost. The relative cost/benefit of such expenditure is often questionable given that the resulting apportionment will usually only involve relatively small sums of money. For that reason we understand that as a matter of practice many trustees adopt a "broad-brush" approach to apportionment based on, but not strictly following, the technical rules. Lay trustees attempting the calculations without professional expertise or assistance would find them very difficult.

[49] [1941] Ch 332, 334–335.

[50] *Re Guinness's Settlement* [1966] 1 WLR 1355, 1365, *per* Goff J.

[51] *Mackie v Mackie* (1845) 5 Hare 70 (Sir James Wigram VC); *Wilkinson v Duncan* (1857) 23 Beav 469 (Sir John Romilly MR); *Rowlls v Bebb* [1901] 2 Ch 107 (CA); *Re Guinness's Settlement* [1966] 1 WLR 1355 (Goff J).

Uncertainty over level of the "fair equivalent"

3.37 There is some uncertainty over what level of interest on the trust capital is due to the life tenant. The most recent authorities suggest a rate of four per cent per annum. Using the word "recent" in this context is, however, highly misleading because no case has been decided on the issue since 1961.[52] Investment income is highly sensitive to changing economic circumstances. This problem is accentuated following the extension of the range of authorised investments by the Trustee Act 2000. Even if the interest rate had kept up with economic developments, a fixed rate based upon the returns of investment in government stock is outdated. Despite these obvious uncertainties, trustees have not sought a modern judicial determination of the proper rate. This is most likely because the amounts of money at stake do not justify the costs of such a determination.

Uncertainty over exclusion of the rules

3.38 As outlined, the question of whether the rules should be excluded by necessary implication from an express power to postpone sale gives rise to subtle and difficult questions of construction. This leads to still more uncertainty in this area.

Routine exclusion of the rules in well-drafted trust instruments

3.39 As a result of these practical difficulties, well-drafted trust instruments routinely exclude both rules. Where the rules do apply it is usually by accident rather than design. Even if the rules, in principle, achieve fairness in the specific circumstances in which they operate, they are of dubious utility if settlors and/or trustees do not make use of them and, as a result, no apportionment takes place. If one accepts the importance of balancing the interests of the life tenant and remainderman it is vital that the rules of apportionment keep pace with modern trust practice.

Ignorance or disregard of the rules

3.40 It is likely that the majority of lay trustees who are not professionally advised will be wholly unaware of the rules and so will fail to make the apportionments required by them. Even when trustees are aware of the apportionment rules they may well be honoured more in the breach than in the observance.

Changing economic circumstances

3.41 Changing economic circumstances have undermined the rationale of the rule in *Howe v Earl of Dartmouth*. Where there is an express or statutory trust for sale of shares,[53] the second branch of the rule in *Howe v Earl of Dartmouth* will still prescribe the level of income payable to the life tenant.

3.42 Contrary to the prevailing view in the nineteenth century, equities are, despite the recent woes of the stock market, today considered to be the best way of

[52] *Re Berry* [1962] Ch 97 (Pennycuick J).

[53] Most shares will now be authorised investments and hence no trust for sale will arise under the first branch of the rule in *Howe v Earl of Dartmouth*: *Re Gough* [1957] Ch 323 (Vaisey J).

preserving or augmenting capital in the long term. Trust investments in shares are generally thought to operate as a hedge against inflation. The rationale of protecting the remainderman from capital depletion therefore no longer applies because investment in equities will often benefit capital over income. "As the price of [the] hedge [against inflation], investors are willing to accept a far lower income yield."[54] Share dividends are today, and have for many years been, lower than the interest payable on medium-dated fixed-interest government stock. There is little point in "limiting" the life tenant's income to a sum which is, in fact, far greater than the actual income generated by the trust property.

3.43 In the current economic climate it would perhaps be more appropriate to have a rule which shifted the balance in share investments back towards the life tenant. The traditional four per cent cap on income can work injustice against life tenants. Whilst the life tenant's income is fixed, the remainderman enjoys year-on-year growth.[55] It might, of course, be possible to persuade a court to increase the level of interest payable to the life tenant. This would, however, hardly alleviate the problem since any shortfall which cannot be paid out of the actual dividends received could only be made up when the shares are finally realised.[56]

APPORTIONMENT OF DEBTS AND LEGACIES OF A DECEASED'S ESTATE

The rule in *Allhusen v Whittell*

3.44 The rule in *Allhusen v Whittell*[57] applies when a testator bequeaths his residuary estate to persons in succession. It operates to apportion the debts, liabilities, legacies and other charges payable out of the residuary estate between capital and income. 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 capital element is deemed to be the amount which, when added to the income accruing upon that amount between the testator's death and the payment,[58] equals the total sum owed. The income element is the income accruing upon the capital element between the testator's death and the payment.[59]

[54] Capital and Income of Trusts (1999) Trust Law Committee Consultation Paper, para 3.8.

[55] Provided, of course, that the total return on share investments (i.e. dividends and capital value increases) is greater than the fixed rate of interest payable to the life tenant. If this is so, the capital value can, other factors being equal, expect an exponential increase from year to year.

[56] See above, paras 3.22 – 3.23.

[57] (1867) 4 Eq 295 (Page-Wood VC).

[58] *Re McEuen* [1913] 2 Ch 704 (Sargant J). In this case Sargant J rejected an argument that the income on the relevant portion of trust capital for the entire period of the "executor's year" should be applied to discharge the obligations, irrespective of the actual date on which the payment was made. If this argument had been accepted it would (as noted by Sargant J at 712-713) lead to the anomalous result that the life tenant could potentially receive a negative income.

[59] *Allhusen v Whittell* (1867) 4 Eq 295, 303, *per* Page Wood VC; *Corbett v Inland Revenue Commissioners* [1938] 1 KB 567, 585, *per* Romer LJ.

3.45 The justice of this approach is not in doubt. The life tenant's only entitlement is to the income of the residue. By definition the residue is the testator's estate net of all debts, legacies and other liabilities. Although it is impractical for the administration of the testator's estate to be accomplished immediately, it would be unfair if the life tenant were able to take the income earned in the meantime from that portion of the estate required to discharge debts, legacies and other liabilities.

3.46 The applicable rate of interest should, in theory, be calculated on the basis of the average income of the entire trust fund for each one year period.[60] Where, however, the debt or legacy in issue is not substantial it may be appropriate to make an approximate calculation of the interest rate for the whole period. This should be the net rate, after deduction of income tax.[61]

3.47 Despite references in *Allhusen v Whittell* to the one year period of administration of the testator's estate, it is clear that the rule applies with equal strength to payments made after the end of the "executor's year".[62] In such a case the relevant amount of income is that which is earned on the appropriate portion of capital up until the date of payment of the debt or legacy.

3.48 The rule in *Allhusen v Whittell* appears to be slightly more flexible than the other equitable rules of apportionment. In *Re McEuen*,[63] Sargant J went so far as to say that: "I do not by any means wish to lay down that this is the only method available, or that extremely elaborate and minute calculations must be gone through in every case."[64] He considered that "the actual accountancy will not be difficult so long as the true object is borne in mind".[65] Similarly in *Re Poyser*,[66] Parker J held that the actual method of apportionment is at the discretion of the court.[67]

3.49 The rule does not apply to contingent legacies.[68] Sums paid to discharge other contingent liabilities are, however, to be apportioned between capital and income.[69]

[60] *Re Wills* [1915] 1 Ch 769 (Sargant J).

[61] *Re Oldham* (1927) 71 SJ 491 (Astbury J).

[62] *Re McEuen* [1913] 2 Ch 704 (Sargant J); *Re Wills* [1915] 1 Ch 769 (Sargant J).

[63] [1913] 2 Ch 704 (Sargant J).

[64] *Ibid*, 716–717.

[65] *Ibid*, 717. The object in question, as with all rules of apportionment, is to ensure that a balance is maintained between the interests of the life tenant and the remainderman.

[66] [1910] 2 Ch 444.

[67] *Ibid*, 448. His Lordship approved comments to this effect by Swinfen Eady J in *Re Dawson* [1906] 2 Ch 211 and *Re Perkins* [1907] 2 Ch 596. It should be noted however that there is no reported case in which an alternative method has been employed.

[68] *Allhusen v Whittell* (1867) 4 Eq 295, 303, *per* Page Wood VC.

[69] *Re Poyser* [1910] 2 Ch 444 (Parker J); *Re Shee* [1934] Ch 345 (Clauson J).

3.50 The rule does apply to payments of instalments of an annuity, so that they are apportioned between income and capital,[70] provided that the annuity is supported by a personal covenant of the testator.[71]

3.51 A strict application of the rule in *Allhusen v Whittell* will usually lead to a fair account of the respective interests of the life tenant and the remainderman, but the rule should not be applied in certain "exceptional cases" where its operation would "produce inconvenience and hardship".[72]

Exclusion of the rule

3.52 The rule may be excluded if the settlor demonstrates his or her intention to do so with sufficient clarity.[73] A standard clause excluding the second branch of the rule in *Howe v Earl of Dartmouth* or the rule in *Re Chesterfield's Trusts* will not suffice to displace the rule in *Allhusen v Whittell*.[74] Similarly section 33(5) of the Administration of Estates Act 1925 is insufficient. A power to postpone conversion of trust property will not exclude the rule. The rule will be excluded when the "nature of the property" or the "circumstances of the payment" make its application impossible.[75]

Criticism of the rule in *Allhusen v Whittell*

3.53 The most significant criticism of the rule is that it requires complex and cumbersome calculations, which in most cases affect only small sums of money. As a result it is excluded as a matter of course in well-drafted wills.

[70] *Re Perkins* [1907] 2 Ch 596 (Swinfen Eady J).

[71] See *Re Popham* (1914) 58 SJ 673 (Joyce J), where rentcharge payments, which were not supported by a personal covenant of the testator, were borne exclusively by income.

[72] *Re Fenwick* [1936] Ch 720. 723, *per* Farwell J. This was a case concerning contingent legacies to which the rule in *Allhusen v Whittell* clearly does not apply.

[73] *Re Darby* [1939] Ch 905, 917, *per* Sir Wilfrid Greene MR; *Re Wynn* [1952] Ch 271, 276, *per* Danckwerts J.

[74] *Re Wills* [1915] 1 Ch 769 (Sargant J); *Re Ullswater* [1952] Ch 105 (Roxburgh J).

[75] In *Re Darby*, for example, a testator bequeathed his residuary estate to his daughter absolutely subject to, and charged with, such payment as should be necessary to bring the testator's widow's annual income up to £3,000. The daughter bequeathed her entire estate (including the testator's residuary estate subject to the charge) on trust for persons in succession. The trustees were directed to pay the testator's widow the sum necessary to supplement her income to £4,000 per annum. It was necessary to determine whether the payments were to be borne by income or capital. The Court of Appeal held that the rule in *Allhusen v Whittell* contemplates when such amounts payable become due they should be made partly out of capital and partly out of income. In the present case no payment could be made to the widow out of the trust capital without her consent. The rule in *Re Perkins* (see above, n 70) was inapplicable because the annuity was secured by an annual charge over the residuary estate. It was not the subject of a personal covenant to pay. The widow's consent to receive payments out of capital was required because such payments would diminish her security. The will could not be treated as demonstrating an implied intention that payments in satisfaction of the annuity should be made in a manner in which they could not be made without the consent of the widow. The annuity was therefore payable wholly out of the income of the estate.

RULES GOVERNING APPORTIONMENT OF DEFICIENT SECURITIES

3.54 Whenever a trustee invests in loan stock there is a risk that the borrower will be unable to meet its obligations and that the security for the loan (if any) will be insufficient to make up the shortfall. A rule of apportionment is required to attribute the loss caused by the deficient security between income and capital.[76]

Authorised security: the rule in *Re Atkinson*

3.55 The rule in *Re Atkinson*[77] applies when security taken by trustees for a loan that they were authorised to make is insufficient to meet both the principal and arrears of interest owed to the trust.

3.56 Trust security is security for both principal (benefiting the remainderman) and interest (benefiting the life tenant). If a security, when realised, is insufficient to satisfy the arrears of interest and the amount of outstanding principal both the income and capital beneficiaries have suffered loss from the investment. This loss should be apportioned rateably between them in proportion to the outstanding debts owed to each of them. The rule requires the sum realised from the security to be apportioned between the life tenant and the remainderman by reference to the ratio of the arrears of interest to the amount of outstanding principal.[78]

3.57 Although *Re Atkinson* itself concerned a mortgage it is clear that the rule of apportionment is not so limited. It applies equally, for example, to debenture stock in a company[79] and payments in respect of mortgage debentures made under a court-approved scheme of arrangement.[80] The rule in *Re Atkinson* does not apply until the security has actually been realised. Until this time the life tenant is ordinarily entitled to receive any income arising from the security.[81] This broad principle is, however, qualified by the decision of Warrington J in *Re Coaks*.[82] Sums received on a mortgage before realisation of the security should only be received by the life tenant insofar as they are necessary to meet the arrears of interest due. Any excess should be apportioned to capital.

3.58 The situation is more complicated when the security is realised following an order for foreclosure.[83]

[76] The rules which exist for apportioning deficient security were not considered in the 23rd Report of the Law Reform Committee, Cmnd 8733, the 1999 Trust Law Committee Consultation Paper or the 2003 Scottish Law Commission Discussion Paper.

[77] [1904] 2 Ch 160 (CA).

[78] If capital is expended in order to protect the security for the benefit of the trust as a whole this sum will be added to the amount of the outstanding principal for the purposes of the rule in *Re Atkinson*.

[79] *Re Walker's Settlement Trusts* [1936] Ch 280 (Farwell J).

[80] *Re Morris's Will Trusts* [1960] 1 WLR 1210 (Cross J).

[81] *Re Broadwood's Settlements* [1908] 1 Ch 115 (Swinfen Eady J).

[82] [1911] 1 Ch 171.

[83] See Law of Property Act 1925, s 31; *Re Horn's Estate* [1924] 2 Ch 222 (P.O. Lawrence J).

3.59 A direction that the life tenant should not be treated as entitled to receive income when the trust property does not actually produce income is insufficient to exclude the rule in *Re Atkinson*.[84]

Unauthorised security: the rule in *Re Bird*

3.60 The rule in *Re Atkinson* does not apply when the deficient security comprises an unauthorised investment. Romer LJ stated in *Re Atkinson* that:

> In dealing with cases of unauthorised investment, 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.[85]

3.61 In *Re Bird*,[86] trustees, without the knowledge of the life tenant or remainderman, sold an authorised investment and invested the proceeds in an unauthorised security. The value of this security was insufficient to meet the sums due to both income and capital. The court approved and applied the principle laid down by James VC in *Cox v Cox*[87] that:

> Neither the tenant for life nor the remainderman is to gain an advantage over the other – neither is to suffer more damage in proportion to his estate and interest than the other suffers – from the default of the obligor. 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.[88]

3.62 Farwell J held in *Re Bird* that where an unauthorised security causes loss to the trust fund, that loss must be borne by income and capital rateably. The proceeds of realisation of the unauthorised investment, plus any income therefrom,[89] must be apportioned between the life tenant and the remainderman in proportion to the total income and capital that would have been received, in the same period, from an authorised investment.

Criticism of the rules governing apportionment of deficient securities

3.63 There has been little criticism of the rules in *Re Atkinson* and *Re Bird*. The rules appear to be less complex than the other equitable rules of apportionment.

[84] *Re Hubbuck* [1896] 1 Ch 754 (CA), where the remainderman argued that such a clause should be effective to exclude the general rule as the deficient security was not actually producing any income. The Court of Appeal reasoned that the sum recovered, on realisation of the security, represented both capital and income. It could not be said, therefore, that the debt failed to produce income, and consequently the clause relied upon was inapplicable.

[85] [1904] 2 Ch 160, 167.

[86] [1901] 1 Ch 916 (Farwell J).

[87] (1869) 8 Eq 343.

[88] *Ibid*, 344.

[89] Although the court will take account of any income received by the life tenant, it will not order the life tenant to repay any income in excess of his or her entitlement unless the life tenant knew of the breach of trust: *Re Bird* [1901] 1 Ch 916, 919–920.

Moreover, as the rules apportion the entirety of the deficient security between income and capital, the sums of money at stake are likely to be somewhat larger than under the other rules, underlining the need for such rules. In the specific circumstances in which the rules operate they broadly achieve fairness between the life tenant and remainderman. It would not, however, be consistent to retain the rules in *Re Atkinson* and in *Re Bird* simply on the basis that they are less unsatisfactory than the other rules. Although we consider that the distinction drawn between authorised and unauthorised investments can be easily justified as a matter of principle, there is no need to resort to rigid and technical rules to achieve fairness between the beneficiaries.

SITUATIONS FOR WHICH NO RULE OF APPORTIONMENT EXISTS

3.64 This Consultation Paper does not seek to give an exhaustive analysis of every situation in which no rule of apportionment exists; this would be of little value. Neither trustees nor the courts have a general discretion to do justice between the life tenant and the remainderman except when the imbalance is caused by a breach of trust.[90] Unless a technical rule of apportionment applies investment returns are therefore attributed in accordance with their primary classification. The compartmentalised approach of the present law leads to injustice in situations where apportionment might be necessary to maintain a proper balance between the life tenant and remainderman. This can be illustrated by considering two particular cases:

(1) The purchase and sale of shares "cum" and "ex" dividend; and

(2) The holding of authorised investments which favour one beneficiary over another.

Purchase and sale of shares "cum" and "ex" dividend

3.65 An important factor affecting the value of shares is the date on which a dividend is or is expected to be declared. Share prices increase when a dividend is expected in order to reflect the additional income which it is anticipated that shareholders will receive.[91] Once a dividend has been declared the value of shares falls as money has left the company and the shares are not expected to produce income in the immediate future.[92]

3.66 Shares held by trustees form the capital of the trust, and therefore the proceeds of sale should also be capital. When shares are sold cum dividend, the share price received reflects in part the additional income expected from the forthcoming dividend. If the shares are sold the life tenant will not, however, receive this income. It is therefore arguable that there should be some apportionment between capital and income.

[90] See above, paras 2.21 – 2.24.

[91] Such shares are described as "cum dividend".

[92] Such shares are described as "ex dividend".

3.67 In *Scholefield v Redfern*[93] Kindersley VC recognised the force of this argument[94] but held that the entire proceeds of the sale of shares should be treated as capital, regardless of whether the shares were sold cum or ex dividend.[95] His reasoning was that it would be far too complex to determine what proportion of the proceeds of sale represents the expected dividend on the shares. Moreover, if the shares were converted and re-invested in shares cum dividend, it would be necessary to give effect to the equity both ways, apportioning a part of the next dividend from income to capital.

3.68 In reaching his decision, the Vice-Chancellor distinguished the earlier case of *Lord Londesborough v Somerville*[96] (where the court ordered an apportionment of the proceeds of sale of trust shares) on the basis that it was decided in "very special circumstances".[97] *Freman v Whitbread*[98] subsequently established that mere delay in the execution of a sale and completion of a subsequent purchase does not constitute "circumstances of a special and exceptional nature".[99] Apportionment was, however, ordered in *Bulkeley v Stephens*[100] because the life tenant succeeded in establishing exceptional circumstances. A testator bequeathed his residuary estate, which comprised stocks in a public limited company, on trust for persons in succession. The will provided that on the death of the life tenant the shares should be distributed amongst a large class of remaindermen. The terms of the will directed that the trust would be carried out by transfer of shares to the remaindermen rather than by sale of the investments. If this had occurred the life tenant was entitled, under the will, to an apportioned part of any dividends subsequently paid upon the shares. The shares were nevertheless sold cum dividend under a court order, so as to facilitate the division of the testator's residuary estate. It was not doubted by Stirling J that the order was "properly made" but his Lordship held that special circumstances were made out because the court order was made in the absence of the legal personal representatives of the life tenant.

3.69 The court's general refusal to order apportionment in unexceptional circumstances appeared to be undermined by the decision in *Re Winterstoke's*

[93] (1863) 2 Drew & Sm 173.

[94] *Ibid*, 182.

[95] This general rule has been affirmed and applied subsequently: *Freman v Whitbread* (1865) 1 Eq 276 (Kindersley VC); *Bulkeley v Stephens* [1896] 2 Ch 241 (Stirling J); *Re Walker* [1934] WN 104 (Clauson J); *Re Firth* [1938] Ch 517 (Farwell J); *Re Henderson* [1940] Ch 368 (Morton J); *Hitch v Ruegg* [1986] TL & P 62 (Nourse J).

[96] (1854) 19 Beav 295 (Sir John Romilly MR).

[97] (1863) 2 Drew & Sm 173, 183.

[98] (1865) 1 Eq 276 (Kindersley VC).

[99] Kindersley VC said (at 276) "[b]ut how can I treat as a special and exceptional circumstance that which is common to by far the largest proportion of cases where real estate is bought or sold under trusts of the same character as in the present case. If this is a special and exceptional case, then out of every twenty such cases, probably nineteen would have to be treated as exceptional and special cases."

[100] [1896] 2 Ch 241 (Stirling J).

Will Trusts.[101] Trustees held shares on trust for persons in succession and sold these shares cum dividend. The life tenant argued that a proportion of the proceeds representing the accrued dividend should be apportioned to income. Clauson J held that, insofar as it is reasonably possible, trustees should preserve the rights of the life tenant when they sell trust investments. This could be achieved by deferring sale until after the dividend had been declared.[102] Alternatively the shares could be sold cum dividend but a portion of the purchase price, representing the expected value of the dividend which had accrued until the date of sale, should be set aside as income, provided that the appropriate figure can be ascertained without undue difficulty.

3.70 The courts have subsequently retreated from *Re Winterstoke's WT* and re-established the general rule that no apportionment in favour of the life tenant should ordinarily take place. In *Re Firth*,[103] Farwell J distinguished *Re Winterstoke's WT* as a case in which "special circumstances" had been identified. Moreover, his Lordship criticised the reliance which Clauson J had placed on the proportion of the proceeds representing the expected dividend being readily ascertainable. The entitlement of the life tenant should not depend on the complexity of the calculation required to determine his or her rights.

3.71 In *Hitch v Ruegg*,[104] Nourse J went further and expressly disapproved the decision in *Re Winterstoke's WT*, stating that "the decision of Clauson J … was wrong and ought not to be followed."[105] As a general rule there is no apportionment of the proceeds of sale of shares between capital and income unless there are special and exceptional circumstances. Special and exceptional circumstances are not, however, made out by the size of the trust fund, the fact that a claim is made on behalf of the life tenant's estate or the fact that the trustees voluntarily sought the directions of the court.

Authorised investments favouring one beneficiary over another

3.72 A trustee exercising the wide powers of investment conferred by the Trustee Act 2000 must maintain a proper balance between the interests of the life tenant and the remainderman. It would be a breach of trust for a trustee systematically to select investments with high capital returns but low income yields, or vice versa. It is inevitable, however, that some individual investments will favour the remainderman and some will favour the life tenant. The crucial consideration, therefore, is whether the portfolio of trust investments, as a whole, maintains a balance between the different beneficiaries' interests.[106]

[101] [1938] Ch 158 (Clauson J).

[102] Clauson J conceded that, in some situations, it may be inconvenient to defer sale until after the dividend has been declared and that it may thus be appropriate for the trustees to sell immediately.

[103] [1938] Ch 517.

[104] [1986] TL & P 62.

[105] *Ibid*, 64.

[106] *Nestlé v National Westminster Bank plc* [1993] 1 WLR 1260, 1279, *per* Staughton LJ.

3.73 Even if a suitable portfolio is selected, it is still possible, however, for an imbalance to arise without there being any breach of trust. When selecting investments the trustee must take account of his duty to maintain a balance between the beneficiaries and, with the benefit of necessary advice, choose investments reasonably expected to keep such a balance. A trustee who does this will have discharged his duty in the selection of trust investments. Liability for breach of trust will not follow if, as a result of the inevitable uncertainty of the stock market or other factors, investment returns prove to favour one beneficiary over another. As neither the trustee nor the court have a general discretion to apportion the returns between the life tenant and the remainderman in order to rectify imbalance the life tenant or remainderman (as appropriate) will have suffered loss for which there is no recompense.

3.74 The fact that, as a result of their duty to keep a balance and the absence of a general power of apportionment, trustees are forced to take into account the expected form of returns when selecting investments also means that trustee investments may not be as productive as they otherwise could be. Instead of seeking to maximise the total returns from trust investments, trustees are concerned to ensure that the portfolio of investments provides returns in a form which will maintain a fair balance between the life tenant and remainderman. If the trustees were free to choose investments without concern for the form of returns, and could maximise total returns, the resulting benefit would be enjoyed by all those interested under the trust.

THE STATUTORY RULES OF APPORTIONMENT

3.75 Section 2 of the Apportionment Act 1870 (the "1870 Act") provides that:

> All rents, annuities and 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 apportioned in respect of time accordingly.

3.76 The apportionment required by the 1870 Act is referred to as "time apportionment" and should be contrasted with the equitable rules of apportionment between life tenants and remaindermen. 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 calculated by the product of the income received for the whole period and the proportion of that period during which each person was entitled to receive income.

3.77 There are two particular situations in which the 1870 Act is relevant to trust income. First, and most importantly, it applies to apportion income between beneficiaries who are successively entitled to trust income. Secondly, the rule in

Re Joel[107] applies in relation to trusts for the maintenance out of income of a class of minors who are contingently entitled to the trust capital on attaining a specified age.

Apportionment between successive beneficiaries entitled to income

3.78 The most obvious situation in which section 2 of the 1870 Act applies is when one life tenant dies (or otherwise ceases to be entitled to receive income) and another life tenant or the remainderman becomes entitled to receive the trust income. As a result of section 2, the original life tenant (or his or her estate) only receives income earned during that part of the whole period which ends on the date his or her entitlement to receive income terminated. The balance is payable to the person who subsequently becomes entitled to receive the trust income.[108]

The rule in *Re Joel*

3.79 Many trustees have power to apply trust income for the maintenance of a class of minors.[109] If the trustees exercise their discretion not to apply the income for the maintenance of the minors it is accumulated.[110] The settlor may also provide that the members of the class are contingently entitled, on reaching a specified age, to receive a share of the capital with the other members of the class who attain that age. In *Re Joel*[111] it was held that the 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 income).[112] The income of the fund can only belong to those who make up the class of contingently entitled persons whilst it accrues. The birth of each new member of the class therefore effects a change of entitlement to income to which the Apportionment Act must apply in the absence of contrary provision in the trust instrument.[113] Any income so apportioned but not applied in the maintenance of the individual member should be accumulated on that member's contingent share.[114] If any member dies before obtaining a vested interest (on attaining the specified age), his contingent interest (including accumulations) should be divided as general capital between all members who have, or subsequently obtain, a vested interest.[115]

[107] [1967] Ch 14 (Goff J).

[108] It is, of course, possible to imagine more complex cases where the person entitled to receive trust income changes more than once during the relevant period. In this case the Apportionment Act 1870 should be applied separately in respect of each occasion on which the entitlement changes.

[109] For example, under the powers contained in section 31(1) of the Trustee Act 1925.

[110] Trustee Act 1925, s 31(2).

[111] [1967] Ch 14 (Goff J).

[112] *Ibid*, 26, *per* Goff J.

[113] *Ibid*, 23-24, *per* Goff J.

[114] Trustee Act 1925, s 31(2)(i).

[115] Trustee Act 1925, s 31(2)(ii).

Exclusion of the 1870 Act

3.80 The 1870 Act is inapplicable to any case where it is clearly and expressly provided that no apportionment is to take place.[116] In the event of any ambiguity the 1870 Act will apply. It is unlikely that any attempt to exclude the Apportionment Act in a document other than the trust instrument would be successful. A provision in a company's articles of association, for example, that any dividend shall be deemed to accrue on the same day that it is declared does not exclude apportionment.[117]

Criticisms of the 1870 Act

Inconvenience and unfairness caused by the rule

3.81 Some of the problems of the 1870 Act can be illustrated by the commonly cited example of the testator who bequeaths a life interest in his residuary estate to his widow. The widow will not receive any dividends on shares in the testator's estate which are paid after his death but which accrued during his life as these receipts will be apportioned to capital (and held for the remainderman on the death of the life tenant). This often means the life tenant receives little income in the difficult period immediately following the spouse's death. As this is usually when the surviving spouse will most need resources (especially if they were financially dependent on the deceased) it is hardly likely to be a result that the testator would have intended or expected.

3.82 The requirement to apportion income under the 1870 Act imposes an onerous burden upon trustees who are obliged to make complex and difficult investigations into the precise period in respect of which each dividend has been declared. It is also unclear how trustees should treat interim dividends which are declared part of the way through an accounting period.[118]

Routine exclusion of the rule

3.83 As a result of the above-mentioned difficulties the 1870 Act is routinely excluded in well-drafted trust instruments. There can be no justification for a rule of apportionment which applies more often by accident than design and which disadvantages settlors and testators who have inadequate legal advice.

Ignorance and disregard of the rule

3.84 As with the other rules discussed in this Part, it is likely that many trustees are unaware of the rule or, if they are aware of it, simply ignore it.

[116] Apportionment Act 1870, s 7.

[117] *Re Oppenheimer* [1907] 1 Ch 399 (Swinfen Eady J).

[118] The best solution appears to be to treat the interim and final dividends as a single dividend which is paid in respect of the entire period covered by the final dividend: Gover, *Capital and Income* (3rd ed) p 30.

Specific criticisms of the rule in Re Joel

3.85 The rule in *Re Joel*[119] is of much less importance today than in the past because there are many fewer substantial family trusts. When it does apply, however, it requires the trustees to undertake complex time apportionments to determine the entitlement of each beneficiary. It is necessary to maintain separate funds in respect of each member of the class to ensure that no mistakes are made.

3.86 Difficulties may also arise when income is received after a beneficiary reaches the age of 18 or marries under that age. The portion of the income which is apportioned to the period before the beneficiary reaches the age of 18 (or marries) cannot be applied for his or her maintenance or accumulated to his or her share in the fund. The trustees' statutory powers[120] to do so end when the beneficiary attains the age of 18 or marries below that age. The "income" will therefore form part of the general capital value of the fund.

3.87 The basis of the rule in *Re Joel* is that individual members of the class should only receive the benefit of income which accrues during their lifetime. This is the reverse of what happens, however, when a contingently entitled beneficiary dies before obtaining a vested interest in the trust fund. The contingent share of the deceased beneficiary (including accumulations of income during his or her lifetime) becomes general capital of the fund. Members of the class who were born after the deceased beneficiary will take the benefit of accumulated income which accrued before their birth.

[119] [1967] Ch 14 (Goff J).

[120] Under the Trustee Act 1925, s 31.

PART IV
PREVIOUS PROPOSALS FOR REFORM

INTRODUCTION

4.1 In Parts II and III we set out at length our criticisms of the current law affecting the classification of trust receipts and the equitable and statutory rules of apportionment. It appears to us that the case for reform is overwhelming. In Part V we will set out provisional proposals for a new statutory scheme.

4.2 Before doing so, however, we should outline briefly the proposals for reform which have been previously made by law reform bodies in the UK. It will become clear that in formulating our own proposals, we have been considerably influenced by the work which has already been carried out.

PREVIOUS PROPOSALS

4.3 As we mentioned in Part I, there have been three major studies of these areas of the law in recent years. The equitable and statutory rules of apportionment were considered by the Law Reform Committee in its Report on the Powers and Duties of Trustees published in 1982.[1] The Trust Law Committee, under the Chairmanship of Sir John Vinelott, published a Consultation Paper on Capital and Income of Trusts in 1999, considering both the rules for classification of investment returns and the equitable and statutory rules of apportionment.[2] In September 2003 the Scottish Law Commission published a Discussion Paper on the Apportionment of Trust Receipts and Outgoings as part of its Sixth Programme of Law Reform.[3] Again, this Paper covered both issues of classification and apportionment.

The 23rd report of the Law Reform Committee (1982)

Duty of "even-handedness"

4.4 The Law Reform Committee recommended that section 6(1) of the Trustee Investments Act 1961 be amended,[4] so that trustees would be required to consider "the need to hold an even hand between beneficiaries with different interests" when making investments.

4.5 Three points should be made regarding this recommendation. First, the subsequent decision in *Nestlé v National Westminster Bank* considered, albeit somewhat briefly, the existing scope of the trustees' duty of even-handedness.[5]

1 The Powers and Duties of Trustees (1982) 23rd Report of the Law Reform Committee, Cmnd 8733 ("LRC").

2 Capital and Income of Trusts (1999) Trust Law Committee Consultation Paper ("TLC").

3 Apportionment of Trust Receipts and Outgoings (2003) Scottish Law Com Discussion Paper No 124 ("SLC").

4 LRC, paras 3.22 and para 3.36. See further TLC, para 6.4.

5 [1993] 1 WLR 1260. We discuss this important issue below, paras 5.19 – 5.26, 5.56 – 5.76.

Secondly, the enactment of the Trustee Act 2000 has comprehensively altered the landscape of trustee investment. The "list approach" to authorised investments set out in the Trustee Investments Act 1961 has now been abandoned in favour of the conferment on trustees of liberal and wide-ranging investment powers, subject to a statutory duty of reasonable care.[6] Thirdly it may be unduly restrictive to require trustees to consider the need to maintain a fair balance between the beneficiaries when making investments if they have a power to remove imbalances which arise on receipt of investment returns.[7] The imposition of such a duty is an obstacle to the adoption of a total return approach to investment.[8]

4.6 The Law Reform Committee acknowledged criticism of the existing equitable rules of apportionment whilst recognising that "each of [the equitable rules of apportionment], taken in isolation, produces a perfectly just result for the special situation with which it is adapted to deal".[9] It considered the trustees' duty of even-handedness between all the beneficiaries (on which the rules are based) to be a "fundamental principle of equity".

4.7 The Committee rejected the suggestion that the existing rules should be left in place because, in practice, they are usually excluded or (if applicable) are "honoured more in the breach than in the observance".[10] It concluded that the need to maintain a fair balance between the interests of all beneficiaries meant it was not practical simply to abolish the existing rules of apportionment.[11] There will always be circumstances when fairness demands an adjustment to be made between capital and income.

4.8 The Committee dismissed the idea of applying the existing rules only when expressly included by the settlor.[12] It considered that express inclusion would in practice be unlikely, leading to possible unfairness when apportionment would have been appropriate. Even if the rules were expressly included the existing problems of complexity and technicality would remain.

4.9 The Law Reform Committee accordingly recommended that the existing technical rules of apportionment should be replaced by a general discretionary power for trustees to adjust the capital and income accounts of the trust. Trustees could exercise this power in order to restore or maintain a fair balance between all the

6 See further above, paras 1.1 - 1.4.

7 See below, paras 5.41 – 5.66, for discussion of the provisionally proposed power of allocation.

8 The statutory trustee power envisaged by the Law Reform Committee would only be available to correct accidental imbalances. The trustees would not be able to invest with the aim of maximising economic return safe in the knowledge that they could discharge their duty of even-handedness by exercising the statutory power to restore a balance at a later date.

9 LRC, para 3.26.

10 *Ibid*, para 3.32.

11 *Ibid*, para 3.33.

12 *Ibid*, para 3.34.

beneficiaries. In deciding whether and how to exercise this power trustees should take account of the trust investments as a whole. Apportionment should no longer be restricted to the specific circumstances covered by the equitable rules of apportionment.

4.10 The recommendations of the Law Reform Committee have been substantially enacted in the Bahamas. Section 89 of the Bahamian Trustee Act 1998 provides:

> (1) The rules of equitable apportionment known as the Rule in *Howe v. Earl of Dartmouth*, the Rule in *Re Earl of Chesterfield's Trusts* and the Rule in *Allhusen v. Whittell* are abolished in all their branches.
>
> (2) Whenever trustees in their discretion determine that property held by them for successive interests is not (when considered as a whole) so invested as to maintain a fair balance between beneficiaries interested in current income and other beneficiaries or that a particular receipt disturbs that balance, the trustees shall apportion income receipts to capital of the trust property or estate or apportion capital receipts to income of the trust property or estate so far (if at all) as they in their discretion consider necessary in order to restore such balance.
>
> (3) On the application of a beneficiary (whether or not under a disability) aggrieved by any act or failure to act by trustees under subsection (2) the Court may give such directions as the Court may think fit for the purpose of redressing such grievance.[13]
>
> (4) A trustee who has acted in good faith shall not be personally liable for the costs of any other party to any such application and the costs of such a trustee of such an application shall be provided for out of the trust property or its income.
>
> (5) Subsections (2), (3) and (4) shall apply if and so far only as a contrary intention is not expressed in the trust instrument and shall have effect subject to that instrument.

Statutory rules of apportionment

4.11 The Law Reform Committee noted that the operation of section 2 of the Apportionment Act 1870 is not confined to trusts in succession. The Committee consequently concluded that recommending the repeal of the 1870 Act was "outside [their] terms of reference".[14] The Committee considered the application of the 1870 Act "on any death when a trust or settlement arises as the result of the death".[15] It recommended that the 1870 Act should be inapplicable in such circumstances unless a contrary intention is expressed in the trust instrument.

[13] See below, paras 5.78 – 5.82, for discussion of the judicial control of our provisionally proposed power of allocation.

[14] LRC, para 3.37. We also consider that the repeal of the 1870 Act lies outside our terms of reference: see below, paras 5.86 – 5.88.

[15] *Ibid*, para 3.40.

The Committee also concluded that there would only be a few cases in which "significant hardship" would be caused by failure to apportion following a change in the beneficial entitlement to income. It therefore recommended that the 1870 Act should be amended so that income belongs exclusively (subject to contrary provision in the trust instrument) to the person entitled to income on the date that the sum becomes due.

Trust Law Committee consultation paper (1999)

Classification of corporate receipts as income or capital

4.12 The Trust Law Committee's analysis of classification focused on the problems encountered with corporate receipts identified in litigation arising from a demerger of ICI.[16] Its Consultation Paper discussed three possible approaches to the classification of trust receipts from companies:

(1) Treat a "reasonable return" on trust capital as income.[17]

(2) Allow the life tenant to take the trading profits of the company earned for the duration of his or her life interest.[18]

(3) Leave the existing rules of classification in place subject to a discretion for the trustees to reallocate income to capital and vice versa.[19]

REASONABLE RETURN ON TRUST CAPITAL

4.13 In *Sinclair v Lee*, Sir Donald Nicholls VC had broached the possibility of allowing the life tenant a "reasonable return" on the invested trust capital as an alternative to the current rules.[20] The Trust Law Committee considered three possible methods of giving legislative effect to such a reform. First, it would be possible to enact a specified percentage rate which would constitute a "reasonable return". The Committee argued, however, that a fixed level of "reasonable return" would, like the "fair equivalent" under the second branch of the rule in *Howe v Earl of Dartmouth* and *Re Chesterfield's Trusts*,[21] easily become out of date with changing economic circumstances. It would also be insufficiently flexible to take account of the specific circumstances of a particular case.

4.14 Secondly, the Trust Law Committee suggested that it might be possible to achieve a "reasonable return" on invested trust capital by imposing a statutory duty on trustees to maintain the value of the trust capital. The life tenant would receive as income any investment returns over and above the level required to maintain the value of the capital investment fund. This would, of course, demand

[16] See *Sinclair v Lee* [1993] Ch 497.

[17] TLC, para 6.9.

[18] *Ibid*, para 6.10.

[19] *Ibid*, para 6.11.

[20] [1993] Ch 497, 508.

[21] See above, para 3.21.

precise ascertainment of the initial capital value of the fund which would then have to be increased over time to take account of the effect of inflation. Both these requirements might involve complex calculations. It is also not entirely clear why the entire risk of a diminution in the value of trust capital should be imposed on the life tenant.

4.15 Thirdly, the concept of a "reasonable return" could be adopted in general terms without further elaboration. This would give trustees a significant amount of flexibility to take account of the circumstances of the trust as a whole. It would amount, in effect, to a broad discretion to classify trust investment returns in order to achieve a fair balance between the interests of all the beneficiaries. The danger would be increased uncertainty, and the possibility of litigation contesting the exercise of discretion by trustees. In the meantime it would be difficult to determine where the beneficial interests in the property lay.

TRADING PROFITS DURING LIFETIME OF TRUST

4.16 The Vice-Chancellor's alternative suggestion in *Sinclair v Lee* was that all the trading profits of the company earned during the lifetime of the trust's shareholding should be received as income.[22] The Trust Law Committee argued that this would impose on trustees the disproportionately onerous task of examining the company's accounts in order to determine how to deal with any extraordinary distribution. Moreover it might be difficult to draw a clear and satisfactory distinction between trading profits and capital profits when, for example, a company elects to distribute some of its accumulated reserves and it is impossible to determine to which profits the distribution is attributable.

DISCRETION TO REALLOCATE INCOME TO CAPITAL AND VICE VERSA

4.17 The preferred approach of the Trust Law Committee was to leave the rule in *Bouch v Sproule* intact, but to give trustees a discretion to re-allocate income to capital and vice versa. The exercise of this power would be informed by the trustees' duty to maintain a fair balance between the beneficiaries entitled to income and those who are interested in capital.

Equitable and statutory rules of apportionment

4.18 The Trust Law Committee proposed that all of the equitable rules of apportionment be abolished. Its Consultation Paper discussed the possibility of not replacing the rules. As the rules of apportionment are routinely excluded in all well-drafted wills and settlements it might be concluded that they are not necessary to maintain a fair balance between the beneficiaries or to give effect to the settlor's or testator's wishes. The Committee rejected this approach in favour of conferring a general discretion on trustees to apportion receipts and expenses in order to discharge their duty to maintain a fair balance between the beneficiaries. In this respect, the Committee supported the earlier recommendations of the Law Reform Committee. It also adopted the recommendations of the Law Reform Committee concerning the 1870 Act.

[22] [1993] Ch 497, 508.

Scottish Law Commission Discussion Paper (2003)

4.19 Although Scots trust law does not rest on the same basis as English trust law,[23] in this area of trust law the same problems arise as are outlined in Parts II and III of this Paper.

4.20 The Scottish Law Commission acknowledged that difficulties of classification arise in a wide range of contexts. The Discussion Paper considered the rules of classification in conjunction with the equitable rules of apportionment. The Commission also made proposals for the reform of the 1870 Act.

Classification of trust receipts and the equitable apportionment rules

4.21 The Scottish Law Commission considered four possible options for reform:

> (1) Enact legislative replacements for the existing rules of classification and apportionment.
>
> (2) Enact a legislative replacement for the rule in *Bouch v Sproule*.
>
> (3) Create a general judicial power to alter a classification or apportionment produced by the existing rules.
>
> (4) Give trustees a general power to allocate receipts and outgoings between income and capital.

COMPLETE LEGISLATIVE REPLACEMENT OF EXISTING RULES

4.22 The Scottish Law Commission considered changing the existing rules by legislation but concluded that this would be unsatisfactory.[24] No legislative scheme of apportionment rules could exhaustively cover all situations in which apportionment might be appropriate. Notwithstanding the limitations of such an approach a huge amount of work would be involved in the preparation of such a statute.

LEGISLATIVE REPLACEMENT FOR RULE IN *BOUCH V SPROULE*

4.23 The possibility of limiting reform to the enactment of a legislative replacement for the rule in *Bouch v Sproule* was also rejected by the Scottish Law Commission.[25] In particular the Commission considered the suggestion of the Trust Law Committee, echoing that of Sir Donald Nicholls VC in *Sinclair v Lee*, to allow the life tenant a "reasonable return" on invested capital. The Commission also noted that the problems of classification of trust receipts were not best addressed by the adoption of new fixed and technical rules. Such rules quickly become out of date as the economic environment changes. Moreover the structure of

[23] In Scotland there is a unified notion of property. Under Scots law a trustee has absolute and undivided ownership of the trust property and the beneficiary has a personal right to require due administration of the trust. There is no separation of legal and beneficial ownership.

[24] SLC, para 2.30.

[25] *Ibid*, para 2.31.

transactions may change to take account of, for example, annual changes in taxation law. The fixed rules may not cater adequately for these new transactions.

JUDICIAL POWER OF CLASSIFICATION AND APPORTIONMENT

4.24 The Scottish Law Commission was not convinced that a judicial power to order the classification or apportionment of trust property would be a satisfactory approach.[26] It would of course encourage a great deal of expensive and time-consuming litigation by disgruntled beneficiaries. Apportionment decisions are highly dependent on specific factual scenarios and are therefore better dealt with by trustees on a day-to-day basis.

TRUSTEE POWER OF CLASSIFICATION AND APPORTIONMENT

4.25 The scheme proposed by the Scottish Law Commission is in many ways similar to that which has been proposed by both the Law Reform Committee and the Trust Law Committee. The Commission proposed that the existing technical rules of apportionment should be abolished and replaced with a general discretionary power for trustees to allocate receipts and outgoings between income and capital in order to maintain a fair balance between income and capital.[27] The power would be to "decide what is capital and what is income and the proportion in which expenses are charged to income and capital respectively".[28]

4.26 The power would automatically be applicable in the absence of contrary provision in the trust instrument.[29] The existing rules of classification would continue to apply as a "background" to the trustees' discretionary power. The power would only be available if the trustees considered that the classification of trust receipts or outgoings under the existing rules was uncertain or unfair. The power would also have to be exercised in the light of the duty of even-handedness.

BUILDING A NEW SCHEME OF CLASSIFICATION AND APPORTIONMENT

4.27 We agree with much of what was recommended by the Law Reform Committee, Trust Law Committee and Scottish Law Commission and our provisional proposals draw heavily on the three previous papers. We do, however, differ in certain material respects.

4.28 First, although the Law Reform Committee recognised the significance of the duty to balance we think it must form the central feature of the new apportionment regime.

4.29 Second, we wish to go further than the Law Reform Committee in the scope of the proposed statutory power. We feel that the investment climate for trustees has been so fundamentally altered by the changes introduced by the Trustee Act

[26] *Ibid*, para 2.32.

[27] *Ibid*, para 2.33 *et seq*.

[28] *Ibid*, para 2.33.

[29] The SLC (at para 2.33) expressly rejected a recommendation of the Ontario Law Reform Committee that settlors should have to "opt in" to a similar regime.

2000 and the development of modern portfolio investment theory that a power merely to rectify accidental imbalances is insufficient.

4.30 Finally, we consider that the current rules of classification of corporate receipts (stemming from the principle in *Bouch v Sproule*) are so unsatisfactory that they cannot be allowed to stand. We therefore suggest a possible replacement.

4.31 We hope that our provisional proposals blend the strengths of previous recommendations into a workable new scheme. Details of the scheme we propose are set out in the next Part.

PART V
ACHIEVING A BALANCE: A NEW APPROACH TO CLASSIFICATION AND APPORTIONMENT

INTRODUCTION

5.1 In this Part we formulate a new scheme governing the classification of trust receipts and trust expenses as income or capital. We analyse the duty of the trustees to balance the respective interests of income and capital beneficiaries ("the duty to balance") and ask whether this obligation should be placed on a statutory footing. We argue that this balance is best achieved by the statutory conferment of a new power on trustees to allocate trust receipts and expenses between income and capital ("the power of allocation"). Where the power of allocation is available[1] the initial classification of receipts or expenses would be subject to that power, whereas if it is not available that classification would be conclusive. We also discuss reforms to the existing equitable and statutory rules of apportionment.

5.2 The provisional proposals and consultation questions in this Part apply to private (that is, non-charitable) trusts. Charitable trusts are considered in Part VI below.

CLASSIFICATION

5.3 The prescriptive rules by which investment returns are currently defined as income or capital sometimes give rise to arbitrary and illogical results. We therefore consider that the rules of classification are in need of reform.

5.4 Ideally, any new classification rule should be of general application. We do not think, however, that it is possible to draft a general rule which gives an acceptable result in all the situations in which classification is required. An alternative approach to the classification of receipts and expenses is exemplified by the United States' Uniform Principal and Income Act 1997 ("UPIA 1997"). This lays down a series of specific statutory rules to deal with the classification of certain types of receipt and expense. We consider, however, that the adoption of the UPIA model, promulgating numerous rules to deal with every different type of investment, would make the task of trustees unacceptably onerous. We anticipate that there would be formidable difficulties in drafting these rules and that they would inevitably fail to keep pace with developments in investment practice. The default classification[2] would become increasingly significant and the burden on trustees with a statutory power of allocation to exercise that power to restore a balance would become correspondingly heavy.

[1] The availability of this power would depend on whether an "opt-in" or "opt-out" scheme is favoured.

[2] Insofar as there is no specific rule in the UPIA 1997 to deal with a particular receipt or expense it is classified as capital (UPIA 1997, s 103(a)(4)).

5.5 It is generally accepted that the current rules of classification work least well in relation to distributions by corporate entities to trustee-shareholders. This is where the major problems, leading to the current reference, have arisen. We therefore propose a separate new rule of classification applying solely to distributions by corporate entities to trustee-shareholders.[3]

Corporate receipts

5.6 It could be argued that the price of legal certainty is that the application of generally sound legal principles occasionally leads to results which we intuitively consider to be unfair. However, it is difficult to accept such injustice where the underlying principles themselves have unstable juridical foundations. It is not obvious why receipts by trustee-shareholders should be classified for trust purposes in accordance with company law rules. The fact that a shareholder holds shares on trust is immaterial to the company; no notice of a trust of shares can be entered on the company's register. The concepts of share capital and trust capital each serve a very different purpose and there is no reason why they should be conflated. Furthermore, there is still significant uncertainty over how the existing rules of classification operate in certain circumstances. The current law does not, therefore, rest on principle and fails to deliver either certainty or fairness.

5.7 While the legal principles on which the classification rules are based are, in theory, relatively clear, their application to a particular set of facts can be more complex. They place a potentially onerous obligation on trustees to investigate the nature of every distribution which they receive. As companies develop new ways of rearranging capital in order to obtain commercial or tax advantages trustees may be unsure how the courts will apply existing classification rules to novel situations. To address this uncertainty they may suffer the inconvenience of making an application to court, at potentially great expense to the trust fund. Alternatively, if circumstances allow, they may decide that it is simpler to sell a lucrative shareholding in advance of a rearrangement of capital. These complexities in the operation of the current rules illustrate the need to adopt a clear and certain statutory alternative.

5.8 In those US states which have not adopted the UPIA 1997, corporate receipts are classified in accordance with common law rules; principally the "Pennsylvania rule" and the "Massachusetts rule". The "Pennsylvania rule" seeks to classify corporate receipts according to the source of each distribution. A dividend which is declared out of income which accrued to the company during the life of the trust is treated as income. Distributions of earlier profits are treated as capital. While this rule usually achieves a fair and just result between the beneficiaries, trustees are faced with the difficult and expensive task of investigating the source of each distribution. The "Massachusetts rule" (which achieves a result broadly in line with that reached under the equivalent rule of the UPIA 1997) holds that cash

[3] Our proposed new rule of classification is only intended to apply to distributions by corporate entities to trustees in their capacity as shareholders of the issuing company (not, for instance, where the payment is made to the trustees in satisfaction of an existing debt).

distributions[4] are treated as income whereas distributions of shares are treated as capital. If the trustee-shareholder has the option to take a distribution in the form of cash *or* shares the distribution will be treated as income regardless of the trustee's election. US authority is fairly evenly divided between the two rules, although in recent years the Massachusetts rule has proved more popular.

5.9 We provisionally propose that a modified form of the Massachusetts rule should be adopted in England and Wales for the classification of distributions by corporate entities to trustee-shareholders. Cash distributions[5] from corporate entities (or distributions in respect of which the trustee has the option of taking cash) should be treated as income and distributions in any other form should be classified as capital.

5.10 Consultees might find it helpful to consider how such a rule of classification would apply to the facts of some cases decided under the existing classification rules. The case of *Re Sechiari* concerned a direct demerger.[6] Trustee-shareholders received British Transport stock. Under our provisionally proposed rule of classification the shares would have been received as capital. This contrasts with the decision of Romer J who held the shares to be income under the current law. In *Sinclair v Lee*, the trustee-shareholders received shares in Zeneca following an indirect demerger of ICI.[7] Our proposed rule of classification would reach the same conclusion as that reached by Sir Donald Nicholls VC (i.e. that the shares were capital) without the need to draw artificial distinctions between direct and indirect demergers.

5.11 We acknowledge that this approach will not remove all complexity or every anomaly. Capital profits dividends, such as those distributed in *Hill v Permanent Trustee Co of New South Wales*,[8] will still be treated as income provided that the trustee-shareholder receives (or has an option to receive) the dividend in cash. Under the proposed rule enhanced scrip dividends will be classified as income (because there is an option to take the dividend in cash). This contrasts with the result in *Re Malam* where an enhanced scrip dividend was treated as a distribution of capital, with the life tenant being entitled to a lien in respect of the amount of cash dividend foregone. However, we believe that the trustee's task would be made easier by a simple, clear rule of classification, the application of which would not be the catalyst for disputes. It should also be remembered that trustees would, if our proposed power of allocation were made available to them, be able to overcome any imbalance caused by the proposed rule by exercising that power to restore the balance.

[4] A payment made on liquidation or on an authorised reduction of capital does not constitute a distribution and is classified as capital.

[5] We provisionally propose that a payment made on liquidation or otherwise on an authorised reduction of capital should fall outside the definition of distribution and should continue to be classified as capital.

[6] See further above, paras 2.11, 2.27.

[7] See further above, paras 2.28 – 2.32.

[8] See further above, paras 2.15 – 2.17.

5.12 The status of the classification given by the new rule will depend on whether trustees have a power to allocate the receipt in question to income or capital. If the trust contains such a power, then classification will only be on a provisional basis ("the default classification") and the receipt will not immediately accrue to the income beneficiary or to capital. Trustees can adjust this default classification by subsequently exercising their power to allocate the receipt to income or to capital, as the case may be.[9] The default classification would only become conclusive when the trustees consciously decide to exercise (or not to exercise) the power of allocation or when, for any reason, the power of allocation ceases to be available in respect of that receipt. If trustees do not have a power of allocation the default classification indicated by this new rule would be conclusive from the start.

We provisionally propose that the existing rules for the classification of distributions by corporate entities to trustee-shareholders should be abolished.

Do consultees agree?

We provisionally propose that cash distributions to trustee-shareholders by corporate entities (excluding payments made on liquidation or on an authorised reduction of capital), 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.

Do consultees agree?

Non-corporate receipts

5.13 The new approach outlined above would not be suitable for trust receipts other than distributions from corporate entities.[10] However, the criticisms of the current rules for the classification of distributions by corporate entities to trustee-shareholders do not apply to other types of receipt. The classification of many receipts (such as rental income or interest) is simple and accords with common sense. The classification of other categories, such as timber, minerals and intellectual property rights is less clear, but does not appear to cause wide-ranging problems in practice.[11] In addition, in the limited cases where unfairness is caused by the current rules, trustees would, if our proposed power of allocation were made available to them, be able to exercise that power to restore a proper balance.

[9] See below, paras 5.41 – 5.82 for discussion of how we contemplate that the proposed statutory power of allocation (when available) would operate.

[10] For example, the proposed new rule would classify a cash repayment of the principal of a loan by a corporate entity to a trustee as income. We do not believe that it is satisfactory to allow the rule to create such significant anomalies, notwithstanding the potential availability of a power of allocation to vary the default classification.

[11] This is perhaps indicated by the dearth of reported English cases in these areas.

5.14 We therefore believe that the existing rules for the classification of receipts other than distributions from corporate entities should stand. Where the statutory power of allocation is available to trustees these rules would only yield a default classification whereas if it is unavailable the classification would be conclusive from the start.[12]

5.15 It could be argued that placing the existing rules of classification for non-corporate receipts (or modified versions of those rules) on a statutory footing could be of some benefit to trustees. We are conscious, however, of the dangers of following too closely the UPIA model with a statutory rule for every imaginable situation in which a rule of classification might be necessary.[13] We would therefore welcome the views of consultees on whether or not difficulty is caused in practice by the existing rules of classification for non-corporate receipts not being in statutory form.

We provisionally propose that the existing rules for the classification of trust receipts other than distributions from corporate entities should be retained.

Do consultees agree?

We invite the views of consultees on whether the existing rules for the classification of trust receipts other than distributions from corporate entities should be placed on a statutory footing.

Trust expenses

5.16 It is not possible for trust expenses to be classified on the same basis as distributions from corporate entities. In the ordinary course of events, all trust expenses will be paid in cash and so no real distinction can be drawn on the basis of the form of the expense. The classification of trust expenses should depend on the purpose for which they were incurred. The House of Lords held in *Carver v Duncan* that income should bear "all ordinary outgoings of a recurrent nature" whereas expenses incurred "for the benefit of the whole estate" should be attributed to capital.[14] While there is some uncertainty in the application of this rule, we do not think that there is a sensible alternative rule for the classification of trust expenses. The rule in *Carver v Duncan* achieves a broadly impartial balance between the interests of competing beneficiaries. If the proposed power of allocation were available, however, the rule in *Carver v Duncan* would yield only a default classification.

5.17 We remain to be convinced that a statutory restatement of the rule in *Carver v Duncan* would reduce uncertainty in this area. We would welcome the views of consultees on whether such a restatement of the rule would be desirable and, in particular, whether its status as a common law rule causes difficulties in practice.

[12] See above, para 5.12.

[13] See above, para 5.4.

[14] [1985] AC 1082, 1120, *per* Lord Templeman. See further above, paras 2.51 – 2.54.

We provisionally propose that the law regarding the classification of trust expenses should remain unchanged. The rule laid down by the House of Lords in *Carver v Duncan* should continue to apply.

Do consultees agree?

We invite the views of consultees on whether the rule in *Carver v Duncan* should be placed on a statutory footing.

Express modification of the rules of classification by the settlor

5.18 Whatever the nature of a particular receipt or expense we believe that a settlor should continue to be able to impose his or her own rules of classification by making express provision to this effect in the terms of the trust.

We provisionally propose that the rules of classification for trust receipts and expenses should be subject to any contrary provision in the terms of the trust.

Do consultees agree?

THE DUTY TO BALANCE

5.19 The Law Reform Committee considered the duty to balance to be a "fundamental principle of equity".[15] In *Re Pauling's Settlement Trusts (No. 2)* (a case involving an application for the appointment of new trustees by the court) Wilberforce J noted that new trustees would be under

> … the normal duty of preserving an equitable balance, and if at any time it was shown they were inclining one way or the other, it would not be a difficult matter to bring them to account.[16]

5.20 The duty to keep what Wilberforce J refers to as "an equitable balance" is variously known as "the duty of even-handedness", "the duty of impartiality" or "the duty to keep a fair balance". The duty broadly requires trustees of trusts in succession, when exercising any of their powers under the trust, to strike a balance, so far as is possible, between the competing interests of the income and capital beneficiaries. In other words, trustees must "be even-handed and not seek to promote the interests of one class over the other".[17] The current rules of apportionment are underpinned by this same general equitable principle. They exist in order to achieve a balance in the limited circumstances in which they apply.

5.21 We consider that the duty to balance and its underlying equitable principle are, and should continue to be, fundamental. In this Part we provisionally propose that

[15] The Powers and Duties of Trustees (1982) 23rd Report of the Law Reform Committee, Cmnd 8733, para 3.26.

[16] [1963] Ch 576, 586.

[17] Discussion Paper on Trust Receipts and Outgoings (2003) Scot Law Com No 124, para 2.34.

the current equitable apportionment rules should be replaced by a new statutory power of allocation.[18] We consider, however, that the duty to balance should underpin any new power relating to the apportionment of capital and income.

5.22 Given the central importance of the duty to balance, it is somewhat surprising that the courts have very rarely been required to consider exactly what "balance" means. When the Court of Appeal was asked in *Nestlé v National Westminster Bank plc*[19] to decide whether a particular factor (the personal circumstances of the beneficiaries) was relevant to the maintenance of balance in the context of trustee investment, "common sense" suggested to Staughton LJ that the relative financial situations of the beneficiaries could be taken into account.

5.23 As *Nestlé* indicates, discussions about the nature of the duty to balance usually relate to whether a particular factor is relevant to the proper exercise of a trustee power informed by that duty (in the case of *Nestlé*, the power of investment). Some jurisdictions, notably in the United States,[20] take a highly prescriptive approach to the meaning of balance in given situations, listing factors which are and are not relevant. In doing so they attempt to define "balance" and so, indirectly, the duty to balance.

5.24 We recognise that a list of factors relevant to the proper meaning of "balance" might help trustees to understand what they are expected to do in particular circumstances. It would ensure that they do not have to consider the question of balance in the abstract, determining for themselves whether a particular factor is or is not relevant. We are concerned, however, that the effect of a list, even if it is explicitly non-exhaustive, might be to focus the minds of trustees on a narrow range of listed factors and to cause them to neglect other factors which might be relevant. A list could also encourage litigation by beneficiaries on the basis of the trustees' failure to take account of relevant considerations or to discount irrelevant considerations.[21]

5.25 The listing of relevant factors, whether or not that list is exhaustive, also goes against the "common sense" approach adopted by Staughton LJ in *Nestlé* and, we believe, by trustees in practice. It is a feature of trust law that so long as trustees take into account all relevant considerations and ignore all irrelevant considerations, they should have a degree of flexibility in the exercise of their powers (and consequently in how they discharge their duties).[22] The weight given to these factors is a matter for the trustees and may only be reviewed by the courts on the grounds that the trustees acted capriciously.[23]

[18] See below, paras 5.83 – 5.85.

[19] *Nestlé v National Westminster Bank plc* [1993] 1 WLR 1260 (CA); [2000] WTLR 795 (Hoffmann J).

[20] Section 104(b) of the UPIA 1997 sets out a non-exhaustive list of factors to be considered by trustees in exercising their discretion to apportion.

[21] *Re Hastings-Bass* [1975] Ch 25.

[22] *Ibid*.

[23] *Edge v Pensions Ombudsman* [2000] Ch 602, 627-630, *per* Chadwick LJ.

5.26 We consider that the scarcity of reported cases on the meaning of the duty to balance suggests that trustees are generally able to discharge the duty to balance in the circumstances in which that duty is currently relevant. We believe that trustees are able to use their common sense in finding a balance and applying the general equitable principle to the particular circumstances that face them. We are therefore of the view that there should not be a statutory list of factors relevant to a proper balance between the competing interests of income and capital beneficiaries.

> **We provisionally propose that there should not be a non-exhaustive statutory list of relevant factors to help trustees determine whether or not a balance has been struck between the competing interests of income and capital beneficiaries.**
>
> **Do consultees agree?**
>
> **If consultees do not agree, we invite their views on which factors should be included in such a list.**

5.27 We invite the views of consultees on whether the existence of the duty to balance should be placed on a statutory footing. By this we merely ask whether or not the fact that trustees are under a duty to balance should be laid down in statute. The statement of the duty in statutory form would not in itself change the common law meaning of "balance" and the continuing development of the content of that duty would be left in the hands of the courts.

5.28 It could be argued that equity has adequately expressed the duty to balance in developing the rules of apportionment and in judicial guidance on the effect of the duty on the exercise by trustees of, for example, their investment powers, without the need for statutory expression of the duty.[24] Furthermore, Parliament has never felt the need to cement other fundamental principles of equity (such as the duty to act in the best interests of the beneficiaries) in legislation. On the other hand, if legislation concerning income and capital in trusts is enacted (and reference to the duty to balance is made in that legislation), it does seem sensible for that legislation to spell out the basic duty which underlies this area of trust law.

> **We invite the views of consultees on whether or not a trustee's duty to balance the interests of income and capital beneficiaries should be given a statutory basis.**

Exclusion of the duty to balance

5.29 We consider that settlors should in principle be free to exclude (or modify) the duty to balance, but only by doing so expressly, or by necessary implication, in the terms of the trust.[25] We recognise that there is potential overlap here with our

[24] *Nestlé v National Westminster Bank plc* [1993] 1 WLR 1260 (CA); [2000] WTLR 795 (Hoffmann J).

[25] If the settlor modifies or excludes the statutory duty to balance, the proposed statutory power of allocation would not be available. A settlor who adopts a modified version of the statutory duty to balance may incorporate an express power of allocation in the terms of the trust but does so at the risk of unfavourable tax treatment: see below, paras 5.63 –

current trustee exemption clauses project.[26] We do not propose to deal in this paper with the circumstances in which the duty to balance might in practice be excludable under any proposed regulation of duty exclusion clauses. Suffice to say, however, we consider that it would be excludable on the same basis as any other duty owed by trustees to the beneficiaries under the general law.

5.30 We discuss in Part III how the duty to balance can be expressly or impliedly excluded under the current law. Few problems arise under the law as it stands when the terms of the trust exclude the operation of the duty to balance either expressly or by necessary implication. Difficulties emerge, however, when the duty to balance is impliedly excluded (insofar as it relates to the original trust property) by the nature of the trust or the trust property. For instance, no implied trust for sale arises by reason of the first branch of the rule in *Howe v Earl of Dartmouth* over authorised investments or over specific gifts.[27] Similarly, a power to postpone the conversion of trust property which is subject to an express trust for sale may exclude the second branch of the rule in *Howe v Earl of Dartmouth*, although this gives rise to difficult issues of construction.[28]

5.31 We consider that the duty to balance should never be excluded (insofar as it applies to original trust property) solely by a power to postpone the conversion of the original trust assets. This would avoid the difficult questions of construction which arise under the current law. We also consider that a settlor should not necessarily be taken to have excluded the statutory duty to balance (insofar as it is applicable to original trust property) solely because the original trust property comprised authorised investments or because the settlor created a trust of land or an *inter vivos* settlement. The settlor may give specific property to be held on trust in the hope that it will maintain a balance. If, however, the original investments fail to strike a balance it is not unlikely that the settlor would expect the trustees to exercise their powers of sale and reinvestment (or, if it were available, the provisionally proposed statutory power of allocation) to rectify the imbalance. It is unrealistic to assume that the settlor has anticipated all the possible circumstances in which the original trust property might fail to achieve a balance and accepted such an outcome in those circumstances.

We provisionally propose that trustees should be subject to the duty to balance except insofar as the settlor expressly, or by necessary implication, excludes or modifies that duty in the terms of the trust.

Do consultees agree?

5.64, for discussion of the potential tax treatment of the power of allocation. Inland Revenue approval will be sought for our proposed scheme in its entirety and not for any modified forms which a settlor might choose to adopt.

[26] The mischief of so-called "duty exclusion clauses" was considered in Trustee Exemption Clauses (2003) Law Com Consultation Paper No 171, paras 4.89 – 4.97.

[27] As no implied trust for sale arises over specific gifts, the rule has no application to realty or to *inter vivos* settlements, the court assuming that such gifts were intended to be enjoyed *in specie*. See above, paras 3.7, 3.9 – 3.14.

[28] See above, para 3.28.

We provisionally propose that the duty to balance should not be impliedly excluded insofar as it relates to the original trust property because that property constitutes an authorised investment, because it was the subject of a specific gift (including any gift of realty or any gift in an *inter vivos* settlement) or because there is a power to postpone conversion of the original trust assets.

Do consultees agree?

Achieving a balance and moving towards total return investment

5.32 In the earlier parts of this paper we set out at length the shortcomings of the current system which allocates trust receipts on the basis of their (rule-based) classification as income or capital.[29] We also discuss the deficiencies of the existing rules of apportionment which attempt to achieve balance between income and capital beneficiaries in specific circumstances.[30]

5.33 In recent years, a number of overseas law reform bodies have considered the classification and apportionment of trust receipts.[31] Their reports have emphasised the importance of the general duty of trustees to balance the competing interests of income and capital beneficiaries and have advocated the adoption of total return investment policies. In particular, the reports of the law reform bodies in four Canadian provinces[32] have argued that the formalistic distinction between capital and income is inimical to the movement away from a list-based approach to authorised investments and towards the application to trusts of modern portfolio investment theory. The Canadian reports place significant weight on the settlor's overriding purpose of conferring financial benefits on the objects of the trust. This aim is undermined by a trust law regime which, like that in England and Wales, forces trustees to sacrifice overall economic growth in order to achieve balanced capital and income returns.

5.34 The Canadian reports recognise two vehicles through which the fruits of total return investment can be distributed by trustees for the benefit of beneficiaries; "percentage trusts" and "discretionary allocation trusts".

Percentage trusts

5.35 The percentage trust model represents a radical means of facilitating total return investment. Percentage trusts have successive interests but do not rely upon the traditional concepts of income and capital. Trustees are instead required to value

[29] See above, paras 2.38 – 2.47.

[30] See above, paras 3.36 – 3.43, 3.53, 3.63.

[31] Notably in Australia - Report on Trustees' Powers of Investment (1984) Law Reform Committee of Western Australia Report No 34(V); Bahamas - Trustee Act 1998 enacts the recommendations of the English Law Reform Committee; Canada - see references below, n 32; United States – Uniform Management of Institutional Funds Act 1972, UPIA 1997.

[32] Ontario (Report on the Law of Trusts (1984)), Manitoba (Trustee Investments: The Modern Portfolio Theory (1999)), British Columbia (Total Return Investing by Trustees (2001)) and Saskatchewan (Proposals for Reform of the Trustees Act (2002)).

the entire trust fund at fixed intervals and then pay a fixed percentage of that value to the "percentage beneficiary". The levels of capital and income in the investment returns have no role to play in defining the beneficiaries' respective entitlements. The value of each beneficiary's interest depends on the total value of the assets in the trust fund regardless of whether they take the form of income or capital on receipt.

5.36 English law does not prohibit a settlor from constituting a percentage trust by making express provision to that effect in the terms of the trust. There are, however, significant obstacles to the widespread adoption of percentage trusts in England and Wales. Aside from the fact that percentage trusts will not be suitable for all settlors or all types of trust property (e.g. the family home), general awareness of the possibility of setting up a percentage trust is low. Furthermore the drafting of percentage trusts is likely to pose problems, even to specialist practitioners, unless some sort of statutory default term were introduced.[33]

5.37 There are also two technical difficulties. First, the rule against excessive accumulations would limit the duration of a percentage trust to 21 years. The Law Commission has recommended the abolition of this rule for private trusts[34] but, although the Government has accepted this recommendation, no implementing legislation has yet been passed. Secondly, the current tax system for trusts is based exclusively on the traditional income/capital dichotomy. Percentage trusts represent a departure from this traditional distinction so it is difficult to see how such trusts would be taxed in the UK.

5.38 We do not intend to make any recommendations concerning percentage trusts. We would, however, be interested to hear the views of any consultees who have experience of percentage trusts.

We invite the views of consultees on the advantages and disadvantages of promoting percentage trusts within England and Wales.

Discretionary allocation trusts

5.39 An alternative model is what the Canadian law reform bodies call "discretionary allocation trusts". Discretionary allocation trusts give trustees a power to allocate receipts and expenses between the income and capital beneficiaries in order to discharge their duty to balance.

5.40 We consider that the best way of achieving total return investment in England and Wales is for the trustees of private trusts to be given a similar statutory power to allocate trust receipts and expenses between income and capital.

[33] For example, something akin to section 33 of the Trustee Act 1925 (which allows settlors to invoke a protective trust by using the phrase "… on protective trusts").

[34] The Rules Against Perpetuities and Excessive Accumulations (1998) Law Com No 251.

A new trustee power of allocation

5.41 We have already made provisional proposals for the classification of trust receipts and trust expenses as income or capital. We have outlined the duty, imposed on all trustees, to balance the respective interests of income and capital beneficiaries. We have set out the merits of "total return" investment policies which seek to maximise the overall level of investment returns irrespective of the form that those receipts might take. We now intend to consider the case for making available to trustees a statutory power to allocate trust receipts and trust expenses to income or capital insofar as is necessary to discharge the duty to balance.

5.42 In the absence of a power to allocate receipts freely between income and capital, compliance with the duty to balance inevitably restricts the trustees in their choice of investments and thereby risks compromising the total level of returns from those investments. Trustees are confined to an investment policy which they hope will deliver returns in a form which holds the necessary balance between income and capital. A power of allocation would give trustees much greater freedom to 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.

5.43 We therefore provisionally propose that a statutory power of allocation should be available to trustees insofar as it is necessary to discharge the duty to balance (and for no other purpose).[35] Trustees will be given a specified time limit during which they must decide on allocation of the particular receipt or expense to income or to capital.[36] If they fail to make a decision within that time limit, the default classification, based on the rules we have provisionally proposed above, would become final and conclusive. We envisage that this time limit would be a set period (such as six months) after the end of the tax year within which the receipt accrues. A similar scheme would apply to trust expenses. The statutory power of allocation would therefore apply to all receipts and expenses, allowing a balance to be readily achieved outside the narrow range of situations covered by the existing apportionment rules.

5.44 Trustees would be required actively to consider whether or not to exercise the power of allocation. We envisage that the minutes of trustees' meetings should record any decision to allocate. Trustees would also need to keep detailed

[35] This provisional proposal broadly follows the previous proposals in this area by the Law Reform Committee, the Trust Law Committee and the Scottish Law Commission (see above, Part IV). It also reflects the general approach adopted in other jurisdictions such as the Bahamas and the United States and recommended in several Canadian provinces. We consider below, see paras 5.49 – 5.55, whether the statutory power of allocation should be made available on an opt-in or opt-out basis.

[36] A time limit is necessary to ensure that receipts are classified, and so available for distribution, within a reasonable period.

accounts in order to record which receipts and expenses had been allocated. It would, we think, be advisable to hold unallocated trust receipts in a separate bank account.

5.45 While delivering the undoubted advantages of total return investment the existence of a power of allocation would inevitably cause there to be a time lag between the trustees' receipt of investment returns and their distribution to beneficiaries. This delay could, we concede, be detrimental to beneficiaries who might be in financial need. In addition, the current practice, standard in relation to many smaller trusts, of mandating income to the life tenant would be endangered. We envisage that in such circumstances the trustees could alleviate the difficulties by meeting in order either to expedite distribution by exercising their power of allocation or to approve a payment on account.

5.46 It will be important that trustees with a power of allocation do not allow receipts to be distributed to the life tenant before either the trustees have consciously decided to exercise (or not to exercise) the power of allocation or the time limit for exercise of the statutory power has expired. The recoupment of sums which have been distributed to a beneficiary raises potential human rights issues, gives rise to a possible change of position or estoppel argument and could lead to a serious breakdown of the relationship between the trustees and beneficiaries. It is contemplated that trustees would only make advance payments on account if they were fairly sure that an amount equal to or exceeding those sums would be allocated to income when the time came to consider exercise of the power of allocation. If the trustees subsequently decided that the payments made on account created an imbalance between the income and capital beneficiaries it would, however, be possible for the trustees to exercise their power of allocation in respect of subsequent receipts to restore a proper balance.

5.47 We recognise that this proposed scheme would place new obligations upon trustees. We consider, however, that some additional burdens are inevitable in any shift from a rule-based to a (partly) discretion-based approach to classification of trust receipts and expenses. And while the introduction of a combined duty to balance and power of allocation would have a significant effect on trustee practice, we do not believe that it would place an excessive or unfair burden upon trustees. We contemplate that the time limit for exercising the power of allocation would not of itself require trustees who meet at least once a year to meet more regularly in order to discharge the proposed duty. If trustees fail for whatever reason to allocate a receipt within the relevant time limit, with the result that the default classification becomes binding and an imbalance results, they should be able to re-establish the necessary balance by careful exercise of the power of allocation in relation to the next receipt. For this reason, we consider that the risk of a trustee incurring personal liability for breach of trust to make good any loss resulting from wrongful exercise or non-exercise of the power of allocation is relatively low.[37]

[37] See below, paras 5.78 – 5.82.

5.48 As we explained in Part I, the Trustee Act 2000 has imposed rigorous duties upon trustees when making investments.[38] By removing the need to achieve balance solely through selection of appropriate forms of investment, we hope that our provisional proposals would take away a layer of difficulty from investment decisions, leaving trustees free to concentrate on balancing growth and risk. Alternatively, trustees could continue to attempt to create a balance by the selection of investments and so not be obliged to exercise the power of allocation unless actual returns failed to match predictions.

We provisionally propose that a statutory power of allocation should be made available to the trustees of private trusts to enable them to discharge their duty to balance and thereby to promote total return investment policies.

Do consultees agree?

We provisionally propose that the exercise of the statutory power of allocation, where it is available, should be subject to a time limit from the date of a particular receipt or expense, after which time the default classification would become conclusive.

Do consultees agree?

We invite the views of consultees on the appropriate length of such a time limit.

We invite the views of consultees on the practical implications of our provisional proposals, particularly in relation to accounting and keeping track of individual receipts.

"Opt in" or "opt out"?[39]

5.49 As we have stated, the duty to balance the respective interests of those entitled to income and those entitled to capital is fundamental to the trust relationship. Whether or not it is given a statutory basis, the duty to balance will remain a central component of all trusts with successive interests. Although it will be open to settlors to exclude or restrict this duty, it will otherwise apply by default.

5.50 Under the current law, the duty to balance should be discharged by the careful selection of investments, which trustees reasonably expect to deliver investment returns in a form which balances the interests of the income and capital beneficiaries. Under our provisional proposals, trustees may have a new power to allocate receipts to income or capital as a means of ensuring that the requisite balance is achieved.

5.51 It would be possible to provide that the power of allocation should be implied into all trusts with successive interests, subject only to express provision by the settlor that the power should not apply to a particular trust. This would be an "opt-out"

[38] See above, paras 1.1 – 1.4.

[39] The "opt-in" or "opt-out" nature of the proposed power of allocation has implications for pre-existing trusts: see below, paras 5.93 – 5.99.

system, in that the power of allocation would apply in the absence of contrary provision in the terms of the trust. Alternatively, it would be possible to provide that the power to allocate should not be implied. It would in that case apply only where the settlor expressly provided that the power should be exercisable by the trustees. This would be an "opt-in" system.

5.52 It may be thought that in view of our strong support for the pre-eminence of the duty to balance, we would advance the case for an opt-out system whereby statute would confer a power of allocation on all trustees of trusts with successive interests, save where a clear contrary intention is expressed. We have argued that the introduction of such a power would be highly advantageous and it follows that it should therefore apply to the largest possible number of trusts.

5.53 There are however counter-arguments. First, we can see that there may be some concerns about the scale of the administrative burden being imposed on trustees by the power of allocation. We do not ourselves consider that the burden is excessive but we cannot deny that the power would require trustees to consider whether and when to exercise it. That would place greater demands upon trustees than there are at present.

5.54 The second counter-argument is visibility. Were the power to apply on an opt-out basis, it is possible that some trustees (in particular, lay trustees) would be unaware of the availability of the power and would continue to attempt to strike a balance through the choice of suitable investments. The benefits of having the power would be lost. By contrast, if an opt-in scheme were adopted, the existence of the power of allocation would be immediately apparent from the trust instrument. Trustees might therefore be more likely to make use of it for the benefit of all the beneficiaries.

5.55 The major disadvantage of an opt-in scheme is that total return investment will be unavailable to the trustees of those trusts which fail to opt in. This group of trusts is likely to include many small trusts where the settlors have not taken proper legal advice before setting up the trust. The duty to balance derives from a fundamental principle of equity and would not be diluted in any way by the failure of the settlor (for whatever reason) to opt in to the proposed power of allocation.[40] Trustees of trusts which have not opted in will therefore still be obliged to discharge the duty to balance but will only be able to do so through their choice of investments.

We invite the views of consultees on whether the provisionally proposed power of allocation should be available on an opt-in or opt-out basis.

Exercising the power of allocation

5.56 The power of allocation is strictly "administrative", in the sense that it is intended to facilitate the internal administration of the trust. Whether the power of

[40] Failure to opt in to the new power would not be sufficient to exclude or modify the duty to balance. See above, paras 5.29 – 5.31, for discussion of the circumstances in which the duty to balance would be excluded or modified.

allocation operates on an opt-out or opt-in basis, 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.

5.57 In our earlier discussion we argued that "balance" should not be defined by reference to a statutory list of relevant factors but that the meaning of "balance" should be a matter of common sense, informed by the common law.[41] In general, we provisionally propose to apply the same approach in relation to the new statutory power of allocation. However, we believe that it is necessary to depart from that approach in one specific respect. We consider it essential that the personal circumstances of beneficiaries should not be a relevant consideration in the exercise of the statutory power of allocation.

5.58 As the power of allocation is an administrative and not a dispositive power, it would in our view be inappropriate for trustees to take account of the personal circumstances of individual beneficiaries in its exercise. In addition, we believe that the inclusion of personal circumstances as a relevant factor would risk departure from the expressed intention of the settlor, provoke legal uncertainty and increase the risk of litigation against trustees, as well as having a potentially adverse impact on the tax treatment of trusts benefiting from the power of allocation.

5.59 We anticipate the argument that permitting trustees to take account of the personal circumstances of the beneficiaries allows trustees to do "what the settlor would have wanted". We recognise that the trustees of many small trusts have or have had a long-standing friendship or familial relationship with the settlor. Even so, if the settlor has not expressed his or her wishes in the terms of the trust the trustees would have to speculate about what the settlor would want and make (possibly false) assumptions about the settlor's underlying wishes. The settlor might not have established the trust with the primary aim of providing support to the life tenant; he or she might, for example, wish to protect the capital of the trust for dynastic reasons. This latter aim is inconsistent with allowing the personal circumstances of beneficiaries to influence their relative entitlements.

5.60 Any evaluation of the beneficiaries' personal circumstances is likely to involve an element of subjectivity on the part of trustees which could lead to different trustees, or even the same trustees at different times, adopting different approaches. Although subjectivity is inherent in any discretionary power, it seems to us that we should strive to minimise inconsistency between the balance struck by different trustees (or by the same trustees at different times).

5.61 It is important to distinguish between factors to which the trustees *may* have regard (that is, are *entitled* to consider) and factors to which trustees *must* have regard (that is, are *obliged* to consider). An entitlement to take account of

[41] See above, paras 5.19 – 5.26.

personal circumstances may cause uncertainty as to the legal consequences of the trustees' unwillingness or failure to have regard to such circumstances. An obligation to take personal circumstances into account would require trustees to monitor such circumstances on a regular basis, possibly in relation to a significant number of beneficiaries. This would impose a not insignificant burden. In *Nestlé*, Hoffmann J considered an extreme example where the life tenant was the testator's widow who had fallen upon hard times and the remainderman was young and well-off.[42] In reality, it is more likely that the beneficiaries' needs would vary to a much lesser extent from year to year. Trustees would have to decide how to react to such short-term fluctuations.

5.62 Recognition of an entitlement, or an obligation, to take account of personal circumstances would in our view increase the potential exposure of trustees to litigation. Any exercise of the power of allocation will have an immediate and quantifiable financial impact on the beneficiaries. We believe that the inclusion of personal circumstances as a relevant consideration would increase the risk of attack by disgruntled beneficiaries on the grounds that the trustees failed to take account of relevant considerations.[43]

5.63 A further consideration is how any legislative change flowing from our provisional proposals might affect the tax treatment of trusts. It is vital that the availability of a statutory power of allocation should not affect the tax treatment of trusts.[44] We have had preliminary discussions with the Inland Revenue in relation to this issue. It is currently not possible to say how trusts would be taxed if our proposed power of allocation were available to trustees. We nevertheless hope that the Inland Revenue will either find themselves able to approve our proposed scheme or to co-operate in the modification of the current tax rules in order to allow it to operate in a tax neutral manner.

5.64 Under our provisionally proposed scheme the power of allocation and the default classification rules would together form part of the process of defining the nature of particular receipts and expenses. The exercise of the power should not be understood as converting income to capital or vice versa. Similarly it should not be viewed as allowing the remainderman to receive income or the life tenant to receive capital. If trustees decide to exercise their statutory power to allocate receipts to income or to capital, the default classification is displaced. The exercise of such a power in order to obtain an objective balance between the income and capital beneficiaries would therefore constitute an administrative (as opposed to dispositive) discretion. We anticipate, however, that the Revenue would be concerned if trustees were able or obliged to take account of the beneficiaries' personal circumstances in exercising the power of allocation. If trustees were able to take account of such circumstances in the exercise of that power, the power could more easily be characterised as a dispositive power.

[42] [2000] WTLR 795, 803.

[43] *Re Hastings-Bass* [1975] Ch 25.

[44] For example, by making them subject to the income and inheritance tax regimes applicable to discretionary trusts.

5.65 We are therefore of the view that it would not be possible for the new statutory power of allocation to operate unless the personal circumstances of beneficiaries are irrelevant to its exercise. Our preliminary soundings of the judiciary support this position. We believe that this view is also supported by the existing equitable rules of apportionment which the power of allocation is intended to replace. The equitable rules make no reference to and take no account of the personal circumstances of beneficiaries in applying mechanical formulae to achieve a balance in specific circumstances.

5.66 Settlors who wish trustees to continue to have the flexibility to vary the balance between income and capital beneficiaries on account of personal circumstances can achieve this in a number of ways. First, it is open to the settlor not to opt in to (or, depending on which approach is taken, to opt out of) the power to allocation. In the absence of judicial developments, the approach set out in *Nestlé* will continue to apply to the exercise by trustees of their investment powers.[45] Secondly, settlors may choose to include express provision in the terms of the trust to the effect that trustees may or must take into account personal circumstances when exercising a power of allocation. As noted above, the tax implications of this are uncertain. Thirdly, settlors may wish to establish a discretionary trust (or a fixed trust with a discretionary power to appoint capital or to accumulate income) in which the personal circumstances of the beneficiaries are clearly a relevant consideration for the trustees.

We provisionally propose that the personal circumstances of beneficiaries should not be a relevant factor in the exercise of the statutory power of allocation.

5.67 We recognise that this provisional proposal may appear to sit uneasily with the prevailing judicial guidance on the meaning of balance, as set out in *Nestlé* ("the *Nestlé* approach"). The judgments of both Staughton LJ, in the Court of Appeal,[46] and Hoffmann J, at first instance, considered that trustees were entitled to take account of the personal circumstances of beneficiaries when determining whether a particular investment policy discharged the duty to balance.[47]

5.68 This is not simply a theoretical issue. We contemplate that the power of allocation will be excludable either on an opt-in or opt-out basis. Where the power of allocation is not available (and the duty to balance must be discharged through the careful selection of investments) the meaning of "balance" will be determined by the current law.

[45] But see below, paras 5.67 – 5.76, where we invite views as to the correctness of the *Nestle* approach in the context of trustee investment.

[46] The other members of the Court of Appeal panel (Dillon and Leggatt LJJ) expressed no opinion on relevance of personal circumstances to the duty to balance.

[47] "The trustees have in my judgement a wide discretion. They are for example entitled to take into account the income needs of the tenant for life or the fact that the tenant for life was a person known to the settlor and a primary object of the trust whereas the remainderman is a remoter relative or a stranger. Of course, these cannot be allowed to become the overriding considerations but the concept of fairness between classes of beneficiaries does not require them to be excluded." ([2000] WTLR 795, 803, *per* Hoffmann J).

5.69 It is possible to try to explain the difference of approach by distinguishing between the contexts in which balance is being considered. The *Nestlé* case concerned factors relevant when formulating an investment policy. As Hoffmann J emphasised:

> … investment decisions are concerned with predictions of the future. Investments will carry current expectations … but there is always a greater or lesser risk that the outcome will deviate from those expectations.[48]

5.70 The introduction of a power of allocation would fundamentally alter the context in which the duty to balance finds expression. The power would provide a tool for trustees to split actual returns between income and capital in whatever proportions they saw fit with precision and certainty. Like the current equitable rules of apportionment the power would apply "after the event" on actual trust receipts.

5.71 The central difference between the formulation of a balanced investment policy and the exercise of a balancing power of allocation flows from the difference in the time at which the duty to balance must be discharged. As Hoffmann J noted in *Nestlé*, at the pre-investment stage trustees are inevitably dealing with uncertain future outcomes. It is perhaps natural to view this attempt to balance as a "broad-brush" exercise in which the relevant factors should not be limited by the courts. In this context, it is possible to have sympathy with the view that it does not do any harm to give trustees a little more flexibility in formulating investment policy by permitting them to take account of the beneficiaries' personal circumstances. One cannot point to specific property which is being diverted from one beneficiary to another since the actual form of investment returns will remain uncertain until the investment policy is actually put into effect. In contrast, when exercising a power of allocation the fruits of the investment policy are already in the trustees' hands. The result of exercising the power of allocation is immediate and certain and it is possible to point to identifiable assets which will be diverted from one class of beneficiary to another.

5.72 The fact remains, however, that the duty underlying both the power of investment and the proposed power of allocation is the sam: the duty to balance.[49] The consequence of making a distinction between the exercise of the power of investment and the exercise of the power of allocation is therefore that the duty to balance means different things in different contexts. 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.

[48] [2000] WTLR 795, 803.

[49] In *Nestlé*, Staughton LJ ([1993] 1 WLR 1260, 1279) did not limits his comments regarding personal circumstances to the duties of trustees in selecting investments. It is clear that his Lordship was discussing the content of a more general duty to preserve an "equitable balance". See also, *Re Pauling's Settlement Trusts (No. 2)* [1963] Ch 576, 586, *per* Wilberforce J (cited with approval by Staughton LJ in *Nestlé* at 1279).

5.73 The alternative to this view is to conclude that the current law (as expressed in *Nestlé*) is incorrect insofar as it deems personal circumstances relevant to the meaning of "balance". The reasons behind the *Nestlé* approach are explored most fully by Hoffmann J at first instance. Hoffmann J felt that a duty to balance which compelled trustees to leave the personal circumstances of beneficiaries out of account when making investment decisions would be an "inhuman law".[50] His Lordship stated that discounting personal circumstances would be "a more mechanistic process than… the law requires".[51] His Lordship appears to share the instinctive response of many trust lawyers that it would be unconscionable or inequitable not to shift the balance of the trust fund to reflect the personal circumstances of the beneficiaries. It is said that trustees should know about and take an interest in the beneficiaries' personal circumstances and that equity should do what is "right".

5.74 This justification of the *Nestlé* approach is attractive and we are aware of no challenges to or any general dissatisfaction with the principle established in that case. Nor are we aware of any desire amongst practitioners to upset the *status quo*. However, that is not to say that the *Nestlé* approach is beyond criticism. The view of the duty to balance set out by Staughton LJ and Hoffmann J has never been re-considered (either by the Court of Appeal or the House of Lords), nor has it, to our knowledge, been specifically applied by the lower courts.

5.75 To some extent, the arguments against the relevance of personal circumstances in the context of the new statutory power of allocation[52] could apply equally to the content of the duty to balance insofar as it relates to the exercise of powers of investment. We believe, however, that these concerns are of greater significance in the context of the provisionally proposed power of allocation. This is because the exercise of the power of allocation would have a much more direct and immediate impact on the relative entitlements of the beneficiaries than the original investment decisions. The causal link with the exercise of the power of allocation is much stronger.

5.76 There may, however, be more fundamental reasons why the *Nestlé* approach could be viewed as flawed. The effect of the *Nestlé* approach is to introduce a degree of flexibility into an otherwise "fixed interest" trust.[53] We recognise that one of the main strengths of the trust is its flexibility. However, there must be limits to that flexibility. The *Nestlé* approach equates the ideas of administering a trust fund "impartially" with administering it "fairly" (in the sense of meritoriously). Introducing the concept of fairness makes the beneficiaries' entitlements dependent upon a much wider range of moral considerations, which otherwise have no place within a fixed interest trust. Although trustees are under a duty to act in the best interests of the beneficiaries, this duty is always limited by the

[50] [2000] WTLR 795, 803.

[51] *Ibid*.

[52] As considered above, paras 5.56 – 5.66.

[53] Although we recognise that there is a danger of drawing too sharp a line between so-called "fixed" and "discretionary" trusts, it is useful to consider the paradigmatic fixed interest trust by way of simple illustration.

terms of the trust. Ideas of "fairness" can only operate within clearly defined boundaries. It cannot, for example, be open to trustees unilaterally to alter the structure of the trust. It is also arguable that the *Nestlé* approach obscures the proper purpose of the duty to balance which is to strike an objective balance between income and capital. If trustees are able to take into account personal circumstances, they would have a power akin to an indirect dispositive discretion for which the settlor has (possibly for good reason) made no provision in the terms of the trust.

We invite the views of consultees on whether or not the *Nestlé* approach (that personal circumstances of the beneficiaries are a relevant factor in discharging the duty to balance through the formulation of investment policy) is correct.

If consultees believe the *Nestlé* approach to be incorrect, we provisionally propose that the duty to balance should be statutorily redefined to exclude the personal circumstances of beneficiaries as a relevant factor. Do consultees agree?

5.77 Finally, we appreciate that this analysis of the factors relevant to the duty to balance and the exercise of the power of allocation is not exhaustive. We would welcome the input of consultees on any further points relating to factors which should be relevant (or irrelevant) to the duty to balance or to the exercise of the statutory power of allocation.

We invite any further views of consultees on factors which should be relevant (or irrelevant) to the duty to balance or to the exercise of the statutory power of allocation.

Judicial control of the statutory power of allocation

5.78 The Law Reform Committee thought that beneficiaries should be able to apply for a court order to ensure that trustees complied with their duty to balance.[54] The beneficiary would bear the burden of showing "substantial prejudice". An order would only be made in an exceptional case after consideration of the administration of the trust as a whole.

5.79 The extent of the judicial control of trustees' discretionary powers is a controversial issue which is arguably in need of general reconsideration. We consider that it is inappropriate to deal with the trustee's statutory power of allocation separately from other powers.[55]

5.80 A beneficiary would ordinarily be able to seek redress for breach of trust if a trustee fails to discharge his duty to balance. The Law Reform Committee recommended that no action for breach of trust should lie against trustees who

[54] The Powers and Duties of Trustees (1982) 23rd Report of the Law Reform Committee, Cmnd 8733, para 3.37.

[55] We agree with the views of the Scottish Law Commission on this question: see Discussion Paper on Apportionment of Trust Receipts and Outgoings (2003) Scot Law Com No 124, para 2.40.

have acted in good faith in exercising (or failing to exercise) their proposed statutory power. It is not clear why the Committee considered that the action for breach of trust should be replaced by judicial control of the new trustee power. Trustees with our proposed power of allocation would presumably be given a fairly wide margin of appreciation before their failure to maintain a balance could be said to constitute a breach of trust. As discussed above,[56] the common law concept of "balance" is rooted in vague notions of common sense. Trustees may also protect themselves by seeking prior directions from the court or by obtaining the agreement of all the beneficiaries to a proposed course of action.[57] A trustee who acts reasonably and in good faith can also seek to invoke the court's discretion to excuse a breach of trust under section 61 of the Trustee Act 1925. We accept, however, that these routes may be more attractive in theory than in practice.[58]

5.81 We believe that the real protection for trustees lies in the continuing availability of the power of allocation. A court finding a breach of trust would in the majority of cases simply require the trustees to exercise that power of allocation to restore a balance.[59] We also foresee that in practice most disputes between beneficiaries and trustees would be resolved without resort to the courts (or to any formal sort of dispute resolution). Most beneficiaries would be satisfied if trustees agree to rectify any imbalance by the exercise of their power of allocation in respect of future receipts or expenses. This is consistent with the policy of the Civil Procedure Rules to encourage the resolution of disputes out of court and to avoid litigation.

5.82 Although we would not anticipate a significant amount of litigation concerning the exercise (or non-exercise) of our proposed power of allocation we consider that there may be advantages in adopting a protocol to assist trustees and beneficiaries in the resolution of disputes out of court. We would welcome the views of consultees on the practical utility of such a protocol in these particular circumstances.

We provisionally propose that the exercise (or non-exercise) of the statutory power of allocation should be subject to review by the courts on the same basis as any other discretionary power conferred upon trustees.

Do consultees agree?

[56] See above, paras 5.19 – 5.26.

[57] Assuming, of course, that all the beneficiaries are *sui juris* and together absolutely entitled to the trust property.

[58] See Trustee Exemption Clauses (2003) Law Com Consultation Paper No 171, paras 4.63 – 4.66, for discussion of the inadequacy of section 61 of the Trustee Act 1925 as the basis of exculpatory relief.

[59] This will not be possible when the life tenant has died.

We provisionally propose that, in principle, an action for breach of trust should lie against trustees who fail to discharge their duty to balance.

Do consultees agree?

We invite the views of consultees on whether a special protocol concerning the resolution of disputes over the exercise of the proposed power of allocation would be of assistance to trustees and beneficiaries.

THE EQUITABLE RULES OF APPORTIONMENT

5.83 The equitable rules of apportionment are intended to give effect to equity's general principle of impartiality. The arbitrary formalism of the current rules sometimes runs counter to this principle, although the rules largely achieve a defensible result in the specific circumstances to which they apply. They neglect, however, the sometimes pressing need for apportionment between the interests of capital and income beneficiaries in those situations which are not covered by the existing rules.

5.84 A number of specific criticisms of the rigid and technical equitable rules is set out in Part III.[60] For these reasons, some of the equitable rules of apportionment have already been abolished by legislation in other common law jurisdictions. The second branch of the rule in *Howe v Earl of Dartmouth* has been abrogated (in the absence of contrary intention) in Western Australia[61] and in New Zealand.[62] The rule in *Allhusen v Whittell* has been abolished in a number of Australian states,[63] in the Canadian provinces of Ontario,[64] British Columbia[65] and Manitoba[66] and in New Zealand.[67]

5.85 Aside from the many criticisms of the equitable rules, we consider that the availability of a statutory power of allocation would render them unnecessary. This power would allow trustees to maintain a balance between the income and capital beneficiaries by allocating receipts or expenses between income and capital, including (where appropriate) the situations covered by the existing equitable rules of apportionment.

We provisionally propose that all the existing equitable rules of apportionment should be abrogated.

Do consultees agree?

[60] See above, paras 3.36 – 3.43, 3.53, 3.63.

[61] Trustee Act 1962, s 105.

[62] Trustee Act 1956, s 85.

[63] Wills, Probate and Administration Act 1898, s 46D (New South Wales); Trustee Act, s 74 (Victoria); Trusts Act 1973, s 78 (Queensland); Trustees Act 1962, s 84 (Western Australia).

[64] Trustee Act RSO 1980, c 512, s 49(1)(a).

[65] Trustee Act RSBC 1979, c 414, s 101(1)(a).

[66] Trustee Act RSM 1970, c T160, s 34.

[67] Trustee Act 1956, s 84.

THE APPORTIONMENT ACT 1870

5.86 The rule set out in section 2 of the 1870 Act has long been criticised as being inconvenient and unfair.[68]

5.87 We recognise that the 1870 Act does not apply exclusively to trusts. We do not, therefore, consider it appropriate to recommend its repeal. We do consider, however, that section 2 of the 1870 Act should not apply to trusts unless the settlor expresses a contrary intention in the terms of the trust. Periodic payments of income should be paid to the beneficiary who is entitled to income at the time when the payment becomes due.

> **We provisionally propose that the statutory apportionment rule contained in section 2 of the Apportionment Act 1870 should not apply to trusts except insofar as the terms of the trust (expressly or by necessary implication) express a contrary intention.**
>
> **Do consultees agree?**

5.88 Where available, the proposed statutory power of allocation would be sufficient to maintain a balance between the income and capital beneficiaries when a receipt arises in respect of a period which started before but ended after the creation of the trust. The abrogation of the statutory apportionment rule contained in section 2 of the 1870 Act would be of little consequence. This relies, however, on the statutory power being available and the receipt becoming due whilst the life interest is still subsisting. On termination of the life interest the remainderman becomes absolutely entitled to the trust property and (since there are no competing interests between which to hold a balance) the proposed statutory power of allocation would no longer be available. The same problem arises when one life interest follows the termination of another life interest. In this latter case there is the added difficulty that the "competing interests" in question are both entitlements to income. The proposed statutory power of allocation between income and capital would not, in any event, be of assistance. There may, however, be circumstances in which the trustees consider that apportionment is necessary to maintain a balance between the beneficiaries and to reflect the substance of the receipt in question. We propose, therefore, that trustees should have a power to apportion receipts in circumstances which are currently covered by section 2 of the 1870 Act when, and in the manner in which, they, in their absolute discretion, deem it just and expedient.

> **We provisionally propose that when trustees receive a payment of income in respect of a period during which two (or more) individuals (or classes of individuals) were entitled to income, they should have a statutory power to apportion when, and in the manner in which, they, in their absolute discretion, deem it just and expedient.**
>
> **Do consultees agree?**

[68] See above, paras 3.81 – 3.87.

TRUSTS FOR SALE

Express and statutory trusts for sale

5.89 A settlor may expressly impose a duty on trustees to convert trust personalty and reinvest the proceeds.[69] This is an important aspect of the settlor's freedom to give property to trustees on such terms as he or she thinks fit. Similarly a statutory trust for sale reflects the will of Parliament that trust property should be converted and the proceeds reinvested.

> **We provisionally propose that where a settlor expressly creates or statute imposes a trust for sale (without a power to postpone sale), trustees should continue to be under a duty to convert the trust property and reinvest the proceeds.**
>
> **Do consultees agree?**

Implied trusts for sale

5.90 In specific circumstances the current duty to balance gives rise to an implied trust for sale of unauthorised investments under the first branch of the rule in *Howe v Earl of Dartmouth*.[70]

5.91 We consider that, in the limited range of circumstances in which the rule operates, there are better ways of discharging the duty to balance than a prescriptive duty to sell trust property. Such a duty is incompatible with our aim of increasing trustees' flexibility in the making of investment decisions. We prefer a position where the trustees may choose to exercise their general power to sell investments which fail to maintain a balance between beneficiaries but may also elect to retain successful investments and, where it is available, discharge their duty to balance by making use of the proposed statutory power of allocation.

> **We provisionally propose that the first branch of the rule in *Howe v Earl of Dartmouth* should be abrogated.**
>
> **Do consultees agree?**

SCOPE OF THE PROVISIONAL PROPOSALS

5.92 We consider that the scheme outlined above should apply to all private (i.e. non-charitable) trusts (including discretionary trusts) which are governed by the law of England and Wales and in which the interests in income and capital are divided.

[69] This is not the case for realty; section 4 of the Trusts of Land and Appointment of Trustees Act 1996 provides that an express trust for sale of realty automatically includes, despite any express provision to the contrary, a power to postpone sale of the land.

[70] See above, paras 3.6 – 3.14.

We provisionally propose that the scheme set out in this Part should be made applicable to all private trusts which are governed by the law of England and Wales and in which there is a division of the capital and income interests.

Do consultees agree?

We invite the views of consultees on whether there are any specific types or categories of private trust to which the provisional proposals in this Part should not apply (or to which they should apply in modified form).

TRANSITIONAL PROVISIONS

5.93 We invite the views of consultees on whether our provisional proposals should apply to trusts created before the proposals come into force. The arguments in this context depend to a large extent on whether an opt-in or opt-out power of allocation is preferred.[71]

5.94 Even if the statutory power of allocation is available on an opt-out basis we do not believe that to apply our proposed scheme to existing trusts would necessarily be unfair to beneficiaries. It can be argued that our provisional proposals only give substantial effect (albeit in a new way) to the duty to balance which already applies to trusts by default. The proposals would not apply to pre-existing trusts in which the existing duty to balance has been excluded. On this analysis beneficiaries would have no legitimate complaint as our proposals merely give the trustees the tools to discharge a duty which they were already under and to which the beneficiaries' interests were always subject. The beneficiaries are getting nothing more nor less than that to which they are entitled.

5.95 There is, however, a counter-argument to this analysis. The settlor of an existing trust will not have had the statutory power of allocation in mind when deciding upon the terms of the trust and so it would be wrong to interpret his or her failure to make contrary provision as a tacit approval of the scheme we have provisionally proposed. The current duty to balance is relatively easily discharged by the trustees making informed investment decisions (although there is no guarantee that the investments chosen will actually maintain a balance). Once investment decisions have been made and the returns received the duty to balance has no significant role to play. The current equitable and statutory apportionment rules are based on the same principle as the duty to balance, but operate automatically according to a prescribed formula. Whereas trustees currently have no general discretionary power to allocate actual investment returns between income and capital, our provisional proposals would make such a power available to trustees. This radically changes the context in which the duty to balance operates and accords much greater significance to the duty.

5.96 We recognise that our proposals may be said to impose novel and potentially onerous obligations upon trustees which they would not have contemplated when they chose to accept the trusteeship. Particular problems might arise in the

[71] See above, paras 5.49 – 5.55.

context of some commercial trusts where the scope of the trustees' duties are strictly limited.[72] It is equally true, however, that trustees who are not prepared to take on the new obligations could retire or resign.

We invite the views of consultees on whether our provisional proposals should apply to trusts created before the proposals come into force if the proposed statutory power of allocation applies on an opt-out basis.

5.97 If the power of allocation is only to be available on an opt-in basis the beneficiaries of pre-existing trusts will be largely unaffected if our provisional proposals are applied to such trusts. No settlor could be said to have opted in to a statutory power of allocation which was not in existence when the trust was created.

5.98 We do, however, anticipate that the trustees of some pre-existing trusts might wish to invest on a total return basis. We therefore invite the views of consultees on whether the trustees of pre-existing trusts should be able, either unilaterally or with the sanction of the court, to opt in to the statutory power of allocation, and adopt a total return approach to investment, when this is in the best interests of the beneficiaries as a whole and is not inconsistent with the terms of the trust.

We invite the views of consultees on whether or not the trustees of pre-existing trusts should be able to opt in to the statutory power of allocation.

We invite the views of consultees on whether or not the trustees of pre-existing trusts, if they are able to opt in to the statutory power of allocation in order to adopt a total return investment policy, should be required to seek the approval of the court before adopting such policies.

5.99 As our provisional proposals may require trustees to adjust their accounting practices we consider that any new statutory scheme should come into effect on the first day of the tax year following the enactment of any implementing legislation.

We provisionally propose that any legislative reform based on our provisional proposals should take effect on the first day of the tax year following the enactment of any implementing legislation.

Do consultees agree?

TAX IMPLICATIONS OF THE PROVISIONAL PROPOSALS

5.100 Our provisional proposals for a new scheme for classification and apportionment must fit within the system of taxation for trusts. The changes to trust law that we provisionally propose should be tax-neutral, neither increasing the revenue and

[72] The extent to which duty exclusion or extended power clauses should be given effect was considered in Trustee Exemption Clauses (2003) Consultation Paper No 171, paras 4.89 – 4.97.

capital tax burdens on trusts and beneficiaries nor offering tax savings or tax planning opportunities.

5.101 We have held initial discussions with the Inland Revenue about the tax implications of our provisional proposals and will continue to work with them to find a workable and fair tax treatment for trusts subject to any new apportionment and classification regime. This will need to fit within the modernised system of trust taxation on which the Inland Revenue is currently consulting. We would be grateful to receive consultees' input on any aspect of trust taxation or individual taxation raised by our provisional proposals.

We would welcome comments of any nature on the tax implications of the provisional proposals in this Paper.

PART VI
CHARITIES

INTRODUCTION

6.1 As we explained in Part I, it was with regard to charities that concerns about the distinction between income and capital in trust law were first raised in Parliament.[1] Many charitable trusts have large permanent endowments but produce insufficient income to further their current charitable purposes adequately; they are, so to speak, "asset rich" but "income poor". The trustees are, however, not entitled to convert that capital into income in order to carry out the charity's purpose or purposes. This inflexibility was criticised in the debates on the Trustee Bill in the House of Lords. Lord Dahrendorf, for instance, 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?[2]

6.2 Lord Phillips of Sudbury also supported the adoption of "total return policies", referring to the conclusion reached by a committee of the Charity Law Association

> that the balance of public interest lay in an amendment to the law… The association believes – the evidence is quite clear – that were an amendment to be made, there would be a great advantage to the charity sector because the present confinement in the management of portfolios where there is an endowed element and the inflexibility by which managers of portfolios are currently caught lead to much lower capital and income returns over a long period of time. That can be in no one's interest.[3]

6.3 The Lord Chancellor responded to these concerns by making the current reference to the Law Commission noting, however, that the Charity Commission was already conducting a consultation process on this topic and that statutory amendments to the powers of charity trustees should not be made in advance of the completion of the work of the Charity Commission.

6.4 Since the reference of this project to the Law Commission, there have been significant developments. Very shortly thereafter, the Charity Commission published further operational guidance regarding total return investment policies. Then in September 2002 the Strategy Unit of the Cabinet Office carried out a consultation on charity law reform. A draft Charities Bill to implement

[1] See above, paras 1.5 – 1.8.

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

[3] *Ibid*, col 389.

recommendations flowing from that consultation process has recently been published.

6.5 In this Part, we set out the problems affecting charities in this area of the law, and discuss the above developments. These problems are clearly different from those faced by private trusts in succession and therefore merit separate consideration. While the classification of trust receipts is of just as much concern to the trustees of charities as it is to the trustees of private trusts, the rationale underlying the rules of apportionment (i.e. balancing the respective interests of income and capital beneficiaries) does not translate to the context of charitable trusts. The vital concerns of trustees of permanently endowed charities relate to the expenditure of permanent endowment for current charitable purposes and the possible adoption of a total return approach to investment.

6.6 As a result of the review of charity law currently being conducted by government, it no longer seems appropriate for the Law Commission to make recommendations of its own with regard to the circumstances in which charity trustees should be entitled to distribute the charity's permanent endowment. The Government's proposed legislative changes in relation to this issue are considered below.[4] We do, however, invite views of consultees on provisional proposals relating to the authorisation of total return investment.

THE SPECIAL POSITION OF CHARITIES WITH A PERMANENT ENDOWMENT

What is a "permanent endowment"?

6.7 A charity's "endowment" has been defined as:

> All property of every description belonging to or held in trust for the charity, whether held on trusts or conditions which render it lawful to apply capital for the maintenance of the charity, or on trusts which confine the charitable application to income.[5]

6.8 In essence an endowment comprises all the property held by a charity which actually produces income or has the potential to do so. It need not be held in perpetuity. It is possible for a charitable trust to have an "expendable endowment" which, in appropriate circumstances, can be distributed in furtherance of the charity's purpose.[6]

6.9 By section 96(3) of the Charities Act 1993:

> 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.

[4] See below, paras 6.31 – 6.34.

[5] *Re Clergy Orphan Corp* [1894] 3 Ch 145 (CA), 150–151, *per* Davey LJ.

[6] *Re Gilchrist Educational Trust* [1895] 1 Ch 367 (Kekewich J).

6.10 This definition reveals that the concept of a permanently endowed charity stretches beyond a charitable trust where capital is held in perpetuity with income alone being distributed in furtherance of its charitable purpose. If the terms of the trust impose any restriction upon the distribution of the charity's endowment it is a permanent endowment.[7] The fact that an endowment is permanent does not, however, prevent it from being converted and re-invested.[8] A charity may also hold a permanent endowment which does not actually produce income. The permanent endowment may, for instance, take the form of a capital asset which can itself be used to further the charity's purposes.[9]

The problems caused by permanent endowments

6.11 The concept of a permanent endowment emerged at a time of low inflation. Investment returns were predictable. There was only a small risk of investment returns unexpectedly taking the form of capital rather than income. Permanent endowments have subsequently become inconvenient as a result of inflationary pressures and low interest rates. Moreover changes to the tax system, such as the abolition of Advance Corporation Tax, have encouraged companies to capitalise rather than distribute their profits. Investments, particularly in equities, have given substantial capital returns. Many permanently endowed charities have become "asset rich" but "income poor" because capital investment returns have accrued to the endowment, and so are unavailable to further the charity's purposes. Some charity trustees have consequently been compelled to distort their investment policies and sacrifice overall economic growth in order to secure a sufficient level of income to meet the present needs of the charity's objects.

6.12 At the same time, charities are subject to the same rules for classification of corporate receipts as apply to private trusts. These rules can (for example, in the case of direct demergers) unfairly favour income over capital. Charities are forced to distribute such unexpectedly large windfalls of income to charitable purposes within a reasonable time,[10] whilst the value of the income-producing permanent endowment is dissipated.

6.13 Despite the administrative inconvenience of permanent endowments, however, they still have strong attractions to settlors. Charitable trusts provide settlors with a unique opportunity to set up a perpetual memorial. Settlors can ensure that their generosity will continue to benefit the charitable purpose of their choice for

[7] On this basis the "unapplied total return" of a charitable trust under the Charity Commission's approach to total return investment (see below, paras 6.45 – 6.49) would be a permanent endowment because its application for charitable purposes is subject to a duty to consider the present and future needs of the charity.

[8] In *Oldham Metropolitan Borough Council v A-G* [1993] Ch 210 (CA) the trustees were not obliged to retain a recreation ground, held on a permanent endowment. They were permitted to convert the property and reinvest the proceeds.

[9] In *Re Adams* [1968] Ch 80 (CA), a permanently endowed gift to provide beds in a hospital was used both to buy the beds and to provide income for their maintenance.

[10] An analogy can be drawn here with the duty of trustees of a discretionary trust to exercise their dispositive discretion within a reasonable time: *Re Locker's Settlement* [1977] 1 WLR 1323 (Goulding J).

an indefinite period. In some cases, it might be the perpetual nature of the gift which encourages the settlor to make the charitable donation in the first place.

Charitable trusts and private trusts compared

6.14 In private trusts the distinction between income and capital is of importance when different persons (or classes of persons) are entitled to income and capital. The issue for charitable trusts is rather different. There are no individual beneficiaries with rights of enforcement. Charitable trusts exist for the furtherance of one or more charitable purposes[11] for the "public benefit".[12] Individuals may of course obtain personal benefit from the carrying out of a charitable purpose, but charities are regulated and enforced by the Charity Commission and the Attorney General on behalf of the public.

6.15 Although it is possible for a charitable trust to include a gift over to a second charitable purpose this is unusual. Successive interests are generally a feature of private trusts. A charitable trust with a permanent endowment has been usefully described as a gift of income in perpetuity.[13] The capital of the trust is always kept out of arm's reach.

6.16 The beneficiaries under a private trust in succession have one concern; to maximise the value of their own interest, whether it be in income or capital. This does not translate to the charitable context. The tension is between the current and future needs of the same charitable purpose. The "beneficiary" is at all times the public (although the identity of the individuals who incidentally benefit from the carrying out of a charitable purpose may not remain constant).

6.17 The overall duty of a charity trustee is to serve the best interests of the charity's specified charitable purpose or purposes. It will almost always be possible to further the purpose of a charity through current expenditure. However, the purpose will often also stretch some way into the future.[14] We consider that all charity trustees are under a duty to consider whether the purpose of the charity is best served by current or future expenditure. In other words, even where there is no permanent endowment the trustees are not free to distribute all of the charity's assets "capriciously", without regard to potential future calls on the charity's resources.[15]

[11] *Special Commissioners of Income Tax v Pemsel* [1891] AC 531 (HL).

[12] According to the Cabinet Office's Strategy Unit stronger emphasis should be placed on the concept of "public benefit": *Private Action, Public Benefit: A Review of Charities and the Wider Not-For-Profit Sector* (September 2002) p 38–40. The Draft Charities Bill 2004 (Cm 6199) proposes to abolish any presumption of sufficient public benefit flowing from the nature of the charitable purpose in question.

[13] *Leahy v A-G of NSW* [1959] AC 457 (PC), 464.

[14] Consider, for example, a charity for the relief of poverty. It is unlikely that this purpose will be successfully achieved in the foreseeable future.

[15] It should be noted that if the original charitable purpose is exhausted or fails the charity trustees are under an obligation to seek a *cy près* scheme: see Charities Act 1993, ss 13-14. Trustees cannot therefore assume that a permanently endowed charity will have no need for income in the future.

6.18 This duty is consistent with a need to protect the permanent endowment. However, it does not in itself lead to the absolute bar on expenditure of permanent endowment. Charity trustees are not entitled to dip into a permanent endowment even if the current income is insufficient to support current needs and the anticipated future needs of the charity are insignificant. The duty to preserve permanent endowment flows from the nature of the settlor's gift on terms rather than the duty to consider the present and future needs of the charity.

6.19 A settlor establishing a permanently endowed charitable trust can therefore be certain that the trustees will be precluded from distributing the permanently endowed funds (unless a statutory power to distribute permanent endowment applies[16]). The duty to consider the present and future demands of the specified charitable purpose does not necessitate such an absolute bar to distribution. When the current needs of charity are great, more public benefit may flow from distributing a significant amount of the charity's assets at one time. In other cases (where the current needs of the charity are not so great) it may be prudent to retain a greater proportion of the charity's assets for future exigencies. It is inevitable in the concept of charity that the level of demand for support will vary over time. Consider, for example, a charity which has as its purpose the provision of housing for the under-privileged. There may well be a greater need for housing following wartime destruction or a natural disaster. It is surely desirable that charities should be able to meet these pressing needs.

When may a permanent endowment be distributed?

6.20 Under the current law there are limited circumstances in which a charity's permanent endowment may be distributed as income.

Winding up of small charities

6.21 Section 75 of the Charities Act 1993 provides for the winding up of a "small" charity and distribution of its permanent endowment in limited circumstances. The section tackles the problem of permanently endowed charities which produce such little income (especially after the expenses of administration are taken into account) that they are unlikely to be able to further any charitable purpose effectively.

6.22 Section 75 is, however, of limited application. It only applies if:

> (a) the charity has a permanent endowment which does not include any land;[17]
>
> (b) the gross income of the charity in the previous financial year is not in excess of £1,000;[18]

[16] See below, paras 6.20 – 6.34.

[17] Charities Act 1993, s 75(1)(a).

[18] *Ibid*, s 75(1)(b).

> (c) the charity is neither an "exempt charity" nor a charitable company.[19]

6.23 If these conditions are met the charity trustees may, if they consider 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", resolve (by at least a two-thirds majority) to distribute the charity's permanent endowment.[20] Before making a resolution under section 75 the trustees must give consideration to whether

> a reasonable possibility exists of effecting a transfer or division of all the charity's property under section 74 [of the Charities Act 1993][21] (disregarding any such transfer or division as would, in their opinion, impose on the charity an unacceptable burden of costs).[22]

6.24 The trustees must publicly advertise and notify the Charity Commission of their resolution.[23] The Charity Commission must approve (or disapprove) the trustees' resolution within three months of notification before the trustees can proceed.[24]

Other powers of the Charity Commission

6.25 The Charity Commission has powers under section 16 of the Charities Act 1993 to establish "a scheme for administration of a charity".[25] The Charity Commission may only exercise this jurisdiction on the application of the charity or following a reference from the High Court or (provided the charity is not an "exempt charity"[26]) on the application of the Attorney General.[27] If the charity's total income does not exceed £500 per year the section 16 powers can additionally be invoked on the application of one or more of the trustees or of any person "interested" in the charity or of two or more inhabitants of an area served by a

[19] *Ibid*, s 75(1). "Exempt charity" is defined by section 3(5) of the Charities Act 1993 as any charity listed in Schedule 2 of that Act. "Charitable company" is defined by section 75(10) as "a charity which is a company or any other body corporate".

[20] *Ibid*, s 75(2).

[21] Section 74 allows trustees to pass a resolution to bring about the merger of two or more charities or the modification of a charity's purposes or terms of administration. The section applies if: (1) the charity's gross income in the previous financial year did not exceed £5,000; (2) it does not own any land "on trusts which stipulate that the land is to be used for the purposes, or any particular purposes, of the charity"; and (3) it is neither an "exempt charity" nor a charitable company (for definitions see above, n 19). There are certain considerations which the trustees are statutorily obliged to take into account before passing a resolution under the section (section 74(4)–(5)). The trustees must publicly advertise and notify the Charity Commission of their resolution (section 74(6); the Charity Commission must approve or disapprove of the trustees' resolution within three months of notification before the trustees can proceed (section 74(8)).

[22] Charities Act 1993, s 75(4).

[23] *Ibid*, s 75(5).

[24] *Ibid*, s 75(7).

[25] *Ibid*, s 16(1)(a).

[26] See definition above, n 19.

[27] Charities Act 1993, s 16(4).

local charity.[28] If the Charity Commission is satisfied that the trustees of a charity, other than an "exempt charity",[29] ought "in the interests of the charity" to apply for a scheme but have "unreasonably refused or neglected to do so" they may proceed as if an application had been made, provided that the trustees are given an opportunity to make representations.[30]

6.26 By section 26(1) of the Charities Act 1993, the Charity Commission has jurisdiction to authorise "any action … in the administration of a charity" which is "expedient in the interests of the charity … whether or not it would otherwise be within the powers exercisable by the charity trustees in the administration of the charity".[31]

6.27 The Charity Commission's power is very broad. Section 26(5) provides:

> An order under this section may authorise an act notwithstanding that it is prohibited by any of the disabling Acts[32] … or that the trusts of the charity provide for the act to be done by or under the authority of the court …

6.28 The power is not, however, unlimited:

> … but no such order shall authorise the doing of any act expressly prohibited by Act of Parliament other than the disabling Acts or by the trusts of the charity or shall extend or alter the purposes of the charity.[33]

6.29 The Charity Commission's powers to authorise the spending of a charity's permanent endowment were considered by the House of Lords at the Committee stage of the Bill which later became the Charities Act 1985. The relevant exchanges in the House[34] illustrate that the provisions of the 1985 Act relating to the expenditure of capital by small permanently endowed charities (now re-enacted in sections 74 and 75 of the 1993 Act)[35] were seen as a limited incursion into the principle that a settlor should be free to set up a charitable trust with a perpetual existence. Lord Brightman described the provision as "a last resort".[36] Much of the debate focussed on how small the charity would have to be before the powers would be engaged. This might suggest that the Charities Act 1993 is not intended to give the Charity Commission any broader powers to authorise the distribution of permanent endowment than those granted by sections 74 and 75.

[28] *Ibid*, s 16(5).

[29] See definition above, n 19.

[30] Charities Act 1993, s 16(6).

[31] *Ibid*, s 26(1).

[32] Section 26(6) of the Charities Act 1993 defines the "disabling Acts" as the Ecclesiastical Leases Acts 1571, 1572, 1575 and 1836.

[33] Charities Act 1993, s 26(5).

[34] *Hansard* (HL) 28 January 1985, vol 459 cols 518–526.

[35] See above, paras 6.21 – 6.24.

[36] *Hansard* (HL) 28 January 1985, vol 459, col 522.

6.30 However, the Charity Commission currently uses its powers under sections 16 and 26 to authorise expenditure of a charity's permanent endowment when it is expedient to do so, on the condition that the capital is recouped from future income.[37] Alternatively the Charity Commission might authorise a permanent endowment to be used to meet a particular capital disbursement. It is, however, quite a different matter to allow the trustees to distribute permanently endowed capital without an obligation to replace it. This results in the permanent depletion of the charity's assets and might undermine the charity's long-term stability.[38] It is also contrary to the settlor's intention settlor that his or her charitable donation should be held in perpetuity.

Proposed changes to the circumstances in which a permanent endowment may be distributed

6.31 The Strategy Unit of the Cabinet Office published a consultation document outlining possible reforms of charity law in September 2002.[39] The consultation document made several recommendations in relation to permanent endowments.[40] The Home Office's response to the Strategy Unit's consultation document approved all these proposals.[41] The Strategy Unit's recommendations on the expenditure of permanent endowment find their expression in the draft Charities Bill which (if enacted) will amend section 75 of the Charities Act 1993 and introduce two further sections whose effect would be to allow charity trustees, in prescribed circumstances, to distribute permanently endowed capital as if it were income.[42]

6.32 The proposed amendments to section 75 would allow more charities to fall within the provisions which enable "small" charities to distribute permanent endowment. The trustees of charities with annual income in excess of the £1,000 threshold would be permitted to distribute permanent endowment, provided that the value of the endowment fund does not exceed £10,000. The requirements for passing a resolution to distribute permanent endowment would also be relaxed; a simple majority of trustees would be sufficient[43] and the trustees would only need to be

[37] See "CC 38 – Expenditure and Replacement of Permanent Endowment" and "OG 83 B4 – Replacing Expenditure from a Charity's Investment Fund" (both available from *www.charitycommission.gov.uk*).

[38] The trustees are under a duty to take account of current and future needs of the charity. The unpredictability of the investment market means, however, that even a trustee who diligently discharges the duty when spending the trust's permanent endowment places the charity's future at risk.

[39] *Private Action, Public Benefit – A Review of Charities and the Wider Not-For-Profit Sector* (September 2002).

[40] *Ibid*, p 48, paras 4.65 – 4.67.

[41] *Charities and Not-For-Profits: A Modern Legal Framework* (July 2003), p 14, para 3.51.

[42] This Paper does not consider the second new section (section 75B) which deals with the particular case of a charity which is a "special trust" and is to be treated as a separate charity. The structure of section 75B broadly matches that of the proposed section 75A: see below, para 6.33.

[43] As opposed to the two-thirds majority of trustees required by the Charities Act 1993, s 75(3).

satisfied that "the purposes of the charity could be carried out more effectively" by the expenditure of capital as well as income.[44] The existing obligations of charity trustees to advertise the resolution publicly[45] and to obtain a notice of concurrence from the Charity Commission[46] would also be removed.

6.33 It is also proposed to add a new section 75A which would allow larger charities to distribute permanent endowment in specified circumstances. Section 75 (as amended) and section 75A would be mutually exclusive since the latter section would only be applicable if the financial condition laid down in section 75 were not met. Section 75A (like the amended section 75) would allow charity trustees, on the basis of a simple majority, to pass a resolution to distribute permanent endowment as if it were income where this would allow the purposes of the charity to be carried out "more effectively". The consent of the Charity Commission would not be required.[47] Section 75A(5)-(10) would introduce certain safeguards where the capital of the endowment fund came entirely from a particular individual or a particular institution. Broadly, these provisions would resurrect the "notice of concurrence" procedure which applies under section 75 of the Charities Act 1993 as currently enacted. The aim of these safeguards is to prevent charity trustees from subverting the settlor's intention to create a perpetual charity. Section 75A(8) would require the Charity Commission, when deciding whether to concur with the trustees' resolution, to consider the wishes of the donor as well as any changes in the circumstances relating to the charity including "its financial position, the needs of its beneficiaries, and the social, economic and legal environment in which it operates". The Charity Commission would not be permitted to concur with a resolution unless it were in keeping with "the spirit of the gift".[48] It should be noted that this is an "all-or-nothing" provision; it would not be possible to limit a resolution under this section to a particular part of the charity's permanent endowment.

6.34 The Charities Bill is currently in draft form. We therefore do not think it appropriate to comment on its provisions in this Paper. Since that part of the Lord Chancellor's reference which refers to permanently endowed charities has been largely overtaken by developments we do not propose to say anything further about this issue in this Consultation Paper.

[44] Under Charities Act 1993, s 75(2), the trustees could only resolve to distribute permanent endowment if they concluded that "the property of the charity is too small, in relation to its purposes, for *any useful purpose* to be achieved by the expenditure of income alone…" (emphasis added).

[45] Charities Act 1993, s 75(5)(a).

[46] *Ibid*, s 75(5)(b), (7), (8).

[47] It should be noted that in this regard section 75A gives somewhat wider powers to charity trustees to distribute permanently endowed funds than were envisaged by the Strategy Unit's original recommendations. The Strategy Unit recommended that any resolution of the trustees of a "larger charity" to distribute permanent endowment should be subject to the "notice of concurrence" procedure: see *Private Action, Public Benefit – A Review of Charities and the Wider Not-For-Profit Sector* (September 2002), p 48, paras 4.65 – 4.67.

[48] See the proposed section 75A(9)(a).

THE APPLICATION OF OUR PROPOSED CLASSIFICATION AND APPORTIONMENT SCHEME FOR PRIVATE TRUSTS TO CHARITIES

6.35 There are problems with applying our provisional proposals for private trusts in their entirety to charitable trusts. As noted above, it does not really make sense to talk about the duty to balance in the context of charitable trusts.[49] Instead, charity trustees are subject to a duty to consider the present and future needs of the charity (flowing from the overriding duty to promote the best interests of the charity's objects). In the absence of the duty to balance it is neither possible nor appropriate for charity trustees to exercise the statutory power of allocation as it is framed for private trusts.

We provisionally propose that charity trustees should not be subject to any duty to balance.

Do consultees agree?

We provisionally propose that the statutory power of allocation which is proposed for private trusts should not be available to charitable trusts.

Do consultees agree?

We invite the views of consultees on whether the duty of charity trustees to consider the present and future needs of the charity and its objects should be placed on a statutory footing.

6.36 The absence of a power of allocation has a "knock-on" effect on the proposed new rules of classification. In the interests of consistency and simplicity we consider that the same rules of classification should be applicable to charities as apply to private trusts.[50] However, the new rules of classification, which we have provisionally proposed for private trusts, only give a default classification which can be displaced by exercise of the trustees' statutory power of allocation. As a result of the absence of a power of allocation, the new rules of classification would not be subject to the exercise of a statutory power or to any time limit when applied to charities.[51]

We provisionally propose that our proposed rules of classification for the receipts and expenses of private trusts should also apply to charitable trusts but should apply to give conclusive rather than default classifications.

Do consultees agree?

6.37 Although charities are not expressly excluded from the scope of the Apportionment Act 1870 there seem to be few circumstances in which it would

[49] See above paras 6.14 – 6.19.

[50] See above, paras 5.3 – 5.18.

[51] There is also no need to adopt the default classification approach in the charitable context because no adverse tax consequences flow from the reclassification of receipts or outgoings from income to capital or vice versa.

actually apply in practice. In the rare cases where the destination of the income of a charitable trust changes from charitable purpose A to charitable purpose B this is likely to result from the determination of the A's interest on the occurrence of a determining event. The private trust cases on protective trusts indicate that the 1870 Act has no application in this context.[52] There is no authority on the point but it also seems unlikely that the equitable rules of apportionment, which grew as practical aids to the administration of private trusts in succession, apply to charities.

6.38 As noted above,[53] the rigid technicalities of the statutory and equitable rules of apportionment have been heavily criticised and they are routinely excluded in well-drawn trust instruments, but we believe that the basis of these rules, i.e. the duty to balance, remains valid for private trusts. This rationale of the rules totally falls away in the charitable context. The draft terms of reference for this project noted that the problems of charitable trusts come from "a different kind of rigidity". That rigidity is a result of the charity trustees' inability to spend the charity's permanent endowment as if it were income.[54] The Government's proposals in relation to the distribution of permanent endowment are outlined above.[55] We now turn to consider whether investment by permanently endowed charities should be liberalised through mechanisms to permit the adoption of total return investment policies.

DEVELOPMENTS TOWARDS THE ADOPTION OF TOTAL RETURN INVESTMENT

6.39 In 2000 the Charity Commission published a consultation document on investment by endowed charities.[56] The consultation offered three paths for the future:

(1) Continuation of then-current approach.

(2) Total freedom for charity trustees to spend or save capital as they please.

(3) "Total return".

The then-current approach

6.40 The Charity Commission noted that their (at that time) current approach caused few problems for charities which have only income funds or expendable endowments. They did, however, recognise that the current rules force the trustees of permanently endowed charities to take investment decisions on the basis of the anticipated form of investment returns when they should be aiming to produce the best overall economic return. Moreover trustees' best efforts to secure a balance between income and capital may fail. The rules are most

[52] *Re Sampson* [1896] 1 Ch 630 (Stirling J); *Re Gourju's Will Trusts* [1943] Ch 24 (Simonds J).

[53] See above, paras 3.36 – 3.43, 3.53, 3.63, 3.81 – 3.87.

[54] The distinction between the duty to balance and the bar on the expenditure of permanent endowment is considered above, paras 6.7 – 6.19.

[55] See above, paras 6.31 – 6.34.

[56] *Endowed Charities – A Fresh Approach to Investment Returns?* (July 2000).

deficient when dealing with extraordinary (and thus unexpected) investment returns.[57] The rules for classification of extraordinary dividends (i.e. the rule in *Bouch v Sproule*) can cause problems for endowed charities (whether permanent or expendable) as a charity may find that a large proportion of its capital value must be distributed as income at one time.[58]

Total freedom

6.41 The Charity Commission rejected the possibility of giving trustees complete and unfettered freedom to distribute capital (whether permanently endowed or not) or to accumulate income.[59] They stated that this would "effectively eliminate" the duty to consider the present and future needs of the charity, and that it would not "keep faith with those that set up charities with capital funds". This would fundamentally alter the nature of permanently endowed charities.

6.42 As we have noted, the inability to spend a charity's permanent endowment does not flow from the trustee's general duty to consider the present and future needs of the charity. The issues of expenditure of permanent endowment and the balancing of present and future needs via investment returns are separable. The Charity Commission could, therefore, have given trustees "total freedom" to allocate investment returns between income and capital without regard to the possible future requirements of the charity whilst leaving the permanent endowment intact. It is submitted, however, that this approach would not have been desirable because the trustee's duty to consider the present and future needs of the charity is an important aspect of the prudent administration of charities.

Total return investment

6.43 The Charity Commission favoured total return investment policies which abolish the distinction between capital and income for the purposes of distributing investment returns.[60] Such policies would allow trustees to invest with the aim of maximising economic returns without regard to their likely form. Trustees would be obliged, however, to exercise their discretion to distribute investment returns in accordance with a duty to consider the present and future needs of the charity.

6.44 The Charity Commission therefore proposed to use its powers under section 16 or section 26 of the Charities Act 1993 to authorise permanently endowed charities (on an individual basis) to allocate investment returns between income and capital, subject to the duty to take account of the charity's present and future needs.[61]

[57] *Ibid*, para 17.

[58] *Ibid*, para 16.

[59] *Ibid*, para 18 – 19.

[60] *Ibid*, para 20.

[61] The trustee would only be able to reallocate investment returns between income and capital if it would not prejudice the charity's perpetual existence to do so.

THE CHARITY COMMISSION'S CURRENT APPROACH TO INVESTMENT BY PERMANENTLY ENDOWED CHARITIES

6.45 In May 2001, the Charity Commission published some "operational guidance" regarding its policy in relation to total return.[62] This stated that authority to invest on the basis of total return may be given to charity trustees on an individual basis using the Charity Commission's powers under section 26 of the Charities Act 1993.[63] Broadly the requirements for authorisation are threefold:

(1) The charity must have a permanent capital endowment.

(2) It must be possible to distinguish between unapplied investment returns and the original gift and its accretions.

(3) The power must be in the charity's interests.

6.46 The trustees must determine how to allocate investment returns between the "trust for application" (i.e. income) and the "unapplied total return" (i.e. capital). Any returns which are allocated to the trust for application must, in accordance with the usual rules, be distributed in furtherance of the trust's charitable purposes within a reasonable time. The charity's unapplied total return may be allocated to the trust for application at any time. The trustees' decisions to allocate investment returns and/or unapplied total return to the trust for application must take account of their duty to consider the present and future needs of the charity.

6.47 The authorisation does not give the charity trustees a power to add funds which have already been allocated to the trust for application to capital. A separate power of accumulation is required to achieve this. Moreover the authorisation does not allow the expenditure of the charity's investment fund, i.e. its original permanent endowment. A separate authorisation is required for this, recognising the distinction between distributing a charity's original endowment and allocating the returns on that endowment between capital and income. This distinction was less apparent in the original consultation where the Charity Commission stated that they did not intend to undermine the principle of permanent endowment[64] but made proposals which seemed to go further and extend to the distribution of the permanently endowed capital.[65] At the same time the Charity Commission has concluded that it does have the power to authorise the expenditure of the

[62] See OG83; available from *www.charitycommission.gov.uk*.

[63] The Charity Commission notes that it might need to rely on its scheme-making powers (i.e. Charities Act 1993, s 16) where the trust instrument expressly prohibits the total return approach to investment. The Charity Commission also states that the trustees would be able to give themselves the authority to invest on a total return basis if the trust instrument contained a power to amend administrative provisions.

[64] *Endowed Charities – A Fresh Approach to Investment Returns?*, para 27: "…[w]e will not relax the concept of a permanent fund in ways that will undermine the primary object of a charity. Our policy in this area will need to recognise a donor's right to create a charity that will have future as well as current beneficiaries. It will also need to take into account the volatility of investment markets."

[65] *Endowed Charities – A Fresh Approach to Investment Returns?*, Appendix C, para C2 – C3.

charity's original permanent endowment. It should be noted, however, that this would ordinarily be on the basis that the expended capital should be recouped over a fixed period from future investment returns.

6.48 An order authorising total return investment will include certain directions to ensure that the present and future interests of the charity are protected. In particular there will be directions:

(1) Placing a duty of care on the trustees.

(2) Imposing a duty to identify the total return.

(3) Requiring the power to be exercised in accordance with the duty to balance the present and future needs of the charity.

(4) Imposing a duty to take advice.

(5) Imposing a duty to follow the directions of the Charity Commission.

(6) Imposing a duty to publicise the use of the power.

6.49 The upshot of these directions is that the trustees must establish a rational policy by which they periodically determine what proportion (if any) of the unapplied total return should be reallocated to the trust for application. This policy must take account of the need to balance the current and future needs of the charity. Relevant factors will include past and anticipated future changes in both the value of trust assets and the demands on the charity for support.

FACILITATING TOTAL RETURN INVESTMENT BY PERMANENTLY ENDOWED CHARITIES: THE WAY FORWARD

6.50 Our goal of encouraging total return investment by charities has already been adopted by the Charity Commission and has been endorsed by the Government.[66] It may nevertheless be appropriate to consider the possible advantages of enacting legislation of general application to replace the current *ad hoc* approach to authorising charities to invest on a total return basis.

6.51 In British Columbia legislation already permits the Vancouver and Victoria Foundations to invest and distribute their investment returns on a total return basis.[67] These non-governmental charitable foundations hold permanent endowments and distribute their investment returns to further a wide range of charitable purposes throughout British Columbia.

6.52 The legislation requires the Vancouver Foundation to distribute, at least once in each tax year, "the portion of returns that it considers proper".[68] The governing

[66] *Private Action, Public Benefit – A Review of Charities and the Wider Not-For-Profit Sector*, p 48, para 4.68.

[67] Vancouver Foundation Act, SBC 2000, c 32, s 10; Victoria Foundation Act, SBC 2000, c 33, ss 8-9.

[68] Vancouver Foundation Act, s 10(1).

board of the foundation is statutorily obliged,[69] when exercising its dispositive powers, to develop "retention and distribution policies" which take account of:

> (1) the need to maintain an appropriate balance between the capital endowment and the level of annual distributions;
>
> (2) expected investment returns;
>
> (3) the current and potential future needs of the foundation;
>
> (4) the level of distributions required by any applicable tax laws;
>
> (5) any other factors which it deems to be relevant.

6.53 The total return provisions of the Vancouver Foundation Act apply to all property held by the Vancouver Foundation whether received before or after their enactment.[70] The provisions do not apply if the terms of a particular donation express a contrary intention.[71] No contrary intention will be manifested solely because a donation is designated as an endowment[72] or is subject to a direction "to use only 'income', or 'interest' or 'dividends, or to 'preserve capital', or [is subject to] any term or terms of similar import".[73]

6.54 The Victoria Foundation operates on a different model of total return investment. The governing board of the foundation may distribute any proportion of the annual investment returns (whether received in the form of income or capital) "for purposes consistent with the objects of the foundation".[74] This discretion is absolute[75] except insofar as the governing board must respect all terms and conditions expressed by the donor in the trust instrument governing the donation in question.[76] After the death of the donor (or the winding up of a corporate donor) the board may ignore any such terms or conditions "to the extent necessary to further the objects of the foundation".[77]

6.55 The Victoria Foundation Act goes somewhat further than the Vancouver Foundation Act insofar as it provides authority for the board to "borrow" from the permanent endowment and to distribute capital in order to further the foundation's objects.[78] This power is available where the terms of the gift in question expressly

[69] *Ibid*, s 10(2).

[70] *Ibid*, s 10(5).

[71] *Ibid*, s 10(6).

[72] *Ibid*, s 10(7)(a).

[73] *Ibid*, s 107(b).

[74] Victoria Foundation Act, s 8(1).

[75] *Ibid*, s 8(1).

[76] *Ibid*, s 8(2).

[77] *Ibid*, s 8(3).

[78] *Ibid*, s 9.

require it.[79] The power may also be exercised following a unanimous resolution of the governing board provided that:

> (1) the capital distribution does not exceed five per cent of the total endowment held by the foundation;
>
> (2) the capital which is distributed must be replaced from investment returns unless a donation is made to the foundation for the purpose of replacing the distributed capital; and
>
> (3) no further distributions of capital can be made until the distributed capital has been replaced.[80]

6.56 In November 2001, the British Columbia Law Institute ("BCLI") published a report on "Total Return Investing by Trustees".[81] The BCLI recommended that any trustee who holds property on charitable trusts or as an endowment for a charitable or non-profit making organisation should be able to invest so as to maximise investment returns without regard to the form which returns might take.[82] Total return investment would be available automatically in the absence of contrary provision in the terms of the trust or legislation governing the investment of the property. These proposals would apply to all charitable trusts and endowed non-profit making organisations regardless of the date of their creation. Similar recommendations have been made by the Manitoba Law Reform Commission[83] and the Saskatchewan Law Reform Commission.[84]

6.57 In the context of our provisional proposals, the absence for charities of a statutory power of allocation (equivalent to that which we propose to make available for private trusts) means that an alternative mechanism will need to be provided if permanently endowed charities are to enjoy the advantages of total return investment.

6.58 We see three ways of allowing charitable trusts to invest on a total return basis. The first option is to maintain the current system whereby trustees of permanently endowed charities must apply to the Charity Commission for authorisation on an individual basis.[85] We do not believe that the proposal to place the existing rules

[79] *Ibid*, s 9(a).

[80] *Ibid*, s 9(b).

[81] This paper is currently being considered by British Columbia's Ministry of the Attorney General. No firm indications have been made concerning the prospect of legislative implementation of its proposals.

[82] (2001) BCLI Report No 16, p 22.

[83] Trustee Investments: The Modern Portfolio Theory (1999) MLRC Report No 101, p 32. This report is currently being considered by the Manitoban Department of Justice. There has so far been no indication as to whether or not and, if so, when legislation to enact its recommendations will be brought forward.

[84] Proposals for Reform of the Trustees Act (2002) SLRC Report. This report is currently being reviewed by the Saskatchewan Department of Justice but, as yet, there has been no indication as to whether the proposals have been accepted.

[85] See above, paras 6.45 – 6.49.

of classification on a statutory footing will prevent the Charity Commission from authorising total return policies on the basis that such an authorisation would "cut across" statutory provisions. Although the rules of classification are expressed to be "conclusive" we envisage that any legislation would make clear that this classification was subject to the power of the Charity Commission to authorise investment on a total return basis. This first approach to total return investment has the benefit of focussing the minds of charity trustees on the need to maintain the value of the permanent endowment in real terms. It also allows the Commission to confirm that, for the particular charity in question, it is possible to draw a distinction between the investment returns to which the power applies and those which should be considered as accretions to the original gift. This approach notifies the Charity Commission of the trustees' intentions and also gives the trustees ready access to the Charity Commission's operational guidance. The obvious disadvantage of this approach is that, despite the best efforts of the Charity Commission to make the procedure as expeditious as possible given the inevitable complexities in this difficult area, making an individual application for authorisation may be relatively costly, time-consuming and inconvenient.

6.59 If the first option is preferred charity trustees who do not apply to the Charity Commission for total return investment powers will have no means of adjusting investment returns and expenses in cases where those returns or expenses fail to balance the current and future needs of the charitable objects. However, in exceptional cases where the rules of classification produce an illogical result the trustees would, we believe, be able to ask the Charity Commission to authorise them to restore an appropriate balance. Moreover, it may be desirable (given that some doubts have been raised about the legal basis for the authorisation of total return policies by the Charity Commission) for some legislative confirmation of the scope of the Charity Commission's powers in this area. For this reason, we invite the views of consultees on whether, should the first option be adopted, the procedure for applying for and obtaining authorisation from the Charity Commission for total return investment should be placed on a statutory footing.

6.60 The second option is to grant a general statutory power to all permanently endowed charities on similar terms to that currently granted by the Charity Commission.[86] This would have the advantage of authorising all charities to invest on a total return basis without requiring each charity to make an individual application.[87] 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.[88] The Charity Commission has already considered the fiduciary duties to which charity trustees

[86] See above, paras 6.45 – 6.49.

[87] The Charity Commission has no power to lay down general authorisations.

[88] It should also be noted that the draft Charities Bill confers on the Charity Commission a power (akin to that provided to the court under section 61 of the Trustee Act 1925) to excuse charity trustees from an honest and reasonable breach of trust for which the trustee "ought fairly to be excused" from personal liability.

who are authorised to invest on a total return basis are subject.[89] In particular, charity trustees are under a duty to consider the present and likely future needs of the charity before deciding what is in the best interests of the charity. We consider that any general statutory power should be subject to this duty. Moreover, in the context of permanently endowed charities it is necessary to maintain the value of the original endowment in real terms in order to give effect to the settlor's intention that the charity should have a perpetual existence. This would preclude giving trustees the power to allocate freely all investment returns between income and capital. Some of the investment returns would have to be "ring-fenced" in order to maintain the value of the endowment.

6.61 A third, and in our view the best, option is a hybrid of the first and second options. Charity trustees would be given a general statutory power to invest on a total return basis.[90] If the trustees do, however, decide to avail themselves of the power they would, on an annual basis, be required to report this decision and (even if they are not otherwise required to do so) submit the accounts of the charity to the Charity Commission.[91] This would allow the Charity Commission to monitor, scrutinise and, if appropriate, query the decisions of charity trustees investing on a total return basis. We consider that this would reduce the burden on the Charity Commission (by comparison with the system of individual authorisations envisaged in the first option) whilst retaining some control over the activities of charity trustees.

We provisionally propose that charity trustees should have a general statutory power to invest on a total return basis. If the trustees chose to invest on a total return basis, they would be required to report this decision and submit the charity's accounts to the Charity Commission each year.

Do consultees agree?

We invite the views of consultees on whether or not, if the current system of individual authorisations by the Charity Commission is maintained, the procedure for applying for and obtaining authorisation should be placed on a statutory footing.

[89] See above, para 6.48.

[90] As with the second option, trustees would be under a duty to consider whether it was appropriate to make use of the power. We do not consider, however, that it would inevitably be a breach of trust not to do so. Total return investment may not be suitable for all charities therefore trustees will be able to discharge their duty through a properly considered decision not to use the power. The exculpatory powers to be conferred on the Charity Commission by the draft Charities Bill (see above, n 88) should also be noted.

[91] Section 41 of the Charities Act 1993 obliges all charity trustees to keep "accounting records". Section 42 requires all charity trustees to prepare an "annual statement of accounts". However, under section 45(3) of the Charities Act 1993 only charities with a gross income or total expenditure in excess of £10,000 are required to submit an "annual report" to the Charity Commission. This "annual report" should include the statement of accounts prepared under section 42 of the Charities Act 1993. Nothing in the draft Charities Bill appears set to change this position.

PART VII
CONSULTATION QUESTIONS

INTRODUCTION

In this Part we list the specific questions for consultees which we have asked in this Paper. We welcome comments from readers on any, or all, of these questions and on any other issues raised by this Paper.

It would be very helpful if, when responding, readers could note the paragraph number of the summary that follows.

CONSULTATION QUESTIONS

Human rights

7.1 We would welcome the views of consultees on the human rights implications of the provisional proposals described in this Paper.

(Paragraph 1.24)

Regulatory impact

7.2 We would welcome any information or views from consultees about the regulatory impact of our provisional proposals.

(Paragraph 1.25)

Classification

7.3 We provisionally propose that the existing rules for the classification of distributions by corporate entities to trustee-shareholders should be abolished. Do consultees agree?

(Paragraph 5.12)

7.4 We provisionally propose that cash distributions to trustee-shareholders by corporate entities (excluding payments made on liquidation or on an authorised reduction of capital), 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. Do consultees agree?

(Paragraph 5.12)

7.5 We provisionally propose that the existing rules for the classification of trust receipts other than distributions from corporate entities should be retained. Do consultees agree?

(Paragraph 5.15)

7.6 We invite the views of consultees on whether the existing rules for the classification of trust receipts other than distributions from corporate entities should be placed on a statutory footing.

(Paragraph 5.15)

7.7 We provisionally propose that the law regarding the classification of trust expenses should remain unchanged. The rule laid down by the House of Lords in *Carver v Duncan* should continue to apply. Do consultees agree?

(Paragraph 5.17)

7.8 We invite the views of consultees on whether the rule in *Carver v Duncan* should be placed on a statutory footing.

(Paragraph 5.17)

7.9 We provisionally propose that the rules of classification for trust receipts and expenses should be subject to any contrary provision in the terms of the trust. Do consultees agree?

(Paragraph 5.18)

The duty to balance

7.10 We provisionally propose that there should not be a non-exhaustive statutory list of relevant factors to help trustees determine whether or not a balance has been struck between the competing interests of income and capital beneficiaries. Do consultees agree?

(Paragraph 5.26)

7.11 If consultees do not agree, we invite their views on which factors should be included in such a list.

(Paragraph 5.26)

7.12 We invite the views of consultees on whether or not a trustee's duty to balance the interests of income and capital beneficiaries should be given a statutory basis.

(Paragraph 5.28)

7.13 We provisionally propose that trustees should be subject to the duty to balance except insofar as the settlor expressly, or by necessary implication, excludes or modifies that duty in the terms of the trust. Do consultees agree?

(Paragraph 5.31)

7.14 We provisionally propose that the duty to balance should not be impliedly excluded insofar as it relates to the original trust property because that property constitutes an authorised investment, because it was the subject of a specific gift (including any gift of realty or any gift in an *inter vivos* settlement) or because

there is a power to postpone conversion of the original trust assets. Do consultees agree?

(Paragraph 5.31)

Percentage trusts

7.15 We invite the views of consultees on the advantages and disadvantages of promoting percentage trusts within England and Wales.

(Paragraph 5.38)

A new trustee power of allocation

7.16 We provisionally propose that a statutory power of allocation should be made available to the trustees of private trusts to enable them to discharge their duty to balance and thereby to promote total return investment policies. Do consultees agree?

(Paragraph 5.48)

7.17 We provisionally propose that the exercise of the statutory power of allocation, where it is available, should be subject to a time limit from the date of a particular receipt or expense, after which time the default classification would become conclusive. Do consultees agree?

(Paragraph 5.48)

7.18 We invite the views of consultees on the appropriate length of such a time limit.

(Paragraph 5.48)

7.19 We invite the views of consultees on the practical implications of our provisional proposals, particularly in relation to accounting and keeping track of individual receipts.

(Paragraph 5.48)

7.20 We invite the views of consultees on whether the provisionally proposed power of allocation should be available on an opt-in or opt-out basis.

(Paragraph 5.55)

7.21 We provisionally propose that the personal circumstances of beneficiaries should not be a relevant factor in the exercise of the statutory power of allocation.

(Paragraph 5.66)

7.22 We invite the views of consultees on whether or not the *Nestlé* approach (that personal circumstances of the beneficiaries are a relevant factor in discharging the duty to balance through the formulation of investment policy) is correct.

(Paragraph 5.76)

7.23 If consultees believe the *Nestlé* approach to be incorrect, we provisionally propose that the duty to balance should be statutorily redefined to exclude the personal circumstances of beneficiaries as a relevant factor. Do consultees agree?

(Paragraph 5.76)

7.24 We invite any further views of consultees on factors which should be relevant (or irrelevant) to the duty to balance or to the exercise of the statutory power of allocation.

(Paragraph 5.77)

7.25 We provisionally propose that the exercise (or non-exercise) of the statutory power of allocation should be subject to review by the courts on the same basis as any other discretionary power conferred upon trustees. Do consultees agree?

(Paragraph 5.82)

7.26 We provisionally propose that, in principle, an action for breach of trust should lie against trustees who fail to discharge their duty to balance. Do consultees agree?

(Paragraph 5.82)

7.27 We invite the views of consultees on whether a special protocol concerning the resolution of disputes over the exercise of the proposed power of allocation would be of assistance to trustees and beneficiaries.

(Paragraph 5.82)

The equitable rules of apportionment

7.28 We provisionally propose that all the existing equitable rules of apportionment should be abrogated. Do consultees agree?

(Paragraph 5.85)

The Apportionment Act 1870

7.29 We provisionally propose that the statutory apportionment rule contained in section 2 of the Apportionment Act 1870 should not apply to trusts except insofar as the terms of the trust (expressly or by necessary implication) express a contrary intention. Do consultees agree?

(Paragraph 5.87)

7.30 We provisionally propose that when trustees receive a payment of income in respect of a period during which two (or more) individuals (or classes of individuals) were entitled to income, they should have a statutory power to apportion when, and in the manner in which, they, in their absolute discretion, deem it just and expedient. Do consultees agree?

(Paragraph 5.88)

Trusts for sale

7.31 We provisionally propose that where a settlor expressly creates or statute imposes a trust for sale (without a power to postpone sale), trustees should continue to be under a duty to convert the trust property and reinvest the proceeds. Do consultees agree?

(Paragraph 5.89)

7.32 We provisionally propose that the first branch of the rule in *Howe v Earl of Dartmouth* should be abrogated. Do consultees agree?

(Paragraph 5.91)

Scope of the provisional proposals

7.33 We provisionally propose that the scheme set out in this Part should be made applicable to all private trusts which are governed by the law of England and Wales and in which there is a division of the capital and income interests. Do consultees agree?

(Paragraph 5.92)

7.34 We invite the views of consultees on whether there are any specific types or categories of private trust to which the provisional proposals in this Part should not apply (or to which they should apply in modified form).

(Paragraph 5.92)

Transitional provisions

7.35 We invite the views of consultees on whether our provisional proposals should apply to trusts created before the proposals come into force if the proposed statutory power of allocation applies on an opt-out basis.

(Paragraph 5.96)

7.36 We invite the views of consultees on whether or not the trustees of pre-existing trusts should be able to opt in to the statutory power of allocation.

(Paragraph 5.98)

7.37 We invite the views of consultees on whether or not the trustees of pre-existing trusts, if they are able to opt in to the statutory power of allocation in order to adopt a total return investment policy, should be required to seek the approval of the court before adopting such policies.

(Paragraph 5.98)

7.38 We provisionally propose that any legislative reform based on our provisional proposals should take effect on the first day of the tax year following the enactment of any implementing legislation. Do consultees agree?

(Paragraph 5.99)

Tax implications of the provisional proposals

7.39 We would welcome comments of any nature on the tax implications of the provisional proposals contained in this Paper.

(Paragraph 5.101)

Charities

7.40 We provisionally propose that charity trustees should not be subject to any duty to balance. Do consultees agree?

(Paragraph 6.35)

7.41 We provisionally propose that the statutory power of allocation which is proposed for private trusts should not be available to charitable trusts. Do consultees agree?

(Paragraph 6.35)

7.42 We invite the views of consultees on whether the duty of charity trustees to consider the present and future needs of the charity and its objects should be placed on a statutory footing.

(Paragraph 6.35)

7.43 We provisionally propose that our proposed rules of classification for the receipts and expenses of private trusts should also apply to charitable trusts but should apply to give conclusive rather than default classifications. Do consultees agree?

(Paragraph 6.36)

7.44 We provisionally propose that charity trustees should have a general statutory power to invest on a total return basis. If the trustees chose to invest on a total return basis, they would be required to report this decision and submit the charity's accounts to the Charity Commission each year. Do consultees agree?

(Paragraph 6.61)

7.45 We invite the views of consultees on whether or not, if the current system of individual authorisations by the Charity Commission is maintained, the procedure for applying for and obtaining authorisation should be placed on a statutory footing.

(Paragraph 6.61)