Law
Commission
Reforming the law

Capital and Income in Trusts: Classification and Apportionment
Analysis of Responses

Law Com No 315 (Analysis of Responses)

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In agreement with the provisional proposal: 21 (78%) 16

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In agreement with the provisional proposal: 22 (85%) 22

In qualified agreement with the provisional proposal: 1 (4%) 22

Not in agreement with the provisional proposal: 2 (8%) 22

Other comments 23

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Existing rules should not be placed on a statutory footing: 13 (59%) 23

Existing rules should be placed on a statutory footing: 9 (41%) 24

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 24

In agreement with the provisional proposal: 19 (73%) 24

Qualified agreement with the provisional proposal: 2 (8%) 25

Not in agreement with the provisional proposal: 5 (19%) 26

Other comments 27

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Existing rule should be placed on a statutory footing: 10 (40%) 28

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In agreement with the provisional proposal: 20 (90%) 29

In qualified agreement with the provisional proposal: 1 (5%) 29

Not in agreement with the provisional proposal: 1 (5%) 29

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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 29

In agreement with the provisional proposal: 21 (84%) 29

Neutral on the issue of a non-exhaustive statutory list of factors: 1 (4%) 30

Not in agreement with the provisional proposal: 3 (12%) 31

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In favour of giving the duty to balance a statutory basis: 18 (67%) 32

Against giving the duty to balance a statutory basis: 8 (30%) 34

Neutral on the issue of giving the duty to balance a statutory basis: 1 (4%) 35

Other comments 35

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 36

In agreement with the provisional proposal: 21 (84%) 36

In partial agreement with the provisional proposal: 2 (8%) 36

Not in agreement with the provisional proposal: 2 (8%) 36

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 37

In agreement with the provisional proposal: 18 (82%) 37

In qualified agreement with the provisional proposal: 1 (5%) 38

Not in agreement with the provisional proposal: 3 (14%) 38

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7.15 We invite the views of consultees on the advantages and disadvantages of promoting percentage trusts within England and Wales 38

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Neutral on issue of percentage trusts: 3 (17%) 40

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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 45

In agreement with the provisional proposal: 13 (54%) 45

In qualified agreement with the provisional proposal: 4 (17%) 45

Not in agreement with the provisional proposal: 7 (29%) 47

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Other comments in relation to total return investment policies 51

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 53

In agreement with the provisional proposal: 20 (91%) 53

In qualified agreement with the provisional proposal: 1 (5%) 53

Not in agreement with the provisional proposal: 1 (5%) 54

7.18 We invite the views of consultees on the appropriate length of such a time limit 54

(1) Three months after tax year end 56

(2) Four months after tax year end 56

(3) Six months after tax year end 56

(4) One year after tax year end 56

(5) Three months from receipt or expense 56

(6) Six months from receipt or expense subject to extension by resolution of the trustees 56

(7) Year and a half to two years from receipt or expense 56

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Power of allocation should be available on an opt-in basis: 6 (33%) 61

Power of allocation should be available on an opt-out basis: 12 (67%) 62

Other comments 62

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 64

In agreement with the provisional proposal: 15 (56%) 64

Trustees should be permitted but not obliged to take account of the personal circumstances of the beneficiaries: 11 (41%) 65

Trustees should be obliged to take personal circumstances into account: 1 (4%) 67

Other comments 67

7.22 We invite the views of consultees on whether or not the *Nestle* 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 69

Of the view that the *Nestle* approach is correct: 10 (59%) 69

Of the view that the *Nestle* approach is incorrect: 7 (41%) 70

Other comments 71

7.23 If consultees believe the *Nestle* 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 71

In agreement with the provisional proposal: 4 (57%) 71

Not in agreement with the provisional proposal: 3 (43%) 71

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 71

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 72

In agreement with the provisional proposal: 27 (100%) 72

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 74

In agreement with the provisional proposal: 23 (96%) 74

In qualified agreement with the provisional proposal: 1 (4%) 76

Other comments 76

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 76

In favour of a pre-action protocol: 10 (56%) 76

Not in favour of a pre-action protocol: 8 (44%) 77

THE EQUITABLE RULES OF APPORTIONMENT **78**

7.28 We provisionally propose that all the existing equitable rules of apportionment should be abrogated 78

In agreement with the provisional proposal: 18 (75%) 78

In qualified agreement with the provisional proposal: 6 (25%) 79

Other comments 80

THE APPORTIONMENT ACT 1870 **81**

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 81

In agreement with the provisional proposal: 22 (88%) 81

Not in agreement with the provisional proposal: 3 (12%) 81

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 82

In agreement with the provisional proposal: 14 (61%) 82

Not in agreement with the provisional proposal: 9 (39%) 83

TRUSTS FOR SALE **84**

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 84

In agreement with the provisional proposal: 13 (59%) 84

Not in agreement with the provisional proposal: 9 (41%) 84

Other comments 85

7.32 We provisionally propose that the first branch of the rule in *Howe v Earl of Dartmouth* should be abrogated 86

In agreement with the provisional proposal: 23 (100%) 86

SCOPE OF THE PROVISIONAL PROPOSALS 87

7.33 We provisionally propose that the scheme set out in this Part [i.e. Part V of the Consultation Paper] 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 87

In agreement with the provisional proposal: 19 (95%) 87

In qualified disagreement with the provisional proposal: 1 (5%) 88

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 [i.e. Part V of the Consultation Paper] should not apply (or to which they should apply in modified form) 88

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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 89

In favour of applying the statutory power of allocation automatically to pre-existing trusts: 8 (38%) 89

In favour of applying the statutory power of allocation to pre-existing trusts *if* the power of allocation is introduced at all: 2 (10%) 90

Not in favour of applying the statutory power of allocation automatically to pre-existing trusts: 10 (48%) 90

Unclear whether or not in favour: 1 (5%) 91

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 91

In favour of allowing the trustees of pre-existing trusts to opt in to the statutory power of allocation: 13 (62%) 91

Not in favour of allowing the trustees of pre-existing trusts to opt in to the statutory power of allocation: 7 (33%) 92

Unclear whether or not in favour: 1 (5%) 92

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 92

In favour of requiring trustees to seek court approval: 5 (31%) 92

Not in favour of requiring trustees to seek court approval: 11 (69%) 93

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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 94

In agreement with the provisional proposal: 19 (95%) 94

Not in agreement with the provisional proposal: 1 (5%) 95

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7.39 We would welcome comments of any nature on the tax implications of the provisional proposals contained in this Paper 95

CHARITIES 100

7.40 We provisionally propose that charity trustees should not be subject to any duty to balance 100

In agreement with the provisional proposal: 10 (59%) 100

In qualified agreement with the provisional proposal: 1 (6%) 101

Not in agreement with the provisional proposal: 6 (35%) 102

7.41 We provisionally propose that the statutory power of allocation which is proposed for private trusts should not be available to charitable trusts 103

In agreement with the provisional proposal: 7 (39%) 103

In qualified agreement with the provisional proposal: 1 (6%) 103

Not in agreement with the provisional proposal: 10 (56%) 103

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 105

In favour of placing the duty to consider the present and future needs on a statutory footing: 6 (40%) 105

Qualified agreement with placing the duty to consider the present and future needs on a statutory footing: 1 (7%) 105

Not in favour of placing the duty to consider the present and future needs on a statutory footing: 8 (53%) 106

Other comments 107

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 107

In agreement with the provisional proposal: 6 (43%) 107

In qualified agreement with the provisional proposal: 2 (14%) 108

Not in agreement with the provisional proposal: 6 (43%) 108

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 109

In agreement with the provisional view: 11 (61%) 109

In qualified agreement with the provisional proposal: 3 (17%) 112

Not in agreement with the provisional proposal: 4 (22%) 113

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 114

If retained, the current system of Charity Commission authorisations should be placed on a statutory footing: 12 (75%) 114

If retained, the current system of Charity Commission authorisations should not be placed on a statutory footing: 4 (25%) 115

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CAPITAL AND INCOME IN TRUSTS: CLASSIFICATION AND APPORTIONMENT – ANALYSIS OF RESPONSES

INTRODUCTION

This is an analysis of responses to the 2004 consultation paper.[1] It was used in the preparation of the Report on Capital and Income in Trusts: Classification and Apportionment[2] and should be read in conjunction with that Report.

The analysis is of responses to the 2004 Consultation Paper; it does not include any material from further correspondence with consultees. It sets out the consultation questions in full, numbered and ordered as they were in Part VII of the Consultation Paper.

Forty-two responses were received. We have grouped them into the following categories: judges (J); legal practitioners (P); academics (A); organisations (including professional bodies) (O); individuals (I); trustees and trust companies (T); government departments and agencies (G). Where a consultee falls within two or more of the above categories the most appropriate single category for the response has been selected. Of the responses, 5 were from judges, 11 were from legal practitioners, 5 were from academics, 11 were from organisations, 3 were from individuals, 5 were from trustees or trust companies and 2 were from government departments and agencies. Appendix A contains a list of consultees. Appendix B lists consultees by group.

It should be noted that some consultees submitted identical responses for two or more different institutions. These responses have been treated separately for statistical purposes. The total number of consultees who responded to each question appears below that question, followed by that number expressed as a percentage of the total number of consultees. The number of consultees who agreed and disagreed with the provisional position is then given, followed by that number expressed as a percentage of the number who responded to the question. A general overview of the respondents' specific comments is then given. Percentages are rounded to the nearest whole number.

We would emphasise that numbers are to be viewed with caution; the views of our consultees are not necessarily the views of the population or of the legal profession. A consultee's view may not be shared be others; equally, when given by a large organisation, it may represent the view of a very large group. Our approach to consultation responses is that they are to be evaluated and taken into consideration; they are weighed, not counted.

1 Capital and Income in Trusts: Classification and Apportionment (2004) Law Commission Consultation Paper No 175.

2 Capital and Income in Trusts: Classification and Apportionment (2009) Law Com No 315.

ANALYSIS OF RESPONSES

HUMAN RIGHTS

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

1. This question was answered by 13 consultees (31%).

No human rights implications: 10 (77%): J1, O2, P2, I2, T5, I3, O8, P8, O10, O11

2. J1 (Association of District Judges) stated "we do not consider that the recommendations proposed in the Paper will have a human rights impact but rather that they seek to clarify in a more balanced way than hitherto the rights of the income and capital beneficiaries".

3. O4 (UK STEP Technical Committee) said:

> We have not initially identified any material human rights considerations in the provisional proposals. In general terms, however, we would observe that the main impact would be potentially in certain circumstances to affect the way in which trust property held for a class of beneficiaries is allocated between those with rights to income and capital respectively, on the basis that the underlying thrust of the proposals is to continue to ensure such respective rights are duly balanced. We do not believe in overall terms that the implications are adverse.

One consultee made a positive argument against the human rights compatibility of the current law

4. P2 (Christopher McCall QC) suggested that the existing rules of classification for corporate receipts give the life tenant "in effect … a right to expropriate a substantial share of capital".

Possible human rights implications: 3 (23%): J2, J4, P7

A few consultees were concerned about the human rights implications of applying our provisional proposals to pre-existing trusts

5. J4 (The Hon Mr Justice Lloyd) made the general observation that:

> As I see it the only situation in which a human rights issue would arise is if the proposed new regime, or part of it, were to apply to trusts in existence at the date when the legislation comes into force. For future trusts, the regime would be part of the general law of trusts, applicable to new trusts as and when created, subject to a settlor's power to opt-out, insofar as the legislation allows this.

6. The consultee noted that the treatment of existing trusts "needed to be considered separately in relation to different aspects of the proposals":

> The change in the rule as regards classification of corporate receipts would be capable of affecting adversely the interests of either capital or income beneficiaries as compared with the present law.

7. However:

> By itself the enactment of a statutory duty to balance would be most unlikely to affect any beneficiary's possessions, especially if it was subject to contrary intention in the trust instrument.

8. Similarly:

> On the face of it the exclusion of the rules of apportionment would make only a very marginal difference to the rights of beneficiaries. In most cases they are already expressly excluded. Given the time and expense involved in carrying them into effect if they do apply, it seems to me that there is a strong case for saying that their abolition, and their replacement with a statutory power of allocation is likely to be neutral in effect in any particular case.

9. J2 (The Hon Mr Justice Etherton) was "not entirely confident that, if the proposals were to apply automatically to existing trusts, they would not give rise to, at least, an arguable case of incompatibility with … Article 1 of the First Protocol [of the ECHR]", especially in light of the broad interpretation which has been given to the concept of "possessions" under Article 1.

10. In particular, J2 (The Hon Mr Justice Etherton) highlighted the consequences of applying our provisionally proposed replacement for the rule in *Bouch v Sproule* automatically to existing trusts. This would amount to:

> … a change to the present, future and contingent rights of those entitled from time to time to income … . The change [would be] made without the knowledge or consent of the settlor, when he created the trust, and may be incompatible with his wishes … .

11. J2 (The Hon Mr Justice Etherton) recognised that:

> … even if that conclusion is correct, there is still a substantial argument that there would be no infringement of Article 1 [of the First Protocol of the ECHR] because the proposed reforms are 'in accordance with the general interest' and may be said to be proportionate to the aim pursued.

12. Similar thoughts were expressed by P7 (Herbert Smith).

REGULATORY IMPACT

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

13. See also responses to question 7.19 and 7.20.

Several consultees highlighted the beneficial effects of simplifying the law

14. J1 (Association of District Judges) commented that "the current law is very complex and the proposals appear to simplify the law so that the impact on trustees and their obligations appears beneficial".

15. P2 (Christopher McCall QC) considered that:

> … the regulatory impact of rule changes such as proposed would be minimal compared with the advantage in terms of tempering regulatory burdens which would follow from the proposed power of allocation, and I think that must be particularly true if the rules can be extended into the realms of charity.

16. A2 (W A Lee) doubted whether:

> … trustees are now being expected to take on any duties that are more onerous than they were formerly under the list-based approach to investment]. Modern portfolio theory is not as arcane as the paraphernalia of the old rules [of apportionment] that derived from list investing. If trustees find the brave new world intimidating they can of course resign.

17. One consultee (P2 - Christopher McCall QC) dealt specifically with the regulatory impact of an opt-out as opposed to opt-in system and concluded that an opt-out system would impose no greater regulatory burdens than an opt-in scheme.

Some consultees highlighted the potential administrative inconvenience of the Commission's proposed scheme, especially in relation to small trusts (although it should be noted that many of these comments assume that the scheme would operate on an opt-out basis)

18. O2 (City of Westminster and Holborn Law Society) stated that "one of the drawbacks of the Commission's suggested scheme is that it could involve an additional administrative process".

19. I2 (Toby Harris) commented that "where the amounts are small, trustees and beneficiaries simply will not tolerate the expenditure of professional time on the issue. In relation to small trusts, therefore, 'rough justice' should always prevail over finely balanced judgment".

20. T5 (Paul Saunders) referred to "significant additional costs" and argued that the proposals would increase the work involved in a trusteeship (see comment in response to question 7.19 for detail). The consultee also referred to possible "knock-on effects" on other investors:

> … if trustees invest in reliance upon the "total return" principle, unless the investments produce an income stream sufficient to meet the identified income requirement, the trustees will need to realise investments to meet that income need. If trustees, as a group, are the largest class of shareholders within most companies this might strongly influence the manner in which companies view the need to make distributions and, thereby, have a significant effect upon other investors, whose objectives differ from those of trustees.

21. P6 (Bircham Dyson Bell) considered that:

> … the additional work that [the provisional proposals] could involve should not be underestimated. Colleagues in this firm who have had personal experience of the operation of such a power in relation to US trusts have commented that while such a power can be of benefit, for the smaller trust the additional burdens of trustee meetings, record keeping and accounting are likely to outweigh any advantages.

22. P10 (Charles Russell) thought that:

> … even in the case of a simple trust a trustee will need to specifically address the question of whether to allocate income to capital and vice versa. The trustees of such trusts who might not normally have needed to meet even on an annual basis may now need to do so. In more complex trusts the additional level of decision making could be particularly onerous.

23. I3 (Ed Kisby) stated:

> Whilst it might be expected that the majority of the ideas for change would have modest impact on current regulatory structures, certain ideas, such as the concept of percentage trusts, would, if introduced, have a potentially radical effect upon the basis of trust accounting. As indicated in paragraph 5.37 this could, depending upon consequential taxation arrangements, impact considerably upon the whole taxation position of settlements adopting this structure.

Several consultees raised the consequences of a perceived increased risk of litigation from aggrieved beneficiaries

24. O2 (City of Westminster and Holborn Law Society) suggested that:

> … in so far as any scheme may require trustees to go through detailed procedures, there is the increased risk of an unmeritorious claim against them should they skip the procedures in arriving at their decision, whether or not those procedures should have been realistic in the particular case. Where a risk of this kind is perceived trustees may inevitably use defensive procedures, by increasing the extent to which they take legal advice or procure their professional advisers to maintain detailed records. It would be a disservice to trusts to impose the cost of defensive action whether the tasks in general are extremely simple and the amounts generally small.

25. O11 (Wills and Equity Committee of the Law Society) said:

> We are concerned that insufficient weight is given to the likely effects of the proposals may have on trustee liability. Beneficiaries, with the benefit of hindsight, may tend increasingly to call into question the proper exercise of a trustee's discretion. Unless given an element of protection, trustees' decisions on allocation will inevitably become negotiations with beneficiaries.

26. T2 (Association of Corporate Trustees) and T3 (HSBC) were also concerned by the increased risk of litigation from trust beneficiaries.

27. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) commented:

> The frequency (and seriousness) of dispute between beneficiaries with different interests does appear to be seriously underestimated by this Paper.

A few consultees were not concerned about the risk of litigation arising out of the new power

28. O8 (Trust Law Committee) suggested that "as a non-statutory duty to balance already exists, the risk of additional litigation against trustees is minimal".

29. A4 (Simon Gardner) thought that:

> … the principal downside is the apparent corollary that trustees who failed to realise its availability would find themselves in breach [of trust]; something that could well happen with lay trustees of new trusts ... . I'm not sure that there's so much of a problem. There must be very few, if any, trustees who know and apply, or would in future apply, the present rules but would be caught out by the advent of new rules. The issue is surely that, being lay, many operate, and will in future operate, in ignorance of the relevant rules: which will surely continue to be true regardless of whether the law is changed.

30. A4 (Simon Gardner) continued by saying that "arguably, the new rules would be kinder to such trustees, in the sense that it's closer than some of the present rules to the approach they do or would probably take anyway".

One consultee specifically noted the possibility of trustees being exculpated for breach of trust

31. A4 (Simon Gardner) commented that "if there were isolated instances of trustees caught out by the new rule but deserving relief, s 61 of the Trustee Act [1925] should be enough to rectify matters".

One consultee highlighted the consequence of possible changes in the way trustees invest

32. P7 (Herbert Smith) commented that "the 'know your client' investment rules will need to be revised because the investment aims of trustees will be likely to be simplified".

CLASSIFICATION

7.3 We provisionally proposed that the existing rules for the classification of distributions by corporate entities to trustee-shareholders should be abolished. Do consultees agree?

33. This question was answered by 27 consultees (64%).

In agreement with the provisional view: 27 (100%): P1, J1, J2, I1, J3, O2, J4, P2, A2, P3, T2, T3, O7, T4, I2, T5, I3, P4, O4, O8, P7, A3, P8, O10, O11, P10, A5

34. J1 (Association of District Judges) agreed that:

> … the present rules relating to the treatment of company distributions by trustees are unsatisfactory. They are, as the paper points out, too dependent on company law rules and do not take into account the complexity and diversity of modern corporate transactions.

35. O10 (UK STEP Technical Committee) agreed that "the current rules of classification generate arbitrary and illogical results and can create considerable complexity and uncertainty for trustees and their advisors".

36. O11 (Wills and Equity Committee of the Law Society) said:

> In our view the existing classification rules result in confusion and uncertainty and random outcomes.

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?

37. This question was answered by 27 consultees (64%).

In agreement with the provisional proposal: 21 (78%): P1, J1, J2, J3, P2, A2, P3, T2, T3, O7, T4, I2, I3, P4, O8, P7, A3, P8, O11, P10, A5

Several consultees agreed that any new rule should be simple and easy to apply

38. J1 (Association of District Judges) commented that they:

> … think it important that the replacement rules should be as simple as is possible to avoid the necessity in the vast majority of cases for trustees to have to take expensive advice and/or court proceedings to clarify treatment. We support the proposal for a modified *Massachusetts* rule on the way set out in the paper.

39. P8 (Moore & Blatch) commented that this rule "would provide a clear and certain rule which would help trustees know what to do and make for less difficulty in the administration of trusts. Although this may be 'rough justice' any exceptions such as by reference to the amount invested would bring back the difficulty and uncertainty of the current law."

A few consultees emphasised the interrelationship of the proposed rules of classification with the proposed power of allocation

40. P2 (Christopher McCall QC) "welcomed" the provisional proposal provided that "the power of allocation can be used for good and indeed sufficient reason to override inappropriate results flowing from the rules proposed". The consultee noted that "any new rules must involve a degree of flexibility to take account of the fact that investment products may be expected to change, and the uses to which they are put". The consultee added that "the danger of strict rules is that they may fit one generation's circumstances but will be wholly unsuited to another; and it is arguable that now one must look forward to a more rapid process of change than ever before … ." The consultee concluded that:

> … to introduce a principle which allows for strict basic rules but on the basis that they apply only as default provisions which can be overridden when circumstances require is in my view not only the right but in truth the only acceptable solution to a problem which cannot be denied and which in the last resort is capable if unaddressed of destroying the credibility of trust law.

41. P8 (Moore & Blatch) commented that "the power of allocation should allow unfairness to beneficiaries to be overcome".

42. A2 (W A Lee) noted:

> In any case if the trustees happen to sell the shares before the accumulated profits are distributed as a large dividend, ie cum dividend at an enhanced price, the proceeds of sale will ordinarily go to capital. If there are multiple sales and purchases of shares over a long period of time sometimes a sale will favour income and sometimes it will favour capital – swings and roundabouts. Only if trustees adopt a policy of selling shares cum dividend when the price is high or ex dividend when it is low should their *policy*, rather than the rule, be called into question. I would suggest that it is better to have a known rule that works both ways than to invent a rule that requires the trustees to agonise over whether a particular receipt, whether in the form of a dividend or the price received upon sale, should be credited to the income or capital accounts or in proportions based upon, well, the word used more than once is "instinct".

43. I3 (Ed Kisby) stated:

> I would favour a modified version of the Massachusetts rule being adopted as provisionally proposed, in the interests of simplification, in place of the current rules, so long as it were coupled with availability to the trustees of a separate power to allocate in order to deal with any perceived imbalance.

One consultee noted possible effects of this proposal on trust accounting

44. P3 (Geoffrey Shindler) noted that:

> … a consequence of this is that trust accounting will have to be made more rigorous to ensure that trustee records are kept much better.

> For instance for CGT purposes the base value of shares received as a dividend will be the value of the dividend. If original details of that value are lost the trustee-shareholders may have problems with their subsequent CGT return.

One consultee noted potential inconsistency with the tax treatment of distributions from non-UK companies

45. O11 (Wills and Equity Committee of the Law Society) commented that:

> … even if the rules relating to the classification of corporate distributions are changed for trust purposes the existing rules will need to be applied for tax purposes where distributions from non-UK companies are involved. Any change will not therefore simplify matters for trustees although it may avoid some of the unfairness of the existing rules. In order to initiate change, the trust rules should be changed even if, for the time being, the tax rules remain the same.

Concern over whether all non-cash distributions could be classified as capital

46. Despite expressing general agreement, P3 (Geoffrey Shindler) was concerned about whether *all* non-cash distributions could appropriately be classified as capital.

Not in agreement with the provisional proposal: 6 (22%): A1, O2, O4, J4, T5, O10

A few consultees attacked the provisionally proposed rule as being unprincipled

47. O2 (City of Westminster and Holborn Law Society) expressed the view that "the initial 'default' classification does not derive from any discernible principle. Rather, it seems to reflect just a supposed convenient method for 'parking' a receipt until trustees should have had time to think about it".

48. O4 (Law Reform Committee of the General Council of the Bar) did not believe that:

> … the Law Commission's proposal will result in any improvement in principle (though it may meet the current practice of corporate distributions for at least a short time, rather as *Bouch v Sproule* itself did in its day. The division "*cash = income, shares = capital*", seems to us to be unjustifiable, and we note that no attempt is made to justify it. It is itself crude and inflexible. Its only apparent advantage is that it rules out the need to apply to court over unusual distributions, but that does not mean it would produce a just result.

A few consultees thought that the provisionally proposed rule was already out-dated given current corporate practice (B Share schemes)

49. T5 (Paul Saunders) noted that the provisional proposal was "perhaps already being undermined by the proposals made this year by both J Sainsburys plc and W H Smith plc for the return of 'value' to shareholders, where the return may be treated as either capital or income, depending on the nature of the election made by the trustee".

50. O10 (UK STEP Technical Committee) commented that:

> … this could replace one set of anomalies with another, given the complexity and diversity in respect of the way in which corporate entities restructure themselves over time. For a recent example of this, there have been recent press comments about concerns raised in respect of new European companies and their ability to merge within different member states.

51. O10 (UK STEP Technical Committee) also noted that:

> … it has become "fashionable" for FTSE companies to return surplus capital to shareholders by way of special dividends, and if the proposed cash/non cash principle were adopted, it would result in such a return being treated as an income receipt in the trustees' hands.

Legislation for direct demergers only

52. One consultee (O10 - UK STEP Technical Committee) thought that specific legislation should be considered in the context of direct demergers.

One consultee thought that companies should have a role in determining the classification of distributions

53. T5 (Paul Saunders) suggested that:

> … in view of this [the fact that in many corporate entities trustee-shareholders hold a significant proportion of the issued shares], I believe that all companies should be required to consider the position of their trustee-shareholders when making any distribution and set out whether the distribution is to be received by a trustee as capital or income (subject to any specific direction that might otherwise be set down by the trust instrument governing any individual trust).

One consultee disagreed with the provisional proposal that the provisionally proposed rule would have the effect of causing the distribution on the facts of Bouch v Sproule *to be classified as income*

54. J4 (The Hon Mr Justice Lloyd) thought that the proposed rule "needs further thought" because the distribution in *Bouch v Sproule* would be classified as income under the new rule as "it could have been taken in cash, albeit that the cash would have been worth very much less than the shares". The consultee agreed that it was desirable to restate the rule in *Bouch v Sproule*, but suggested that the proposal "needs further thought, so that the need, as a matter of company law, in some circumstances to declare a dividend before proceeding to a distribution of shares does not divert what is really capital (as in *Bouch v. Sproule*) and classify it as income. That would be another example of technical requirements of company law overriding the substance of matters within the trust". The consultee, however, recognised the difficulty of producing a "sensible variant of the rule which remains clear, certain and simple to apply".

55. The consultee nevertheless expressed agreement with the Commission's view that the new rule should be clear and easy to apply, notwithstanding that any such rule would necessarily operate arbitrarily:

> It is important to have a rule for the classification of distributions by corporate entities to trustee-shareholders which is clear, certain and easy to apply. The consultee accepted the difficulties of drafting a rule which would be more fact-sensitive than that proposed by the Commission: The aim in setting out a new rule should be to reach a result which corresponds to the economic reality of the situation within the trust so far as possible. However, any such rule will, in some circumstances operate arbitrarily. A rule which could achieve a result corresponding to a general concept of fairness in all circumstances would have to be very flexible and would therefore be very uncertain, and productive of undesirable expense as regards advice and litigation.

A few consultees favoured the UPIA 1997 model

56. O10 (UK STEP Technical Committee) thought that the UPIA model "provides the possibility to be more precise about different sets of factual circumstances than the generic rule, making reference to cash/non cash distributions, permits".

57. A1 (Professor John Langbein) supported the efficacy of the UPIA legislation:

> We have a core set of rules that deal with the main assets, securities and rental income, and then we have some special rules to deal with unusual types of assets. These assets seldom show up in routine trust administration, but that's no reason for not providing for them in default law. Timber differs from gravel pits which differ from derivatives. Our policy is to identify the most suitable treatment for these unusual assets, but to allow the drafter of a trust to depart from the statutory default rule if departure better serves the purposes of the particular trust. Far from making the task of the trustee 'unacceptably onerous,' our act means that the default law supplies a wise and authoritative solution for allocation issues that would otherwise bedevil trust administration when unusual assets are found in the portfolio. The American trust industry, by which I mean the corporate fiduciaries and the specialist legal profession, has strongly supported the Uniform Act, which is why the 1997 revision has already sailed through the 36 state legislatures that have enacted it. We in the Uniform Law Commission expect it to be enacted in almost all states over the next few years.

One consultee demonstrated total opposition to the idea of having legal rules governing the classification of trust receipts

58. O2 (City of Westminster and Holborn Law Society) considered that a fallacy underpinned the decision of the House of Lords in *Bouch v Sproule*. It was based, in the consultee's opinion, on the assumption that a transaction has a "single character" for both parties to it. The consultee continued:

> The assumption is wrong in theory, because classification depends on purpose, and the parties may have different purposes. More practically, it may be demonstrated to be wrong by examples from the world of commerce. For example, an individual buying a holding of shares will doubtless have purchased them as capital, but if the seller is a dealer in securities he may correctly regard the proceeds as income. A building contractor credits payments received for his work to a revenue account, but his client may treat the same payments as capital expenditure.

59. O2 (City of Westminster and Holborn Law Society) concluded that it is a "corollary" of this analysis that a particular receipt or expense may occasionally be classified differently by different trusts. The consultee went on to state that:

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

60. O2 (City of Westminster and Holborn Law Society) conceded that it might be necessary to have a framework of guidance for trustees. It suggested that "the most formalised framework might eventually be a Statement of Recommended Practice". Alternatively, guidance might be forthcoming from a "respected organisation". The consultee suggested that trustees should "be required by statute to conform to good accounting practice" but emphasised that "the legislation should [not] indicate any particular source of guidance".

61. O2 (City of Westminster and Holborn Law Society) added that "it should remain the duty of the trustees to depart from the formal guidance if in all the circumstances of the case, including circumstances relating to the particular trust, that guidance did not produce the result they judge to be correct".

62. O2 (City of Westminster and Holborn Law Society) noted that many trust portfolios are handled by investment managers or other professionals – such persons are "likely to notice and draw attention to any receipt which raises a difficult question of classification". The answer to such problems is likely to come from discussions between professionals or, occasionally, from the court. The consultee added that most distributions are announced several weeks before they are paid "so that trustees and professionals never have to make snap decisions". The consultee added that:

> … problems are seldom likely to arise except in distributions from large family companies or specialised investment vehicles with a few shareholders only. Companies of that kind are likely to have professional advisers.

One consultee expressly criticised the possibility of adopting such an approach

63. O10 (UK STEP Technical Committee) were not convinced that a discretionary approach looking at the "substance" of the matter "would materially improve the position as it could place trustees in the invidious situation where a deliberation could be open to challenge by income and capital beneficiaries alike".

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?

64. This question was answered by 26 consultees (62%).

In agreement with the provisional proposal: 22 (85%): P1, J1, J2, I1, I2, J3, J4, P2, A2, T2, T3, O7, T4, T5, P4, O8, P7, A3, P8, O4, O10, P10

65. J1 (Association of District Judges) commented that "there is little or no need for change [to] the existing classification, the law being in the main clear".

In qualified agreement with the provisional proposal: 1 (4%): O11

66. O11 (Wills and Equity Committee of the Law Society) agreed "subject to there being a fair allocation system".

Not in agreement with the provisional proposal: 2 (8%): O2, I3

67. O2 (City of Westminster and Holborn Law Society) suggested that *Campbell v Wardlaw* was "not a very happy precedent". The consultee continued that:

> … as a general proposition [the decision in *Campbell v Wardlaw*] is unrealistic. On many estates there can be limited mineral workings which in no way diminish the value of the estate as a whole.

One consultee was not convinced that the current rules are sufficiently clear, and did not support reliance upon the power of allocation to clear up any ambiguities

68. I3 (Ed Kisby) commented that:

> … there is a pressing need for consolidation and clarification in modern language of various rules regarding non-corporate source receipts. There is very limited practical guidance available to practitioners regarding, for example, the classification of receipts from interests in timber/woodlands, mineral rights, and intellectual property, and a subsidiary power of allocation should not be relied on to counteract inadequacies in the principal rules. Archaic language such as "impeachable for waste" which determines the treatment of woodlands and mineral transactions does not help, and these particular rules are tucked away in the Settled Land Act 1925. In some cases, eg where discretionary interests apply to minerals etc, the rules appear unclear and inadequate. Along with representatives of the Inland Revenue who have admitted the same difficulties, I have periodically encountered consequential difficulties in agreeing client tax liabilities which have been required to be computed by reference to an unclear trust classification.

> This would seem to be the ideal opportunity to correct what is admitted in the consultation document as "less clear" rules, and we have known disputes to have arisen over classification of such receipts.

Other comments:

One consultee drew our attention to other forms of corporate (and trust) distributions

69. A5 (Professor Catherine Brown) suggested we look at distributions from mutual fund trusts and commercial investment vehicles:

> I have been doing some work in Canada on how to allocate distributions from mutual fund trusts and corporations. These are very popular investment choices for smaller trust[s] and for charities. As a result I think there is a need to look at allocation rules with respect to distributions from such commercial investment vehicles including Income Trusts, and Mutual Fund Trusts.

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.

70. This question was answered by 22 consultees (52%).

Existing rules should not be placed on a statutory footing: 13 (59%): P1, J1, O2, I2, J4, G1, P2, T5, P4, P7, O8, O11, O4

Several consultees noted that placing the rules on a statutory footing would result in a loss of flexibility

71. J4 (The Hon Mr Justice Lloyd) commented (also in relation to question 7.8 below) that:

> … to lay down a rule in statute would incur the risk that some situation which is not foreseen might be dealt with in an inappropriate way … it seems to me more desirable that the position on both these points should continue to be laid down by judicial decision and therefore remain more capable of being matched appropriately to circumstances than would be the case if there were a statutory rule.

72. P2 (Christopher McCall QC) commented that:

> I see no merit in any attempt to put the classification of receipts in general on a statutory footing; any attempt to do so must lead to rough edges which can be more readily smoothed away by the operation of equitable principles.

73. T5 (Paul Saunders) suggested that "the introduction of a statutory basis would … create a degree of rigidity that is likely to counteract the perceived benefits that might arise from the creation of a statutory foundation".

One consultee noted the difficulties in drafting such statutory rules

74. P7 (Herbert Smith) commented that it:

> … would be very difficult to draft [a statutory provision] to cover all non-corporate situations. For example, clarifying the fruits of copyright is notoriously difficult, in particular where the scientific means of exploitation have not yet been discovered ... and where the basis on which exploitation will take place is not yet known.

Existing rules should be placed on a statutory footing: 9 (41%): J2, A2, T2, T3, O7, T4, I3, P8, O10

Several consultees saw advantages in the production of a comprehensive statutory code

75. A2 (W A Lee) commented that:

> … it will be difficult to put these [rules] in statutory form but trustees are more likely to take account of statutory provisions than rules of equity buried in case law that they have never heard of because they chose not to study trustees in their law degree programmes.

76. Similar comments were made by O10 (UK STEP Technical Committee) who pointed to the precedent of the UPIA 1997.

77. J2 (The Hon Mr Justice Etherton) considered that "a comprehensive code dealing with both corporate and non-corporate payments is desirable".

78. One consultee (I3 - Ed Kisby) thought that the rules of classification should be modified and placed on a statutory footing.

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 consultee agree?

79. This question was answered by 26 consultees (62%).

In agreement with the provisional proposal: 19 (73%): P1, J1, J2, I1, J4, G1, P2, A2, P3, T2, T3, O7, T4, T5, P4, O8, P7, A3, P10

80. P2 (Christopher McCall QC) stated:

> So far as concerns expenses I regard the rule in *Carver v Duncan* as one which is not only beyond question but also suffices for its purposes and does not (subject to one possible exception mentioned below) need statutory confirmation.

81. J1 (Association of District Judges) argued that:

> … the treatment of trustee expenses is reasonably understood to be classified in the way explained in *Carver v Duncan* … and, though we accept that there will always be anomalies, the rule is fair and provides an appropriate balance between income and capital beneficiaries.

One consultee noted difficulties of practical application whilst supporting the provisional proposal

82. I1 (Tim Smith) opined that "there are still areas of confusion" in the application of the rule in *Carver v Duncan* to particular factual situations, such as, for example, audit fees which are often charged to income when they are properly chargeable to capital.

One consultee highlighted the discrepancy between the rule in Carver v Duncan *and professional practices*

83. A2 (W A Lee) gave the following example of a charitable trust of which he is a trustee:

> The paid professional trustee … routinely charged all fees and disbursements to the income account. Since these fees might touch AUS$ 1 million I felt that the income account was being prejudiced; but when I raised it all the trustees insisted that the practice was appropriate … . It so happens that the trustees have a power to transfer income to capital and vice versa, although the practice I mention has not been seen as an exercise of that power.

One consultee took issue with the statement in the Consultation Paper that there was no authority on the proper classification of recurrent trustee remuneration

84. P2 (Christopher McCall QC) argued that "the recurrent element of trustee remuneration … is properly paid out of income (*per* Walton J in *Norfolk* [1979] Ch at 62D)". The consultee continued:

> Walton J's remarks … represent a clear statement of practice which in the context must be regarded as of the greatest persuasive authority. I would add that *Norfolk* was referred to in argument in *Carver v Duncan* and not either expressly or by implication questioned in Lord Templeman's speech. I therefore myself regard it as part of what he stated to be the accepted general rules as to the incidence of trust expenses.

Qualified agreement with the provisional proposal: 2 (8%): P8, O11

One consultee thought that a range of general rules would be helpful

85. P8 (Moore & Blatch) broadly agreed with the provisional proposal, but commented that "a more wide ranging set of rules of general application could be of use".

One consultee thought that some modification to the rule might be appropriate

86. O11 (Wills and Equity Committee of the Law Society) commented that:

> … it would be preferable to have more clarity on what expenses can be properly allocated to income. In addition, there is a case for allocating more expenses to income than is possible under the principle laid down in *Carver v Duncan*. There seems to be no reason in principle why expenses which benefit both capital and income should be charged solely to capital.

Not in agreement with the provisional proposal: 5 (19%): J3, O2, I3, O4, A4

A few consultees considered that the rule in Carver v Duncan *was insufficiently certain*

87. J3 (The Rt Hon Lord Walker of Gestingthorpe) considered that the "test of expenses 'for the benefit of the whole estate' is vague and unworkable. In practice, it appears to be just a residuary category, all non-income expenditure".

88. I3 (Ed Kisby) commented that the rule "requires a significant degree of interpretation and risks confusion, as many expenses arguably fall within both income and capital classifications under a literal interpretation of the rule. Whilst the rule may produce broadly fair results, much more work is required to re-define the bases for classification".

A few consultees doubted whether the rule in Carver v Duncan *adopted the right approach*

89. O4 (Law Reform Committee of the General Council of the Bar) thought that the rule in *Carver v Duncan* "adopt[s] the wrong approach" and recommended:

> … a change so that if an expense is recurrent, there should at the very least be a presumption that it should be paid out of income. We disagree with Lord Templeman's view that annual premiums on insurance policies to protect the capital value of the trust fund should be paid out of capital. Protection of the capital also protects income. Annual fees of investment advisers ought to benefit both capital and income beneficiaries, and so should not be debited to capital alone.

90. A4 (Simon Gardner) wondered:

> … whether *Carver v Duncan* actually makes sense? It depends on the two categorise it uses being both mutually exclusive and exhaustive. The two categories are "all ordinary outgoings of a recurrent nature" and expenses incurred "for the benefit of the whole estate". But surely one could have ordinary, recurrent expenditure that benefited the whole estate (eg the annual insurance premiums on the estate's commercial property investments; and also one-off expenditure that did not (eg payment for professional advice towards raising rents on those investments). One might excuse *Carver v Duncan* on the ground that it isn't supposed to represent a statutory code - but if you are engaging in legislative reform, it seems appropriate to try and do better.

One consultee considered that trustees should not be constrained by rules in the classification of trust expenses

91. O2 (City of Westminster and Holborn Law Society) suggested that the classification of expenses "should be at the discretion of the trustees".

Other comments:

A few consultees drew on the close relationship between trust classification and tax law in this area

92. I2 (Toby Harris) noted that

> … this is actually a very important issue from the point of view of the taxation of trusts, especially small ones. A good deal of work is done every year in maintaining trust records, not always full accounts, and in completing the Trust and Estate Tax Return. Often a significant proportion of professional fees relate to income rather than capital. At the moment part at least of the tax treatment follows the treatment for trusts. What is needed is a rule of thumb that, in relation to small estates, will have the result that a standard proportion of fees is allowable for tax purposes. This might stop short of putting the rule in *Carver v Duncan* on a statutory footing. This is an area where trust law could follow tax law, rather than the other way round, at least for smaller trusts.

93. O10 (UK STEP Technical Committee) commented that it is "fundamentally important to ensure there [is] a proper alignment from a fiscal perspective in allowing proper deductibility of appropriate income expenses".

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

94. This question was answered by 25 consultees (60%).

Existing rule should not be placed on a statutory footing: 15 (60%): P1, J1, J3, O2, J4, P2, P3, T5, P4, O8, P7, O11, O4, P10, A4

95. See comments of J4 (The Hon Mr Justice Lloyd) in relation to question 7.6 above.

One consultee considered that legislation was needed to deal only with the specific case of recurrent trustee remuneration

96. P2 (Christopher McCall QC) felt that "legislation is needed in the one special case of recurrent trustee remuneration (as distinct from exceptional remuneration) to confirm that such fees should, subject to the power of allocation and subject to contrary direction, be borne by income".

One consultee nevertheless thought that statutory intervention might be necessary in the event that the Inland Revenue challenged the current law

97. P2 (Christopher McCall QC) noted that:

> … recent experience has suggested to me [that] the Crown is concerned to explore the whole area of trustee expenses and may wish to raise challenges to what may hitherto have appeared to be beyond challenge. If so, then there may be more cause for statutory intervention on *Carver v Duncan*, even if only to confirm the rule that might otherwise have appeared.

A few consultees thought that guidance would be more appropriate than statutory intervention

98. P10 (Charles Russell) favoured:

> … the approach taken in the Revenue consultation on modernising the taxation of trusts under which the rule in *Carver v Duncan* would not be placed on a statutory footing but would be retained and additional guidance provided by the Inland Revenue ... . It is perhaps worth noting that the Settled Land Act 1925 used to provide guidance on the incidence of trust expenses which was not replicated in the Trusts of Land and Appointment of Trustees Act 1996.

Existing rule should be placed on a statutory footing: 10 (40%): J2, G1 A2, T2, T3, O7, T4, I3, A3, P8

99. G1 (Inland Revenue) stated that:

> … making the existing principle statutory would, we hope, just make the currently prevailing position clearer. Although the principle dictating when expenses are to be borne by income appears clear to the Revenue, and to the Law Commission, it does not seem clear to all taxpayers.

100. G1 (Inland Revenue) asked that, if the Commission were to go along this route, it

> … could be involved in any discussions on the text of the codification. We would be concerned if, rather than codifying existing rules, any new rules were introduced by way of statute.

101. J2 (The Hon Mr Justice Etherton) stated that "the rule in *Carver v Duncan* should be placed on a statutory footing, in order to provide as comprehensive a statutory code as possible".

102. A3 (Richard Nolan) commented that "I have no strong view [on whether the rule should be placed on a statutory footing] but think it might usefully be, given the other things proposed for the face of any new bill, and given the amount that appears on the face of TA 2000".

A few consultees considered that a new rule for classification of trust expenses should be placed on a statutory footing

103. O10 (UK STEP Technical Committee) commented that:

> … this is an area where there appears to be considerable scope for disagreement and confusion between the Inland Revenue and professional advisors, and therefore there is merit in considering placing the rule in relation to trust expenses on a firmer footing to provide greater clarity and in particular to enable trustees to apportion expenses between income and capital on a just and reasonable basis with greater transparency.

104. I3 (Ed Kisby) made similar comments.

105. Alternatively, O10 (UK STEP Technical Committee) thought that at the least it was necessary to have "clear guidance notes on the allocation of trust expenses which could be agreed by the relevant professional bodies and Inland Revenue authorities to provide a greater uniformity of approach".

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?

106. This question was answered by 22 consultees (52%).

In agreement with the provisional proposal: 20 (90%): A3, P1, J2, J3, J4, P2, A2, P3, T2, T3, I2, I3, P4, O8, P7, P8, O10, O11, O4, P10

One consultee suggested that the rules of classification should also be excluded by necessary implication from the terms of the trust

107. J4 (The Hon Mr Justice Lloyd) stated that "it seems to me that [exclusion of the rules of classification by necessary implication from the terms of the trust] would also be acceptable, though I would not go further".

108. One consultee (P7 - Herbert Smith) noted that in practice any contrary provision is likely to give rise to tax issues.

In qualified agreement with the provisional proposal: 1 (5%): T5

109. T5 (Paul Saunders) was in agreement with the proposal provided that the "contrary provision" was "clearly expressed, and not merely implied."

Not in agreement with the provisional proposal: 1 (5%): I1

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?

110. This question was answered by 25 consultees (60%).

In agreement with the provisional proposal: 21 (84%): P1, J1, J2, J3, O2, J4, A2, T2, T3, O7, T4, T5, I3, P4, O8, P7, A3, O10, O11, O4, P10

Several consultees suggested that a list of factors would not be suitable for all circumstances and that it might focus trustees' attention on an unduly narrow range of issues

111. J1 (Association of District Judges) reasoned that:

> … whilst we can see that lists of relevant factors to be taken into account by trustees in exercising their duty to maintain a proper balance would have some uses, the difficulties raised in the paper in that the list would be unlikely to meet all possibilities and could also result in the lack of a common sense approach lead us to support the view that there should be no such list.

112. O2 (City of Westminster and Holborn Law Society) quoted the Scottish Law Commission's Discussion Paper on the Apportionment of Trust Receipts and Outgoings:

> Most of [the factors referred to in the US Uniform Principal and Income Act 1997 are considerations that trustees would naturally take into account or would receive advice on from their professional advisers. There is a danger that focusing on the listed factors, the trustees would omit to take into account some other considerations that were relevant in the particular circumstances.

113. O10 (UK STEP Technical Committee) commented that "such a list would potentially create a 'box-ticking' compliance mentality, which might distract trustees from looking at the substance of the duty to seek an appropriate balance".

114. O11 (Wills and Equity Committee) noted that:

> … balanced interests are achieved in as many different ways as there are trusts and trustees should consider the needs of their own trust without reference to what constitutes a proper balance in another trust. A statutory list, even non-exhaustive, will inevitably be restrictive as trustees will not look beyond those factors even where others may have an impact on their judgement but are not included in the list.

One consultee, however, expressed a word of caution concerning making the nature and purpose of the duty to balance clear

115. J2 (The Hon Mr Justice Etherton) stated that "while I agree that a non-exhaustive statutory list of relevant factors to guide the trustees should not be laid down by statute, I think it would be important and helpful to trustees and beneficiaries for the statute to define in clear and ample terms the nature and purpose of the duty to balance … ".

One consultee thought that a statutory list of factors might be "misleading" but that some guidance might be necessary

116. P7 (Herbert Smith) suggested that:

> … some guidance might be helpful where a substantial "windfall" arises on income or capital account. In some trusts, for example where the only trust asset is a holding of private company shares, there may have been no income or capital available for distribution for many years. How should part of a large gain, for example on flotation, be allocated back to the income account bearing in mind that the life tenant may have had no income for many years?

Neutral on the issue of a non-exhaustive statutory list of factors: 1 (4%): P2

One consultee did not disagree with the concept of a statutory list but did not feel it was necessary

117. P2 (Christopher McCall QC) considered that "a non-exhaustive list of relevant considerations might be given but I do not regard this as essential".

Not in agreement with the provisional proposal: 3 (12%): P3, I2, P8

A few consultees thought that a non-exhaustive statutory list would be helpful

118. P8 (Moore & Blatch) considered that "a non-exhaustive statutory list could be a helpful checklist for trustees".

One consultee thought that the lack of reported cases on the duty to balance did not necessarily indicate that trustees knew what the concept of "balance" involved

119. I2 (Toby Harris) commented that:

> … whilst it is attractive to conclude that the lack of reported cases suggests that trustees know how to balance interests, that may be optimistic. Litigation is on the increase. Trustees should have statutory guidance … .

7.11 If consultees do not agree, we invite their views on which factors should be included in such a list.

A few consultees noted the importance of keeping the list of factors up-to-date

120. P8 (Moore & Blatch) suggested that:

> … it is important that the list is kept up-to-date to reflect current investment theory. It is essential that there is a mechanism to change the list easily ... . Further research should be undertaken ... especially in the light of current investment theory.

121. O11 (Wills and Equity Committee of the Law Society) made similar comments.

One consultee gave an indication of some of the factors which it thought to be relevant

122. O11 (Wills and Equity Committee of the Law Society) noted the following factors:

(1) age [presumably of the beneficiaries];

(2) personal circumstances;

(3) financial circumstances;

(4) nature of the assets; and

(5) size and extent of the assets.

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.

123. This question was answered by 27 consultees (64%).

In favour of giving the duty to balance a statutory basis: 18 (67%): J2, I1, J4, P2, A2, P3, T2, T3, O7, T4, I2, I3, P6, O8, A3, P8, O10, O11

A few consultees considered that this followed automatically from there being any statutory intervention in the trust capital/income divide

124. P2 (Christopher McCall QC) stated that the "any statutory intervention in the income/capital balance makes it essential that the duty to balance be given statutory force".

125. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) considered that:

> … as part of a reform of income/capital issues, it would be a strange omission not to set out the basic underlying principle that should drive a trustee's approach to this issue. We would be in favour of a statutory definition of this duty that mirrors the existing equitable duty.

A few consultees thought that the retrospective (as opposed to prospective) duty to balance was a new duty which should accordingly be enshrined in statute

126. P2 (Christopher McCall QC) stated that "equity does not recognise a duty to balance *ex post facto* so the new duty to balance is quite different from that which has applied hitherto and can only therefore be based in statutory intervention". The "expanded form" of the duty to balance which the CP envisages underpinning a power of allocation "will in my view achieve nothing if it cannot be used to rebalance where the balance of net receipts is out of line with the balance which ought to have been sought, looking back as well as forwards … it has in my view to be recognised that a retrospective duty to balance is a novel legal concept, and not merely another aspect of the prospective duty to balance which does undoubtedly exist as a matter of the current law".

127. O8 (Trust Law Committee) commented that:

> … the new duty to balance will in essence be a different one and arise only after income and capital has been received. That being so, we believe there will need to be a statutory provision to prevent the welcome changes being ineffective.

A few consultees highlighted the benefit of visibility

128. A3 (Richard Nolan) suggested that:

> … these rules will largely be of use to "small" trusts ... . "Big" trusts will continue to make detailed and careful express provision. Accessibility to the non-specialist is particularly important where a statute is likely to have impact primarily amongst the non-specialists: visibility of the law is more than usually important here. That militates in favour of putting the duty on the face of the statute.

129. P8 (Moore & Blatch) commented that "this could be helpful if it [led] to greater clarity and awareness of the duty".

130. One consultee (O10 - UK STEP Technical Committee) thought that this was only necessary if the rules of classification were also to be placed on a statutory footing.

A few consultees believed that statute should make an attempt to define the concept of balance in broad terms

131. P2 (Christopher McCall QC) thought it essential that the statutory provisions "make plain that the duty can be properly discharged by actions which fall within those same wide parameters of propriety which would govern the exercise of investment powers for the future". An absolute duty to balance would "produce more arguments than it resolves". The consultee considered that "the duty to balance will have to be defined in statute, and in some such elastic sense as follows, namely a duty so to administer the trust and (if so thought fit) to exercise the proposed power of allocation as will secure a balance between income and capital within that range of possibilities which could reasonably have been justified had it been predictable as the consequence of the trustees' chosen investment policy having regard to all the circumstances of the case and any express terms of the settlement".

132. A2 (W A Lee) commented that "the terms of the provision should be general and not run a risk of too much specificity".

A few consultees thought the "common sense" approach to balance gave insufficient guidance to trustees

133. P6 (Bircham Dyson Bell) suggested that "it might be difficult for trustees to decide what is fair and in accordance with common sense unless there is statutory guidance which they can take into account".

134. A4 (Simon Gardner) considered that:

> … the issue [of determining balance] was much easier in past times, when trustees were expected largely to sit on the assets that the settlor had placed in the trust so merely maintaining whatever balance between income and capital was already implicit in the settlement, and could be ascribed to the settlor's own choice. Ever since trustees have been expected to "play the markets" with the trust fund (which did not begin in 2000, as the Paper cheesily tends to suggest!), however, the issue has in principle been live - though in practice not talked about.

135. These comments are also relevant to questions 7.10 and 7.11 which, although not directly addressed by the consultee, relate to the question of statutory guidance on the meaning of balance.

One consultee thought that giving the duty to balance a statutory basis would reduce the scope for litigation

136. I2 (Toby Harris) suggested that "we are simply lucky that this has not been more of a problem hitherto".

Against giving the duty to balance a statutory basis: 8 (30%): P1, J3, O2, T5, P7, O4, P10, P11

A few consultees suggested that codification would exaggerate the relative importance of the duty to balance

137. O2 (City of Westminster and Holborn Law Society) stated that "it is not appropriate to codify this single one of the many trustees' duties; to do so gives it artificial prominence".

138. P10 (Charles Russell) commented that giving the duty to balance a statutory basis "would suggest that other equally fundamental trust obligations and concepts should also be given a statutory basis, which we believe would be unnecessary".

One consultee suggested that codification would increase the risk of litigation from disgruntled beneficiaries

139. O2 (City of Westminster and Holborn Law Society) suggested that placing the duty to balance on a statutory footing would "tend to encourage unmeritorious claims against trustees for perceived breaches".

A few consultees highlighted difficulties in drafting the concept of "balance"

140. O2 (City of Westminster and Holborn Law Society) suggested that:

> … "balance" to a judge means the process of selecting circumstances held to be relevant and giving to each interest the weight deemed to be appropriate. However, the word could easily be misunderstood to mean that equal weight should be given in favour of each interest.

141. T5 (Paul Saunders) commented that:

> … there is no definition of "balance", and that the point at which "balance" is achieved in any particular trust might vary, depending on the intentions of the settlor. To create a statutory definition to cater for the wide range of possibilities intended by a settlor will undoubtedly require a complex form of wording. I believe that "balance" should be identified on a case by case basis and, therefore, it would be inappropriate to seek to produce a statutory definition.

One consultee thought that the duty to balance should not be statutorily confined to traditional trust relationships

142. P7 (Herbert Smith) commented that the duty to balance "is a fundamental principle of equity and the duty to act fairly can arise in fiduciary situations other than traditional trust relationships".

One consultee expressly disapproved of the rigidity imposed by statute

143. P11 (Edward Nugee QC) thought that:

> … the flexibility of equity, compared with the straitjacket of statute if it is to do more than state principles in the most broad and unhelpful way, is one of the most admirable features of the law. There have

> been plenty of examples of the courts developing equitable principles in a way that our Victorian forefathers, in the different circumstances of their time, would not have foreseen; and the courts have much more freedom to do this unfettered by statute than if they had always to consider whether what was thought desirable was consistent with the words chosen by the Parliamentary draftsman ... possibly 50 or more years earlier. It would be tedious to give examples; but one which has already attracted the criticism of the Law Commission is the power in s 19 of the Trustee Act 1925 to insure trust property at the expense of income only up to three quarters of its value – perhaps this seemed sensible to the original draftsman in 1888 or 1893 or even 1925, but it now appears to impose an unreasonable limit on what trustees, acting as prudent men of business in the interests of all their beneficiaries, would think it sensible to do, as the 2000 Act recognises.

Neutral on the issue of giving the duty to balance a statutory basis: 1 (4%): J1

144. J1 (Association of District Judges) stated that:

> … we are neutral as to whether it would be appropriate for the trustee's duty to balance the interests of their various beneficiaries to be given a statutory basis. It is a long understood principle that, except where the settlement provides otherwise, trustees should act fairly as between the beneficiaries and with common sense.

Other comments:

One consultee recommended a change in terminology

145. P11 (Edward Nugee QC), in accordance with his view on the content of the trustees' duty, thought "the phrase 'duty to balance' should be replaced in the final report by 'duty to act fairly'".

One consultee noted the position taken by STEP on the duty to balance

146. O4 (Law Reform Committee of the General Council of the Bar) commented that:

> The duty to keep a balance between life tenant and remainderman is rightly stated to be fundamental (although the Law Commission have overlooked the fact that it is excluded – in our view unwisely – in STEP's so-called standard provisions).

One consultee commented on the difficulty of challenging a trustee's compliance with the duty

147. O4 (Law Reform Committee of the General Council of the Bar):

> It is, however, extremely expensive & difficult to take on a trustee on [grounds of breach of the duty to balance]. *Nestle* graphically demonstrates that. The absence of reported decisions should not be taken as meaning that all is well on the "balance" question.

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?

148. This question was answered by 25 consultees (60%).

In agreement with the provisional proposal: 21 (84%): P1, J1, J2, J4, P2, A2, P3, T2, T3, O7, T4, I3, P4, O8, P7, A3, P8, O10, O11, O4, P10

A few consultees emphasised the importance of settlor autonomy

149. A3 (Richard Nolan) argued that:

> … the rules should certainly be excludable. The terms of benefit under a trust are, most fundamentally, what the settlor makes them. It is no business of the law to infringe the "contracting" ... of private parties who are *sui juris* and exercising their free will ... .

A few consultees expressed some concerns with regard to this proposal

150. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) noted that "in principle a settlor should be able to express[ly] modify this duty". However, the consultees expressed two concerns:

> [1] To remove the duty altogether, rather than modifying it, is open to abuse (much like the standard use of clauses ousting the duty of care which are currently promoted far more by the draftsman than the settlor). Removing the duty altogether diminishes the responsibility of the trustee and weakens the position of the beneficiary. We would far rather see the duty modified expressly so that in the case of a simple life interest the settlor could expressly empower the trustee to favour the interests of the income beneficiary should their circumstances require it, but in the absence of the exercise of the power to benefit income, the duty to balance should remain. [2] Modification by implication should be only on the clearest possible grounds.

One consultee commented on the treatment of existing trusts

151. O11 (Wills and Equity Committee of the Law Society) noted:

> Existing trusts would need to continue under the existing law with a non-statutory duty to balance the interests of the life tenant and remainderman. Any new provision could only apply to trusts created after passing the appropriate legislation.

In partial agreement with the provisional proposal: 2 (8%): I2, T5

152. A few consultees (I2 - Toby Harris, T5 - Paul Saunders) thought that the duty should not be modified or excluded by implication from the terms of the trust.

Not in agreement with the provisional proposal: 2 (8%): I1, J3

153. I1 (Tim Smith) considered that the duty to balance should not be capable of exclusion by the settlor.

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?

154. This question was answered by 22 consultees (52%).

In agreement with the provisional proposal: 18 (82%): J2, J4, P2, A2, A3, P3, T2, T3, O7, T4, I2, I3, P4, P7, P8, O10, O11, O4

155. A2 (W A Lee) noted that:

> … this duty does not require trustees to convert such assets. With the abolition of the list investments as found in a trust created inter vivos will not be unauthorised. There could not be a duty to convert because one would ask convert into what? The question that will arise will be whether their retention is *consistent* with the establishment of an appropriately diversified portfolio. The purpose of a power to postpone conversion will in future give trustees time to construct a suitable "total return" portfolio.

A few consultees emphasised, however, that the duty to balance should not trump the express or implied terms of the trust

156. P2 (Christopher McCall QC) considered that:

> … if a trust entitles the life tenant to a picture it cannot be said that the picture should be sold because there is otherwise no power to keep a balance, if a settlor has given his trustees power to retain low yielding investments it cannot be right that the duty to balance means that they have no such power or must so act as to give the life tenant enhanced income rights which the settlor did not seek to confer on him.

157. P3 (Geoffrey Shindler) made similar comments:

> Whilst it may be sensible to confirm that the duty to balance should not be impliedly excluded insofar as it relates to original trust property, nevertheless there should be statutory provisions to the effect that trustees who hold onto property originally settled either because they wish to, possibly agreeing with the settlor's views as set out in a letter of wishes, or because in the real world there is no realistic market for the shares (especially shares in private companies) should not find themselves on the end of a law suit.

158. A similar concern was expressed by P4 (John Ross Martyn):

> Has any thought been given to whether [the provisional] proposal would create problems where the main or only asset of a trust is a family home?

In qualified agreement with the provisional proposal: 1 (5%): O8

One consultee thought that this provisional proposal should not apply to pre-existing trusts

159. O8 (Trust Law Committee) commented that:

> … the trustees [of pre-existing trusts] might have been relying on the types of implications to which the [consultation paper] refers in considering their duty to balance beneficiaries' interests and that position should not be changed.

Not in agreement with the provisional proposal: 3 (14%): J3, T5, P10

One consultee thought that primacy should be given to the settlor's intentions

160. T5 (Paul Saunders) commented:

> All the time that the original property … satisfies the settlor's intentions as to the purpose and nature of the trust, I believe that the trustee should be entitled to retain such property whilst it continues to fulfil the original purpose.

161. One consultee (J3 - Rt Hon Lord Walker of Gestingthorpe) thought that the provisional proposal would give rise to more uncertainty and litigation.

One consultee thought that there were arguments for retaining the implied exclusion of the duty to balance

162. P10 (Charles Russell) suggested that it was important to bear in mind:

> … the common scenario where, say, shares of a family company are settled on children or grandchildren. There may be little or no income and no sale proceeds but it may well be the settlor's intention that the shares should be retained for the longer term benefit of the family. The danger of abrogating any implied exclusion of the duty to balance is that, in such a situation, the draftsman forgets to make the exclusion express in the wording of the trust.

PERCENTAGE TRUSTS

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

163. This question was answered by 18 consultees (43%).

Opposed to promotion of percentage trusts: 6 (33%): P1, O2, G1, P2, T5, O4

Several consultees referred to the practical difficulties posed by percentage trusts in the context of private trusts

164. O2 (City of Westminster and Holborn Law Society) found it difficult to "evoke any real excitement" about promoting percentage trusts. It noted that "they are not impossible under the existing law" but that "they are unlikely to be popular while their complex tax problems are unresolved" and that "they are also inhibited by the accumulation rules."

165. G1 (Inland Revenue) stated that "we still see significant practical difficulties in determining the correct tax treatment of such entities".

One consultee referred to the inflexibility of percentage trusts

166. P2 (Christopher McCall QC) stated that the percentage trust model:

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

One consultee doubted whether it was the Law Commission's role to promote percentage trusts.

167. O4 (Law Reform Committee of the General Council of the Bar) was not sure that:

> … law reform is the appropriate tool for the promotion of a new type of trust. This is not the same as the very useful word-saving provisions included in the Trustee Act 1925, which shortened trust documents and made drafting much easier. They reflected current practice and usage, which had already developed the concepts and even the wording.

One consultee noted that percentage trusts are not unheard of in the UK but that few people understand their underpinning principles

168. T5 (Paul Saunders) commented that:

> … the use of 'percentage trusts' is not alien to the UK - they effectively arise when an investment bond with, say, a 5% annual withdrawal is settled. However, those promulgating such trusts appear to have little perception of the underlying trust or tax principles and I would be reluctant to suggest percentage trusts be promoted in the UK.

Opposed to insistence upon percentage trusts: 1 (6%): A2

169. One consultee thought that percentage trusts should not be the default vehicle for ensuring a balanced portfolio, but thought that trustees would find percentage guidelines helpful.

170. A2 (W A Lee) suggested that:

> … trustees should be given some sort of statutory but not binding benchmark to give them confidence if they are on the right lines but to warn them if they are not … . I imagine that it is possible to find out relatively easily what average interest rates are over a given period of time and to find out what is the average return from a relevant stock exchange such as the FTSE. If trustees were informed that a return of between say 90% and 120% of such an average is deemed to

> provide a satisfactory balance between the income and capital accounts that would give trustees guidance and flexibility and would relieve them of anxiety. Income beneficiaries should be receiving returns and if trustees are returning less than 90% or more than 120% of an average then one might argue that they are not performing their duty to balance. To take this further, since these are issues that particularly affect charity law, I would have thought that the Charity Commissioners would have ample resources to assess what average returns are in various investment markets and could publish from time to time parameters centred upon those averages that could be regarded as indicating appropriate trustee compliance with the duty to balance.

171. These comments might also be considered relevant to question 7.10 regarding whether a statutory list of factors relevant to the duty to balance is appropriate.

Neutral on issue of percentage trusts: 3 (17%): I2, I3, O8

One consultee highlighted the pros and cons of percentage trusts without reaching a firm conclusion on whether or not they should be promoted

172. I3 (Ed Kisby) commented that:

> … in many ways these represent an attractive basis for a modern system of trusts. Inevitably, however, their introduction would involve a requirement for new guidance/rules for accounting purposes, and for the application of current/future taxation rules to the new style structure.

One consultee thought that the Law Commission should not be distracted by the issue of percentage trusts

173. O8 (Trust Law Committee) suggested that:

> … while the rule against excessive accumulations remains, percentage trusts appear impractical. If that rule is abolished, there can be no objection in principle to percentage trusts. Those drafting them must work out the taxation consequences depending on the law at that time. There does not, however, appear to be any considerable pressure for change in this area of the law and we do not believe the Law Commission should feel obliged to recommend that the law should be changed merely to facilitate their adoption.

One consultee noted potential effects on the UK trust industry of discouraging percentage trusts

174. I2 (Toby Harris) noted that "discouragement of any new form of trust can encourage settlers to use jurisdictions other than that of England and Wales, with loss of business to the UK".

Supportive of percentage trusts: 5 (28%): P7, P8, O10, P11, J5

175. P7 (Herbert Smith) commented that percentage trusts:

> … could be an interesting and, indeed practical, way of dealing with the 'balancing' ab initio. The disadvantage is that, like old fashioned annuities, the percentage income yield could become out of line. There would be significant Inheritance Tax issues to consider and a specific statutory Inheritance Tax regime would be likely to be needed.

176. O10 (UK STEP Technical Committee) commented that percentage trusts have “considerable merit”:

> In general terms, where trustees seek to strike a balance between the interests of income and capital beneficiaries they are more constrained in terms of their ability to achieve a particular investment result at a lower level of anticipated risk/volatility than in circumstances where they can pursue a “total return” approach.

177. However, the consultee noted that percentage trusts would require “an appropriate adaptation of the taxation framework of such trusts” because such trusts would not be regarded as interest in possession trusts.

178. O11 (Wills and Equity Committee of the Law Society) commented:

> We can see some merit in promoting percentage trusts, which would be particularly useful where trustees wish to operate on a “total return” basis. It would remove much of the artificiality which often occurs in operating a trust and would clearly make distribution calculations easier ... . We see no reason why trusts cannot be accommodated by analogy with rules relating to annuities within the present regime [of trust taxation].

179. This would allow the interest in possession regime to apply to percentage trusts.

180. P8 (Moore & Blatch) suggested that:

> It seems desirable that they should be available for those who might want to use them. The tax treatment would be the major influence on whether they would be used. … This is outside the scope of this Consultation. Similar comments apply to Discretionary Allocation Trusts.

One consultee encouraged the Law Commission to “be bold: go the whole way and not three quarters of the way

181. P5 (Mr Justice Hayton) was of the view that “the time has come to introduce the “percentage trust” or “unitrust” into English (and Welsh) law” and encouraged the Law Commission to “take this opportunity so as comprehensively to deal with capital and income and the total return approach to investment”.

182. Mr Justice Hayton argued:

> As you rightly point out in your CP, modern portfolio investment theory requires trustees for best results to invest for total return without distinction between capital and income, while financial

markets for the foreseeable future are such that most of the return from a well-invested portfolio comes from capital gains allocable to capital. To be fair to the income beneficiary, the trustees therefore need to invest less efficiently (though there is then less capital growth to produce higher capital to produce a higher income yield) or, better, take advantage of a statutory power to reallocate or adjust receipts and expenses as proposed in your CP.

This is very good for existing trusts but it still leaves some complex work for the trustees which is also work that exposes them to the risk of lawsuits. Moreover, retrospective allocation of receipts and expenses can lead to a life tenant receiving significantly less or significantly more than would be justified under the default rules determining what is an income and what is a capital receipt or expense, thereby preventing an interest being an interest in possession (with very significant tax effects) or converting an indefeasible capital interest into a defeasible interest.

Taking account of a life tenant being very poor and needy, while the capital beneficiary is wealthy and not at all needy, can then lead to a heavy bias towards receipts being allocated as income and expenses being allocated as capital - or the reverse if the life tenant is wealthy and not in need of income, while the remainderman is poor. The latter could well attract the Revenue's attention as a machination to avoid tax that results in converting the life tenant's interest from an interest in possession to a somewhat discretionary interest. Thus, you provisionally recommend that the personal circumstances of the respective beneficiaries should be ignored by the trustees in achieving a fair balance between them.

Quite apart from a statutory precept to ignore the beneficiaries' personal circumstances contradicting a conventional fundamental duty of trustees, it is surely unrealistic to believe that the trustees will ignore something well-known to them, like the wealth of a life tenant and the poverty of a needy remainderman (who could be assisted by advancements under section 32 of the Trustee Act). Thus trustees will try to get away with an allocation process resulting in the life tenant (and thus the Revenue) receiving as little as possible.

The Revenue will then need a yardstick (whether in-house or statutory) to spot trustees who go too far. This yardstick in this total return era will need to be based on a percentage of the total capital and income of the trust fund. In this era also of open governance and accountability, this yardstick ought to be statutory, capable of change annually in the Finance Act.

Such a yardstick will definitely be required if, as I believe many respondents to your CP will submit, we retain the current position whereby trustees are under a duty to consider the beneficiaries' personal circumstances when balancing capital and income.

> Once this percentage yardstick stage is reached, why should not a settlor in the future be able to create a statutorily authorised percentage trust in which s/he selects the percentage of the value of the entire trust fund of income and capital to be paid to a life tenant at particular intervals. This has the great advantage that it is the settlor, not the trustees, who determines the matter, while it also means that the trustees' charges will be less than in traditional interest in possession trusts. After all, they do not have to make any time-taking complex allocations which might also expose them to litigation.
>
> This percentage trust product should therefore be made available to the consumer, attractive to settlors and their beneficiaries and also to professional trustees. For the USA position see from the 1972 Uniform Management of Institutional Funds Act to the Delaware provision for unitrusts in Del. Code Ann-title 12, para. 3527 (2004), with charitable remainder unitrusts favoured in Inland Revenue Code para. 664.
>
> The English Revenue should be brought into the proposal for a new percentage trust or unitrust to appreciate how useful it is and to provide a taxing structure for it. To help the Revenue and settlers, it may be wise to limit the percentage of a valid percentage trust to a figure no less than 3% nor more than 5% per annum: indeed, to prevent erosion of capital in the light of fees, taxes and inflation 3% is probably the most appropriate figure (see JC Dobris, "Why Five? The Strange, Magnetic and Mesmerizing Affect of the 5 per cent Unitrust and Spending Rate on Settlors, their Advisors, and Retirees" in Vol. 40, Number 1, Spring 2005 of Real Property Probate and Trust Journal pp 39-73).

183. Mr Justice Hayton noted that "the function of the Law Commission is to be bold and look at things with fresh eyes, starting with a clean sheet of paper". He concluded by encouraging us to "be bold: go the whole way and not three quarters of the way".

One consultee noted the practical difficulties of percentage trusts where the percentage is fixed at the outset, but suggested an alternative which might be more appropriate in the context of private trusts

184. P11 (Edward Nugee QC) commented that:

> … tax considerations effectively rule [percentage trusts] out, so long as the Revenue adheres to the traditional distinction between capital and income. For charitable trusts, for which the distinction has no tax implications, something very like a percentage trust has been adopted by a number of large charities, the main difference being that the percentage of the total assets which can be treated as income is not fixed in advance but is subject to annual determination by trustees ... . If the Revenue were to accept that the trustees' determination of what part of their assets could be prudently applied as income should be effective for tax purposes, perhaps by setting limits within which the determination was effective, percentage trusts [along these lines] could be usefully made available for adoption by trustees of non-

> charitable trusts, with consequent freedom to invest for total return without too much regard to tax ... . I do not regard the 21-year limit on accumulation need present an obstacle. If a scheme for investment for total return with a percentage of total assets being treated as income was adopted, then *ex hypothesi* what was applied as income would be income and what was not applied ... would be capital, and there would be no question of accumulation.

Supportive of percentage trusts in the charitable context: 3 (17%): O5, P10, P11

185. O5 (Charity Law Association) emphasised that:

> … any relaxation of the permanent endowment principle must recognise the volatility and risk of the investment process and allow charity trustees to maintain a spending pattern, which is consistent and sustainable.

186. The consultee added that "a power of allocation would not deal with [the] problem [of periods of negative returns] because it applies only to profits (unless used in a somewhat artificial way)". The consultee concluded that:

> … the percentage trust model is one that could be adopted for charities with permanent endowment. The technical difficulties are of limited significance to charities and their beneficiaries give that charities are not taxpayers … . It is a relatively simple model and avoids a requirement to make what may be seen to be arbitrary and possibly artificial decisions on allocation of incoming resources and expenditure.

187. The consultee suggested that the principle of permanent endowment "could sensibly be supplemented by a power permitting charity trustees to apply up to a certain percentage … of the charity's total assets … towards its charitable objects, regardless of strict capital and income classification".

188. O5 (Charity Law Association) thought that the "percentage power" should be voluntary rather than compulsory. In broad terms, the consultee recommended that the power:

> … should be based on a form of statutory default provision; that the provision specifies a default percentage that should apply, subject to amendment by statutory instrument, based on the asset value at the previous balance sheet date; and that Trustees are permitted to opt into the use of that power (and indeed to opt out) at any time, subject to a requirement to report the decision to the Charity Commission and to duties of disclosure in the statutory report and the accounts.

189. P10 (Charles Russell) broadly supported this suggestion (referring to the CLA's paper of 2 November 2004).

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?

190. This question was answered by 24 consultees (57%).

In agreement with the provisional proposal: 13 (54%): P1, J2, J4, P2, I2, I3, P4, O8, P7, A3, P8, O11, P10

191. O11 (Wills and Equity Committee of the Law Society) stated:

> A power of allocation would be helpful for those trustees who wish to pursue a total return investment policy. It is not helpful for trustees to be constrained in their investment policy by the requirement to generate a certain level of income.

One consultee stressed the importance of statutory clarity on the nature and purpose of the power of allocation

192. J2 (The Hon Mr Justice Etherton) commented:

> Whilst I agree that a non-exhaustive statutory list of relevant factors to guide the trustees should not be laid down by statute, I think it would be important and helpful to trustees and beneficiaries for the statute to define in clear and ample terms the nature and purpose of the … power of allocation: eg making clear that the object is fairly and properly to allocate expenses and receipts so as to reflect the legitimate interests of those entitled to income and capital respectively, but without regard to personal circumstances (save possibly in relation to investment decisions if it is decided to continue the approach in *Nestle*).

In qualified agreement with the provisional proposal: 4 (17%): J1, J3, A2, P3

One consultee was concerned about the consequences of a failure to exercise the power of allocation following investment (as part of a total return investment policy) in assets which favour one account over the other

193. J1 (Association of District Judges) said:

> We are impressed by the concept of a new power of allocation being given to trustees which will enable them to make appropriate investments to maximise the growth of the trust fund in appropriate cases and to be able to … exercise such a power where necessary with the benefit of hindsight, but we do have concerns that where there is someone entitled to current income a failure to exercise a power of allocation within a default period could result in that person being unfairly treated as a result of the trustee's decision to invest in capital-increasing assets. We suggest that such default allocation is more suitable to those trusts where the income is currently subject to accumulation but that where that is not so the trustees should be required to exercise the power so that failure so to do would prima

> facie be a breach of trust. We agree that there should be a period given to the trustees for reflection as to the appropriate allocation to be made and that a period of say 4 months after the end of the tax year end would be appropriate (this would also enable those having to make tax returns so to do before the September 30 cut-off date for Revenue calculation).

One consultee, although broadly in favour had some misgivings regarding the creation of uncertainty and tax consequences

194. J3 (The Rt Hon Lord Walker of Gestingthorpe) agreed with the provisional proposal "with some misgivings (as to creating more uncertainty and litigation) and subject to tax considerations".

One consultee was concerned that the Commission's proposals placed insufficient emphasis on the power of portfolio investment to maintain a balance

195. A2 (W A Lee) considered that:

> … the object of law reform should be to underwrite portfolio theory investing and I think that the Consultation Paper is trying to do that, although here and there the old list investment thinking seems to obtrude … . I would have thought that if trustees construct a portfolio of investments that is appropriate to the purposes of the trust reasonably diverse, the law can confidently *assume* that both capital and income accounts will be adequately protected. …
>
> I hope that any new legislation cannot be seen as reflecting any general doubt about the efficacy of modern portfolio theory. Some of the fears expressed in the Consultation Paper may be unfounded. The ink of trustee investment reform is hardly dry on the paper. The profession should be given an opportunity to adjust to it and resolve their needs … . [I]t would be premature to embark on any sort of law reform respecting the application of modern portfolio theory.

One consultee expressed concerns about the purposes for which the power of allocation might be used

196. P3 (Geoffrey Shindler) had:

> … no problem with the proposed new statutory power of allocation provided that it is enacted in a way that sets out the objective, namely to enable trustees to discharge their duties fairly. I do not agree that the power of allocation should be allied with, and allied only with, the concept of modern portfolio theory of investment. As stated in the Consultation Paper the legislation must make it clear that the power of allocation is an administrative one and not a dispositive one … . [T]he fiduciary duties of trustees must apply to the exercise of administrative … powers; statute should make this clear.

Not in agreement with the provisional proposal: 7 (29%): O2, T2, T3, O7, T4, T5, O4

One consultee thought that there was no need to introduce a power of allocation

197. O4 (Law Reform Committee of the General Council of the Bar) thought that:

> … there is no current practice or demand in trusts ... for a power to allocate excess capital returns to income or vice versa. Indeed, this is very nearly the sort of thing that is being excluded (and being abolished) as overcomplicated. There may well be some trusts where such a power would be useful (though most well-drawn trusts will have a power to benefit the same beneficiaries from both capital and income, making allocation completely otiose). There is no trust (as opposed to tax) reason why it could not be included, if wanted. In real terms, a trustee will try to keep a balance over the entire portfolio, thus allowing [for] fluctuations of return within individual investments.

198. The consultee thought that a wide power to allocate

> … would risk imposing unwanted bureaucracy and obligation on a trustee in relation to general investments. It is striking that no suggestions have been given as to matters which should be taken into account in making the allocation. Trustees need clarity, simplicity and certainty. They won't get it under these proposals.

199. The consultee added that "this power will be excluded in all well-drawn trusts, or else so modified ... as to be a power which can be used, but need not".

One consultee proposed an alternative model under which the power of allocation would be unnecessary

200. O2 (City of Westminster and Holborn Law Society) thought a power of allocation to be unnecessary under the alternative regime which it proposed in its response. Receipts and expenses would instead be classified in accordance with "ordinary accounting methods".

Several consultees were concerned about the practical implications of the power of allocation for trustees

201. (See responses to question 7.19 below.)

One consultee considered that the introduction of the power of allocation might undermine the duty to balance

202. T5 (Paul Saunders) suggested that:

> … the introduction of a power of allocation may dilute [the duty to balance] as trustees might seek to rely upon the power to maintain a "balance" between the competing capital and income interests, rather than undertake any investment changes for fear of incurring a capital gains tax liability.

Other comments in relation to the power of allocation:

One consultee considered the interaction of the duty to balance with the idea of total return investment

203. O11 (Wills and Equity Committee of the Law Society) welcomed "any regime in which total investment policies were encouraged" but thought that "necessary legislation should only be driven by the underlying duty to balance".

One consultee raised a point of terminology

204. O2 (City of Westminster and Holborn Law Society) suggested that:

> … the use of the word "power" … suggests a greater element of choice than is appropriate. One would prefer language using the word "duty", or possibly "discretion".

One consultee thought that the exercise of the power of allocation should be exceptional

205. A2 (W A Lee) considered that:

> … trustees should not use the power to allocate as a means of rectifying the inadequacy of an inappropriately constructed portfolio. The duty to balance as I see it, is performed by the construction of a portfolio that is appropriate for the purposes of the trust. This is the crucial duty. The power to allocate should not have to be used where the portfolio meets the requirements of the trust. It is only where the portfolio unduly favours capital or income, contrary to the purpose of the trust, that the question of exercising the power to allocate will arise. If the trustees find themselves having to exercise the power to allocate every year, they should move on to a reconsideration of the portfolio.

A few consultees had major concerns over whether the power could genuinely be classified as administrative

206. O10 (UK STEP Technical Committee) thought that:

> … the power could have a significant impact on the respective economic interests of income and capital beneficiaries in trust assets and therefore would seem to use to be more akin to a dispositive power. In conceptual terms, we also wonder whether envisaging a statutory power of allocation... misses the point that there is a more general philosophical question as to how to classify economic value ... . Unless there is a fundamental acceptance of this as applicable for fiscal purposes as well as to trust law, it will not be possible to align the consequences of allocation from a trust perspective with those that are accepted for tax and related purposes.

207. A4 (Simon Gardner) noted that:

> … glaring departures [from balance] will be obvious enough ... but is there such a thing as an *optimal* balance ... and if so by what principle(s) is it to be identified? If there isn't, and trustees have

> power to fix on any balance within an acceptable range – with ... differing implications for the different classes of beneficiaries - surely it cannot be said that their power is merely administrative? The issue was much easier in past times, when the trustees were expected largely to sit on the assets that the settlor had placed in the trust, so merely maintaining whatever balance between income and capital was already implicit in that settlement, and could be ascribed to the settlor's own choice. Ever since trustees have been expected to "play the markets" with the trust fund … , however, the issue has in principle been live – though in practice not talked about.

A few consultees did not think that the power of allocation should necessarily be limited to receipts and expenses which were incurred in a particular accounting period and stressed that it should apply to capital.

208. O11 (Wills and Equity Committee of the Law Society) commented that:

> However, it would be necessary for the trustees to be able to provide a fairly stable level of "income" to the income beneficiary year on year. That is not to say that there will not be fluctuations as there would with a conventional investment policy but the trustees must be able to allocate from capital to income even in years where there have been only losses and no profits and in years where there have been no realisations at all – for example, where the trustees just hold shares or units in a mutual fund which have not changed over the year in question. It should be possible to give effect to the allocation by means of accounting entries rather than having to sell investments in order to generate proceeds, which can be allocated to income.
>
> The power of allocation should not therefore be limited to receipts and expenses. Within the constraints of promoting balance it should include a wider power to re-categorise capital (as opposed to capital receipts) as income, subject to there being no liability on trustees for the way in which the allocation is exercised, and no liability for their opting out of or opting in to such a scheme.

209. A4 (Simon Gardner) asked whether the power of allocation "or a sister power" should also apply to capital:

> … the Paper's treatment of the default classification rules makes it clear that they only apply to receipts (see eg headings above paras 5.6 and 5.13). It follows, I think, that the power to allocate applies only to receipts. But should it (or a sister power) also apply to capital? Imagine that the trustees consider that their income beneficiaries have lost out, and that the only, or best, way to redress this is to allocate some of the trust's capital to them. Is there any reason, from first principles, why they should not do that?

210. A4 (Simon Gardner) demonstrated why there should be no objection to a statutory power of capital advancement linked to the duty to balance:

> Say for the moment that the law does not make it possible for trustees to [allocate capital to income in order to restore a

> balance] ... . Can the trustees nonetheless take however much out of the trust fund it requires to do what I am about to suggest, and reinvest it in a new vehicle - one which delivers a very high yield, but with dreadful capital value retention? ... And then, as the resulting income begins to flow, direct it (naturally enough) to the hitherto short-changed income beneficiaries? But if they can do that, would it really be any different (except cheaper and quicker) if they cut out the middle-man by allocating the capital itself direct to these beneficiaries ... . Another way of thinking about the question may be this. Say the trustees consider, conversely, that the capital beneficiaries have been hard done by. It seems to me that your power will certainly allow them to redress that, by taking as much of the receipts as may be required and consolidating them into the trust capital. The question I am addressing appears to be simply the mirror image of that. Doesn't the overarching concept of a fair balance suggest that it needs an affirmative answer? ... And ... when you discuss "percentage trusts" ... you imply ... that the drawdown can be taken from capital, if this is necessary because the receipts are insufficient. And yet, when you identify the difficulties associated with such trusts, you don't include among these a suggestion that accessing capital in this way ... crosses some uncrossable line.

211. The consultees expressly recognised the dispositive nature of this power, but did not necessarily view this as an obstacle:

> … that the question I am posing makes sense only if ... we recognise that delivering a fair balance isn't a merely administrative exercise ... . But to answer the question negatively on the basis of a prior assumption that the power must be merely administrative seems to me to put the cart well before the horse.

Two consultees were concerned that the new power of allocation may be excluded on the basis of complexity

212. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) stated:

> It is worth considering that [the existing equitable rules of apportionment] arose out of the court's views on maintaining a balance, but because of their complex and often onerous nature the practice has been to reject them at the possible expense of balance. A similar view may well be taken of the Commission's new proposals.

One consultee was concerned as to how the power of allocation would actually be exercised

213. O10 (UK STEP Technical Committee) said:

> In addition, we do have a particular concerns as to how trustees will go about exercising their power of allocation: where investments are undertaken in hedge or roll up funds where all the investment return will accrue to capital and trustees will then be obliged to make an allocation to income. We anticipate this could be problematic in particular given the "opaqueness" of underlying hedge fund returns.

214. The consultee went on to note two particular difficulties:

> How do trustees do equity by the life tenant in relation to roll up funds and hedge funds which, after a certain period, will generate a wholly capital return; should trustees hold the fund as a chose in action or as interest in capital?
>
> How should distributions in specie be classified, ie as income or capital, where there is a complex restructuring of family trusts, as these constitute an ambiguous return?

Other comments in relation to total return investment policies:

215. A number of consultees supported the adoption of total return

216. O11 (Wills and Equity Committee of the Law Society) considered that "It is not helpful for trustees to be constrained in their investment policy by the requirement to generate a certain level of income".

One consultee demonstrated improved returns under a total returns policy

217. O10 (UK STEP Technical Committee) produced an analysis to demonstrate the improved returns which should be achieved under a total return policy. This can be found at Appendix 2 of the consultee's response.

One consultee doubted whether the current law on balance obstructs trustees in maximising returns for the trust

218. O4 (Law Reform Committee of the General Council of the Bar) did not necessarily agree that:

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

One consultee noted that there are different ways of looking at total return investment

219. O2 (City of Westminster and Holborn Law Society) commented that:

> … there could indeed be a place for "total return investment policies", such as might allow a trust fund to be invested partly in markets where dividend yields were negligible but growth strong … . If the phrase "total return investment policies" were to imply a scheme under which some proportion of the total trust assets is periodically realised and credited to income, like a drawdown from a personal pension fund, the response would be that there is no need for such a scheme to be available generally to all trusts.

One consultee suggested that all "total return" could properly be expended as income without prejudicing the capital account

220. A2 (W A Lee) suggested that:

> … one might argue that all receipts under a "total return" portfolio, other than receipts resulting from the sale of a trust asset, are income: so a power of allocation allows trustees to allocate income to the capital account. The basis for conferring this power is an assumption that a "total return" portfolio prejudices capital. I do not share that assumption … . One might then ask the question: would trustees need a power of allocation to come to a decision that all receipts under a "total receipt" portfolio shall be expended as income? I would argue that if trustees perform their duty to balance when constructing their portfolio, the total return may confidently be expended as income, and the capital account will look after itself.

A few consultees doubted the value of "total return" investment for some private trusts

221. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) asked whether "for trusts where there are separate interests in income and capital … is the greater investment returns sufficiently certain to counterbalance the decreased certainty of the individual beneficiaries' interests? While the case is arguable from both sides it is by no means as clear as the [Consultation Paper] suggests". Moreover, "to suggest limiting *some* trustees from investing for total return is not in the interests of the national economy is badly overstating the issue".

One consultee thought that the widespread adoption of "total return" investment by trusts might have a "knock-on effect" on other investors

222. T5 (Paul Saunders) explained that:

> … if trustees invest in reliance upon the "total return" principle, unless the investments produce an income stream sufficient to meet the identified income requirement, the trustees will need to realise investments to meet that income need. If trustees, as a group, are the largest class of shareholders within most companies this might strongly influence the manner in which companies view the need to make distributions and, thereby, have a significant effect upon other investors, whose objectives differ from those of trustees.

One consultee expressed the view that the provisional proposals should not be used by trustees to disregard their duty to balance at the investment stage

223. O8 (Trust Law Committee) commented that "the power to allocate is not a trust to allocate and in many cases may hardly ever need to be used in the light of the trustees' investment policy".

224. Two consultees made detailed comments about operation of total return investment in the charitable context

225. See the comments of T1 (David Palfreyman) in response to question 7.44 and P11 (Edward Nugee QC) in response to question 7.45.

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?

226. This question was answered by 22 consultees (52%).

In agreement with the provisional proposal: 20 (91%): P1, J1, J2, J4, G1, P2, A2, T2, T3, O7, T4, I2, I3, O8, P7, A3, P8, O10, O4, P10

One consultee considered a time limit essential in order to provide certainty

227. O8 (Trust Law Committee) suggested that "there has to be a time-limit otherwise certainty can never be achieved".

One consultee considered that it was important to give the trustees an opportunity to step back and consider how they were going to exercise the power "in the round".

228. J1 (Association of District Judges) thought it important that "there should be a period given to the trustees for reflection as to the appropriate allocation to be made".

One consultee highlighted other positive effects of introducing a time limit for the exercise of the power of allocation

229. I2 (Toby Harris) noted that "in the context of trusts whose trustees hardly meet more than twice in a decade, the proposals might seem onerous but would almost certainly be good for the majority of trusts. A higher level (or quality) of record keeping would probably benefit nearly all trusts, particularly the smaller ones."

230. One consultee (P8 - Moore & Blatch) highlighted the need to make trustees aware of the time limits. The consultee asked whether a settlor could exclude a trustee's liability for missing the time limit.

In qualified agreement with the provisional proposal: 1 (5%): A4

One consultee thought that the effect of a failure to exercise the power within the time limit should not be spelled out in statute

231. A4 (Simon Gardner) commented that "I would delete the last nine words ('after which time ... etc) of the ... provisional recommendation ... leaving the consequences of a wrongful failure to consider timely exercise of the (evolving?) general law on the reviewability of trustees' discretionary decisions".

232. This suggestion was made in the context of discussion of the reviewability of the non-exercise of the power of allocation. The consultee noted that it was not proposed to deal with the general issue of the judicial review of trustees' discretionary powers in this consultation. He thought that it was important not to make "assumptions" about that issue in the present context.

Not in agreement with the provisional proposal: 1 (5%): O2

233. O2 (City of Westminster and Holborn Law Society) suggested that "the concept of time limits is misguided. Allocation would only be necessary – or indeed permissible – if the 'default' position turned out to be wrong. If wrong, it should be corrected however long it takes".

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

One consultee identified the balancing act which must be performed when determining the appropriate length of any time limit for the exercise of the power of allocation

234. J4 (The Hon Mr Justice Lloyd) said that:

> I can see the force of [the] objection to a period expiring up to 18 months after receipt, in delaying the moment when the beneficiary gets his hand on the money. On the other hand trustees will need to be able to take a view about their receipts over a given period, which may well be up to a whole year, for which either the trust's accounting period or the tax year would be a sensible period.

One consultee considered whether trustees should be able to choose which period of a year should be their reference point for allocation

235. J4 (The Hon Mr Justice Lloyd) commented that

> … if it were thought that different periods of a year [eg tax year, calendar year, accounting year] should be capable of being chosen, the trustees would have to resolve to adopt a given period … and, having done so, could only change to a different period by a further express resolution.

One consultee considered when the time limit for allocation should start to run

236. J4 (The Hon Mr Justice Lloyd) considered that:

> … as regards receipt, the starting date would be the date when the trustees received a particular sum (or, if mandated, when the beneficiary receives it). As regards expenses, the date might be when it was incurred, when it was billed or when it was paid. The first might be too difficult to identify with precision, so probably the better course would be to define the starting date as when the sum was paid or, if earlier, when it was billed.

One consultee thought that it was important that the power of allocation should remain available for a period after the end of a life interest

237. J4 (The Hon Mr Justice Lloyd) thought that "the power should be available for a time even after the end of the income interest, to make any necessary retrospective adjustments".

One consultee thought that the time limit should be as short as possible

238. G1 (Inland Revenue) stated that "if it is decided to proceed with a time limit within which trustees can change the status of receipts then the Revenue would prefer the time for any exercise of the discretion to be kept as short as possible".

One consultee expressly noted that the trustee must be in a position to consider the trust's annual accounts before being obliged to exercise the power of allocation

239. A2 (W A Lee) commented that:

> … the duty to allocate appertains to the "total return". That cannot be known after three or even six months into the accounting period. If this is so trustees should not be *required* to allocate before they are in a position to consider their annual accounts. But trustees would have to consider whether to exercise the power at least once a year.

Many consultees commented that the time limit should be related to the tax year and/or the Revenue's proposed changes to the trust tax regime

240. T2 (Association of Corporate Trustees) and T3 (HSBC) suggested that "the time limit could be tied in with the proposals for income streaming included in the [Revenue] Consultation Paper 'Modernising the Tax System for Trusts'".

241. O7 (British Bankers' Association) and T4 (HSBC) commented that "some consideration needs to be given to the necessity to link this calculation to the maintenance of income tax reserves and the payment of income tax liabilities". The consultees considered, however, that "six months is too short".

242. I2 (Toby Harris) suggested that "the time limit should be 31 December following 5 April in the year in which the trust year ends. That would tie in neatly with current proposals for the modernisation of the taxation of trusts".

243. O8 (Trust Law Committee) thought that the time limited should be:

> … linked to the previous tax year, which is the accounting year for nearly all UK trusts. A period of 6 months appears reasonable. The maximum can only be 8 months as trustees need to submit the tax return for the previous year by 31 January.

244. P7 (Herbert Smith) commented that "a re-allocation will presumably need to integrate with tax returns, and a time limit linked to the period for submission of tax returns would seem sensible".

245. O10 (UK STEP Technical Committee), O11 (Wills and Equity Committee of the Law Society), O4 (Law Reform Committee of the General Council of the Bar) and P10 (Charles Russell) made similar comments.

246. It should be noted, however, that O4 (Law Reform Committee of the General Council of the Bar) would, in the absence of tax constraints, favour a different time period (see below).

(1) Three months after tax year end:

247. I1 (Tim Smith) noted that the "opportunity cost" of keeping money out of the hands of the life tenants for significant periods of time. He also raised a possible human rights point in relation to reclaiming over-payments on account.

(2) Four months after tax year end:

248. J1 (Association of District Judges) noted that "this would enable those having to make tax returns to do so before the September 30 cut-off date for Revenue calculation."

(3) Six months after tax year end:

249. J4 (The Hon Mr Justice Lloyd) considered that:

> … a period of 6 months after the end of a year (whether it be a tax year, calendar year or a trust's accounting year) be laid down as a deadline for the exercise of the power of allocation as regards any given receipt or expense. I can see the attraction of using the tax year, for simplicity.

250. O8 (Trust Law Committee) made similar comments.

(4) One year after tax year end:

251. I3 (Ed Kisby).

(5) Three months from receipt or expense:

252. A3 (Richard Nolan).

(6) Six months from receipt or expense subject to extension by resolution of the trustees:

253. J2 (The Hon Mr Justice Etherton) was concerned that a time limit as long as six months after tax year end:

> … could mean a delay of up to 18 months in determining the entitlement of a beneficiary to a particular payment. I do not believe it unreasonable to expect that trustees will (or should) meet at least once every six months. I would have thought that it would be preferable to provide that the time limit should be 6 months subject to extension for a specified period by decision of the trustees before the end of the 6 months provided that the extension is for proper reasons and for no longer than is reasonably necessary (possibly with an absolute limit of, say, 18 months from the time of the receipt).

(7) Year and a half to two years from receipt or expense:

254. O4 (Law Reform Committee of the General Council of the Bar) commented that:

> … for the purposes of flexibility and ease, the same informal common-law time limit as applies to accumulations would be sensible: about a year and a half to 2 years.

However, the Committee conceded that "this may in practice be too long, for tax reasons" and concluded "we favour up to 31 January in the year following (ie the last moment before income tax returns have to be submitted. Anything earlier seems unduly tight".

(8) Three years from receipt or expense:

255. P1 (Richards Butler).

(9) Six to nine months from the end of accounting period:

256. P8 (Moore & Blatch).

(10) Not less than one year from end of accounting period:

257. P2 (Christopher McCall QC) suggested that the time limit should be "reasonably lengthy since there will be many factors to take into account". The consultee considered "any period less than one year after the end of the accounting period in question inadequate". The consultee did not see "any difficulty in keeping track of receipts or accounting". The consultee acknowledged, however, that:

> … this may prove difficult for tax purposes give the duty to self-assess within a specific period of time; in my view the answer must be found in a recognition that beneficiaries cannot be exposed to fiscal penalty for acting on provisional information as to their income from a trust even if it then has to be reviewed, because we all know that in some situations there may be uncertainty as to the position under a trust which needs the intervention of the Court and that will not be possible within the self-assessment period.

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.

258. See summary of responses to consultation question 7.4 for the possible consequences of our provisional proposals on classification.

One consultee recommended adoption of statements of recommended practice, but noted training issues for trust accountants

259. O10 (UK STEP Technical Committee) stated:

> So far as the practical implications are concerned, clearly trustees will need to be able to appropriately identify receipts and expenses that will enter this category. In our view the adoption of statements of recommended practice for trust accounting would materially assist this process in conceptual terms, although the information gathering would pose practical training issues for individual trust accountants.

One consultee thought that, whilst useful, power to reallocate receipts and expenses may expose trustees to more lawsuits

260. P5 (Mr Justice Hayton) noted that a power to reallocate receipts and expenses may be good for existing trusts, although leaving some difficult work for trustees. In particular, the consultee noted that an allocation process would "leave some

complex work for the trustees which is also work that exposes them to the risk of lawsuits". The consultee suggested that the introduction of a percentage yardstick could solve this problem:

> This has the great advantage that it is the settlor, not the trustees, who determines the matter, while it also means that the trustees' charges will be less than in traditional interest in possession trusts. After all, they do not have to make any time-taking complex allocations which might also expose them to litigation.

One consultee thought that trustees should take a "practical" approach to the distribution of net receipts

261. J4 (The Hon Mr Justice Lloyd) stated that:

> … trustees will need to adopt a practical approach to the distribution of net receipts … and no doubt in many cases of simple trusts with life interests they will be able to continue mandating dividends and other income to the income beneficiary. If they cannot do so, they will need to work out a system of interim distributions. This should not be difficult because, in the ordinary way, much or all of a trust's receipts and expenses will not give rise to any issue about apportionment or allocation.

A few consultees thought that administrative inconvenience would cause trust administrators largely to ignore the practical implications of the provisional proposals

262. O2 (City of Westminster and Holborn Law Society) suggested that:

> … trust administrators would doubtless carry on exactly as present, simply making adjusting transfers between capital and income in the event that the trustees exercised the proposed power of allocation … literal compliance with the scheme would be pointless.

A few consultees foresaw accounting difficulties with the provisional proposals

263. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) commented that:

> … the changes required to accounting procedures in order to hold items pending allocation will be expensive, particularly where the trustee operates computer based accounting systems linked to automated production of tax returns. For many professional trustees this will mean significant work on the accounting software and the tax return software.

264. T5 (Paul Saunders) observed that:

> … the need to decide within a particular periods as to the allocation of a receipt between income and capital may give rise to complex accounting issues. Whilst it should be possible for such matters to be tracked within a computerised accounting system, the costs of development of such a system must be taken into account when

> considering the implications of the introduction of any power of allocation. It should also be noted that private trustees might have to rely upon manual systems … .

One consultee saw no such difficulties

265. O8 (Trust Law Committee) did "not believe that the new rules would create serious accounting difficulties. They will only apply once the receipts and payments have been ascertained and properly accounted for."

A few consultees criticised the provisional proposals for delaying the classification of trust receipts

266. O2 (City of Westminster and Holborn Law Society) thought that the provisional proposals "envisage payment of all company distributions into some form of suspense account, from which transfers would be made from time to time in accordance with the decisions of trustees".

267. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) stated that "the abandonment of mandating income directly to income beneficiaries' bank accounts will involve delay in the receipt of income which will be detrimental to the life tenant". Moreover, "making frequent small assessments is potential[ly] very costly for the trustee and there will be a natural inclination to leave decision-making to ensure the maximum number of items is dealt with in each review".

268. T2 (Association of Corporate Trustees) and T3 (HSBC) had similar concerns.

A few consultees commented on the impact of the provisional proposals on life tenants

269. T2 (Association of Corporate Trustees) and T3 (HSBC) commented on the "delay in making payments of income to life tenants, uncertainty for life tenants regarding the income they will receive from the Trust … and difficulties in Trust accounting as automated payments of income to life tenants would no longer be possible".

270. O7 (British Bankers' Association), T4 (Barclays Bank Trust Company), T5 (Paul Saunders) and P7 (Herbert Smith) had similar concerns.

271. T5 (Paul Saunders) also suggested that "in order to reduce the costs burden on a trust, the trustees are likely to look to exercise the power of allocation as sparingly as possible, which will, undoubtedly, have a negative impact on the income beneficiary [who is used to a stable and regular income stream]".

A few consultees suggested that the new regime would result in an increase in trust expenses.

272. T5 (Paul Saunders) commented that:

> … any decision on the allocation of a receipt will need to be taken on a case by case basis, taking into account the particular circumstances of the trust, including the manner in which other receipts had previously been allocated between the income and capital interests. For professionals, whether acting or advising trustee clients, this will

> represent a very significant burden, which may, in many cases, be passed on to the trust by way of additional costs.

273. T2 (Association of Corporate Trustees) and T3 (HSBC) commented that the statutory power of allocation "would require the Trustee to review and allocate all income receipts and expenses, resulting in a significant increase in work for the Trustee and, consequently, a substantial rise in trust management expenses".

274. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) thought that:

> … the necessity to review and allocate all income receipts and expenses will add significantly to the burden of work for a trustee and will unquestionably result in a substantial rise in trust management expenses. There must be a clear, demonstrable and certain advantage to a trust before such a power is imposed.

275. Moreover:

> … where a trust corporation, or similar professional trustee, acts in a considerable number of trusts … all economies of scale of management will be lost and the additional work and expense will be disproportionate to any perceived advantages to the trusts.

276. P7 (Herbert Smith) said:

> The proposals will be likely to increase administrative activity. Currently, balancing is essentially an investment issue and dealt with as part of the investment mandate, subject to monitoring by the trustees. For the future, balancing will be likely to be outwith the investment mandate, creating a further level of administrative and, almost certainly, advice as to what is an appropriate balance. In order to reduce administrative costs, income is often mandated directly to the life tenant and trustees only file a capital gains tax return. The power of allocation could increase the costs of running such trusts.

A few consultees thought that trustees would have difficulties in implementing the new regime

277. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) commented that "the complexity of the exercise is going to be beyond the knowledge and in many cases the capability of private trustees".

Another consultee considered that the effect of the proposals would be broadly neutral

278. I3 (Ed Kisby) suggested that "appropriate accounting guidance would be required in order to ensure correct compliance" but considered that "record keeping should not be significantly affected if a suggested time limit of one year from the end of the relevant UK tax year … is used".

A few consultees played down the risk of litigation arising out of the new power

279. O8 (Trust Law Committee) suggested that "as a non-statutory duty to balance already exists, the risk of additional litigation against trustees is minimal".

280. A4 (Simon Gardner) thought that:

> … the principal downside is the apparent corollary that trustees who failed to realise its availability would find themselves in breach [of trust]; something that could well happen with lay trustees of new trusts ... . I'm not sure that there's so much of a problem. There must be very few, if any, trustees who know and apply, or would in future apply, the present rules but would be caught out by the advent of new rules. The issue is surely that, being lay, many operate, and will in future operate, in ignorance of the relevant rules: which will surely continue to be true regardless of whether the law is changed.

281. A4 (Simon Gardner) interestingly continued by saying that "arguably, the new rules would be kinder to such [ignorant] trustees, in the sense that they're closer than some of the present rules to the approach they do or would probably take anyway".

One consultee specifically noted the possibility of trustees being exculpated for breach of trust

282. A4 (Simon Gardner) commented that "if there were isolated instances of trustees caught out by the new rule but deserving relief, s 61 of the Trustee Act [1925] should be enough to rectify matters".

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.

283. This question was answered by 18 consultees (43%).

Power of allocation should be available on an opt-in basis: 6 (33%): J1, T2, T3, T5, P4, O4

284. P4 (John Ross Martyn) commented that:

> … it would be an important new power, with quite wide ranging effects… . The problems identified at 5.53 [administrative burden] and 5.54 [visibility] are real ones. As for 5.55 [inadvertent failure to opt in], I suspect there are very few trusts were the settlor has not taken sufficient legal advice before setting up the trust.

285. J1 (Association of District Judges) favoured this option on the basis of its concern that a failure by the trustees to exercise the power could in some circumstances lead to unfairness.

Power of allocation should be available on an opt-out basis: 12 (67%): P1, J2, J4, P2, I2, I3, O8, P7, A3, P8, O11, A4

A few consultees drew attention to the benefits of the proposed new allocation regime which militate in favour of applying the power of allocation on an opt-out basis

286. J2 (The Hon Mr Justice Etherton) stated that:

> … so far as concerns trusts which come into existence after the date of any legislation to give effect to the Commission's proposals, there seems to be no logical reason why there should be an "opt in". The proposals are intended to provide a better and more equitable trust regime, and, in my view, should plainly apply automatically and immediately to all new trusts.

287. O8 (Trust Law Committee) thought that the opt-out position was "preferable in order to ensure that most trustees will be able to use the new powers as soon as they learn of them. … If trustees find the new rules are difficult to apply in the circumstances of a particular trust they can exercise the opt-out option".

288. P8 (Moore & Blatch) commented that unless the power applied on an opt-out basis "it would only apply to the well advised".

289. A4 (Simon Gardner) commented that "the crucial consideration ... is the fact that this would make the benefits of the new approach available to all trustees (unless positively excluded by the settlor)".

One consultee thought that a publicity campaign would be necessary in relation to the provisional proposals if they applied on an opt-out basis

290. I2 (Toby Harris) suggested that "there should be a publicity campaign, perhaps orchestrated through a well-motivated organisation such as the Society of Trust and Estate Practitioners, to bring the change to the notice of all trustees, professional or lay".

One consultee considered the circumstances in which a trust would be said to have "opted out"

291. J4 (The Hon Mr Justice Lloyd) considered that the power of allocation would "only be displaced by an express provision, or a necessary implication, to the contrary".

Other comments:

A few consultees assumed that the opt in/opt out question related to trustees rather than settlors.

292. A2 (W A Lee) commented:

> I do not like the opt in/opt out concept. Trustees should simply be empowered to allocate if they take the view that to do so will result in better fairness as between capital and income accounts. They should not be required or permitted to make any decision – opt in or opt out – that binds them for the future, if that is what is being suggested. The

> power to allocate is like any other power, to be exercised ad hoc for the purpose for which it is given.

293. O8 (Trust Law Committee) also appeared to think that trustees would be able to opt out of the proposed regime if they found it "difficult to apply in the circumstances of a particular trust".

294. O10 (UK STEP Technical Committee) said:

> In our view the statutory powers introduced should be available on an "opt in" rather than on an "opt out" basis. This should either be by an express exercise by trustees powers or, alternatively by a expensive "fast track" procedure similar to that which was made available to executors of estates in the context of *Re Yorke (Deceased)* [1997] 4 All ER 907.

A few consultees thought that it might be helpful to allow trustees to change the settlor's decision at a later date

295. P6 (Bircham Dyson Bell) commented that:

> For new trusts, the additional administration costs would be something which a settlor could take into account in deciding whether the trust should be opted out of or into the new power. However, … the circumstances of a trust are quite likely to change over time. We suggest that the settlor should be able to opt in or out, but that (unless specifically prohibited by the settlor) the trustees should be able later to change that choice. …
>
> Plainly changing from one status to the other would need to be done in an orderly fashion, but we suggest it might be sufficient if (say) it had to be recorded in writing before the start of the tax year.

296. O8 (Trust Law Committee) also favoured such an approach.

A few consultees thought that this question would in practice be largely irrelevant

297. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) noted that:

> … there is unlikely to be an informed choice on this point by the settlor/testator. Professional trustees will want to avoid the administrative burdens and many standard trust deeds will omit the power. The omission will be on a similar basis to the current exoneration clause issue, i.e. it will be at the instigation of the trustee or draftsmen, not the settlor, and this would be a very unsatisfactory approach.

298. One consultee (P7 – Herbert Smith) noted (in a different context) the issue of trusts arising automatically (such as on an intestacy), which should be borne in mind when considering whether the power should operate on an opt-in or opt-out basis.

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.

299. This question was answered by 27 consultees (64%).

In agreement with the provisional proposal: 15 (56%): P1, J1, J2, O2, J4, A2, T2, T3, O7, T4, I3, P8, O10, A4, A3

300. It should be noted that although O2 (City of Westminster and Holborn Law Society) expressly stated its agreement with the provisional proposal, it commented at a later point in its response that "where the life tenant is an impoverished widow, trustees will select investments from the top of the yield range. This would seem to be a proper exercise of discretion, and care must be taken in any reform to preserve this".

Some consultees noted that allowing trustees to take account of personal circumstances blurs the distinction between fixed interest and discretionary trusts

301. O2 (City of Westminster and Holborn Law Society) commented that "if trustees should have unfettered power to choose which beneficiary should benefit most from their investment policy, that power would approach becoming a power to vary beneficial interests".

302. J4 (The Hon Mr Justice Lloyd) suggested that "if a settlor wishes [the trustees] to take [personal circumstances of the beneficiaries] into account, he should give them a dispositive discretionary power for the purpose".

303. A4 (Simon Gardner) commented that "I am glad that you have noticed the overtly dispositive tone in *Nestle*, and regard it as objectionable - I'd begun to think that I was in a minority of one in troubling over this".

304. A2 (W A Lee) made similar comments.

Several consultees thought it was important that the power of allocation be viewed as an administrative power

305. J4 (The Hon Mr Justice Lloyd) emphasised that:

> … when it comes to the exercise of the power of allocation, I feel strongly that it should be seen as an administrative power, not a dispositive one, and it should therefore not be capable of being influenced by the personal circumstances of the beneficiaries. Trustees should not only not be obliged to consider such circumstances, they should not be entitled to do so, in relation to this exercise.

Some consultees noted the practical implications of allowing trustees to take account of personal circumstances

306. O2 (City of Westminster and Holborn Law Society) noted that:

> … if the personal circumstances of beneficiaries should indeed be relevant, then trustees ought to make adequate inquiries of each of their beneficiaries about their personal circumstances. There is

> nothing impossible in such a requirement, but it seems to run contrary to present practice, and would impose additional burdens upon trustees and costs upon the trust.

307. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) commented that:

> … this is a welcome concession. Bringing the personal circumstances of the beneficiaries into account would not only impose a greater burden on trustees, but would also have a strong tendency to promote conflict between the beneficiaries and also between beneficiaries and trustees.

308. P8 (Moore & Blatch) commented that "objective criteria are needed if unnecessary aggravation and litigation are to be avoided".

Some consultees nevertheless considered that there might be difficulties with excluding personal circumstances from consideration.

309. O2 (City of Westminster and Holborn Law Society) considered that "there may be a problem in defining exactly what are the circumstances to be disregarded". Consequently, the consultee suggested that "one formula might be to allow trustees to take account of the general character of the trust, of the ages of the beneficiaries, and of the relationship of the beneficiaries to each other, but not, unless the trust document so permits, of the financial and other circumstances of the beneficiaries individually". However, the consultee did not find this formula "very attractive".

Trustees should be permitted but not obliged to take account of the personal circumstances of the beneficiaries: 11 (41%): J3, P2, P3, I2, P4, O8, O11, O4, P10, P11, T5

Several consultees emphasised the importance of flexibility in exercising investment powers

310. J3 (The Rt Hon Lord Walker of Gestingthorpe) thought that "settlors and testators cannot foresee the future, and they trust their trustees to exercise discretions in a flexible manner to meet unforeseen circumstances".

311. P2 (Christopher McCall QC) stated that:

> … a duty to balance cannot be absolute, and if seen as such will produce more arguments than it resolves. The prospective duty to balance is one which is well recognised as giving a trustee scope to choose between a range of objectives, and beneficiaries are not allowed to complain of a failure to keep to one specific measure of the capital/income divide. … [The trustee] can justify a range of alternative [income yields] without fear of criticism because investment is not an exact science. …
>
> [The trustee] must have elastic powers … . We must not expose trustees to demands which no reasonable person can be expected to achieve, or yardsticks by reference to which settlors would not wish them to be judged.

312. I2 (Toby Harris) stated a preference for "a rule that the personal circumstances are relevant unless the settlor specifically provides otherwise". He continued:

> This will be particularly relevant in the selection of investments that might, from a tax perspective, favour one beneficiary rather than another. I respectfully agree with the observations of Hoffman J (as he then was) as noted at para 5.73. I entirely approve the suggestion that the trustees should know about and should take an interest in the personal circumstances of the beneficiaries.

313. P11 (Edward Nugee QC) commented that:

> … in many respects the paper rightly moves on from the rather rigid rules of the Victorian era, when the only investments available to trustees were generally fixed interest stocks; but in this particular instance the Law Commission proposes to move backwards from the present law. I think it would be wrong to do so.

314. Later, the consultee continued:

> Hoffmann J's statement [in *Nestle*] of the principles by which trustees should be guided is much more in tune with the approach that trustees ought to adopt. They are not mechanical administrators of an impersonal fund of investments. In the normal kind of family trust they may, and in my opinion should, have regard to the well-being of all their beneficiaries and act in a manner which is fair to all of them but not lacking in sensitivity to personal factors, so far as they can do so without departing from a proper regard for their fiduciary duties.

315. O11 (Wills and Equity Committee of the Law Society) commented that:

> … there is a primary duty to maintain a balance, and that duty creates a band across which the trustees can exercise their power of allocation. Within this band they should have total discretion to take into account any circumstances which they deem to be relevant.

One consultee considered that excluding personal circumstances from consideration would cause problems for pre-existing trusts.

316. P2 (Christopher McCall QC) thought that excluding personal circumstances will:

> … in particular throw up real difficulties in terms of the application of the new rules to pre-existing trusts, even though it is often the pre-existing trust drafted without thought to problems such as instanced in *Sinclair v Lee* which have the greatest need for the rough edges of the capital income divide to be smoothed away by changes in the law such as are now proposed.

One consultee drew attention to the likely practice of trustees

317. O8 (Trust Law Committee) considered that:

> … many trustees would find [taking into account of the personal circumstances of beneficiaries] irresistible in practice ... . The statute

> should be silent on this point as a positive duty to consider this factor would undoubtedly create problems for trustees.

One consultee nevertheless recognised potential difficulties flowing from taking personal circumstances into account

318. P10 (Charles Russell) appreciated that "allowing trustees to take account of personal circumstances may create difficulties with the tax implications of the power of allocation" but still believed that "they should be capable of being considered".

One consultee emphasised the importance of settlor autonomy

319. T5 (Paul Saunders) stated:

> If a power of allocation is created, the personal circumstances of a beneficiary should be taken into account to the extent directed by the settlor. In some instances, the settlor will direct that the trustees must have regard exclusively to the circumstances of the income beneficiary. For the trustee to ignore such direction will strike at the very substance of the trust.

Trustees should be obliged to take personal circumstances into account: 1 (4%): I1

320. I1 (Tim Smith) argued that the flexibility given by consideration of personal circumstances was a necessary corollary of the flexibility which we argued for elsewhere in support of the power of allocation over the existing rules of apportionment.

Other comments:

Several consultees noted the importance of settlor autonomy in relation to the content of the duty to balance

321. J1 (Association of District Judges) sought to emphasise that their preferred approach only applied “unless the trust document says otherwise”.

322. J2 (The Hon Mr Justice Etherton) stated that “the settlor should be able … to modify the statutory regime in any particular case”.

323. P4 (John Ross Martyn) agreed that “whether the exercise of the power of allocation can take into account the personal circumstances of the beneficiaries should be something for the settlor to decide”. He considered that

> This is an argument in favour of opting in. The settlor should be left to make the two interdependent decisions, whether to have the power of allocations and whether, if so, to have its exercise take account of the personal of the beneficiaries. The absence of a decision should leave his trustees subject to the current law.

324. The consultee went on to note two different contexts in which the duty to balance could be important:

First, where there is no community of sentiment or interest between the life tenant and the persons entitled in remainder, rather than the possibility of discord between them. In that situation, the trustees will be careful to maintain a balance. They will do nothing that could give either side grounds for challenging their decisions. Secondly, there may be community of sentiment or interest. An obvious example is that between a widow and her children. The children may want their mother to have as large an income as possible, rather than capital accumulation that will be taxed at 40% when she dies. If her income were smaller, they might feel obliged to help her financially. Even if they are under no such moral obligation, there may be tax reasons for increasing her income. She may, for example, be using part of her enlarged income to make exempt gifts to her children or grandchildren. A general ban on taking personal circumstances into account might create problems.

325. O2 (City of Westminster and Holborn Law Society) considered that:

> … trustees must ask themselves whether upon the trust construction … of the trust they are required to act in one way or in another. They must take into account all relevant considerations, one of which (at least sometimes) may be the wishes of the settlor … . The meaning of the trust will generally have to be determined by the terms of the trust document, if there is one, or of, for example, the intestacy, in the context of the circumstances existing at the time the trust was created. That approach would usually exclude the personal circumstances of beneficiaries at a later date.

One consultee thought that tax problems created by taking into account the personal circumstances of the beneficiaries could be remedied by statutory drafting

326. O8 (Trust Law Committee) thought that:

> … the power of allocation will rightly be categorised as an administrative as opposed to a dispositive power ... . This should be stated in the proposed statutory provision.

Two consultees noted that it may be unrealistic to expect trustees to ignore something that they already know

327. P5 (Mr Justice Hayton) commented:

> Quite apart from a statutory precept to ignore the beneficiaries' personal circumstances contradicting a conventional fundamental duty of trustees, it is surely unrealistic to believe that the trustees will ignore something well-known to them, like the wealth of a life tenant and the poverty of a needy remainderman (who could be assisted by advancements under section 32 of the Trustee Act).

328. The consultee noted that in these circumstances the "trustees will try to get away with an allocation process resulting in the life tenant (and thus the Revenue) receiving as little as possible". If personal circumstances are to be taken into

account this may indirectly have tax implications. For this reason the consultee advocated the introduction of a percentage trust product.

329. P7 (Herbert Smith) commented:

> We imagine that the Inland Revenue may insist on this, one way or another, but we have grave doubts as to how realistic it is to imagine that such circumstances will not influence trustees.

7.22 We invite the views of consultees on whether or not the *Nestle* 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.

330. This question was answered by 17 consultees (40%).

Of the view that the *Nestle* approach is correct: 10 (59%): P1, J3, P3, I2, T5, O8, P7, O11, O4, P11

Several consultees noted that personal circumstances are just one of many factors taken into account when trustees exercise their powers of investment

331. P1 (Richards Butler) commented that:

> … the personal circumstances of a beneficiary must be a factor in the matrix of considerations for a trustee in this field. The real question is the height to which this duty should be elevated.

332. P3 (Geoffrey Shindler) noted that trustees:

> … are faced with a broad range of factors which they bring into account when coming to their financial conclusion. I do not think that any one or more of the factors is overriding but all of them have to be taken into account in the round … . I do not think that it is correct that the trustees should be obliged to take account of the needs of the life tenant, any more than they should be obliged to take account of the needs of the reversioners. It is simply one of the factors that they take into account.

Several consultees emphasised that personal circumstances will always be taken into account by trustees

333. P1 (Richards Butler) felt that "a legal regime under which personal circumstances are not, in strict law, to be a factor will inevitably be disregarded by the more thoughtful or conscientious trustee and it is not satisfactory that they should thereby be exposed to a breach of trust claim".

334. P3 (Geoffrey Shindler) suggested that "when choosing [a] portfolio the trustees, consciously or sub-consciously, take into account the needs of the life tenant. I think it is unreal to suggest that trustees are not influenced by the needs of the life tenant".

335. T5 (Paul Saunders) stated:

> The personal circumstances of a beneficiary may impact upon various issues that a trustee must bear in mind when formulating investment policy. The personal circumstances may have a wider impact than only the balance between capital and income, as where the income beneficiary with an interest in possession is outside of the UK it may be possible to structure the investment strategy to avoid the payment of UK inheritance tax upon the termination of that person's interest in the trust.

A few consultees relied on the presumed intention of the settlor in small family trusts

336. I2 (Toby Harris) commented that:

> … it takes the argument too far to suggest that the trustees are altering the structure of the trust if they take account of the circumstances of the beneficiaries. Very likely, however, that is precisely what many settlers would have wanted, if they had been asked at the time of preparation of the will or settlement. In the context of small family trusts, fairness of this kind is what most people want.

One consultee commented at length on the Nestle *decision – a case in which he acted*

See response of P11 (Edward Nugee QC).

Of the view that the *Nestle* approach is incorrect: 7 (41%): A2, T2, T3, O7, T4, I3, P8

A few consultees noted the problems of taking personal circumstances of beneficiaries into account

337. T2 (Association of Corporate Trustees) and T3 (HSBC) commented that "there are practical difficulties for Trustees in knowing and accommodating beneficiaries' personal circumstances when making investment decisions and the need to take account of such circumstances can lead to disputes between beneficiaries and Trustees".

338. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) indicated that:

> … the *Nestle* approach has … been a *de facto* element of trust investment, particularly in the period 1945 to 1961. The reasons for preferring, usually, the income beneficiary, led to wild distortions of investment performance once we moved into the 1960-70 period of high inflation. Trustees are still paying for this approach with investment performance arguments with residuary beneficiaries today. We would welcome beneficiaries' circumstances being excluded from the investment process, unless the settlor/testator has expressly directed it for a particular beneficiary.

Other comments:

One consultee had difficulty reconciling the application of the Nestle *approach with the power of allocation model. In essence, can both approaches co-exist?*

339. P6 (Bircham Dyson Bell) commented that:

> … we must confess to some difficulty in understanding how the reconciliation with the *Nestle* decision… would work in practice, when allied to a policy of investing for total return. At present, if trustees believe that they are in a *Nestle* situation, they achieve the desired result by investing for higher income which, when it comes in, can be paid to the life tenant. If, however, … they believe that they should use their new powers to maximise investment performance by investing for total return, and this happens to produce low income and high growth, it seems that they can only use their administrative power of allocation to allocate a 'proper amount to income. So by investing for total return they seem to have deprived themselves of *Nestle* flexibility … .

340. O10 (UK STEP Technical Committee) stated:

> In respect of whether the approach in *Nestle v National Westminster Bank* [1993] 1 WLR 1260 (CA); [2000] WTLR 795 (Hoffmann J) is correct, in our view, it would be preferable for trustees to have an overriding ability to take into account all of the circumstances of the case, including factoring in the relevant tax, when dividing and determining the total return.

7.23 If consultees believe the *Nestle* 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?

341. This question was answered by 7 consultees (17%).

In agreement with the provisional proposal: 4 (57%): T2, T3, I3, P8

342. One consultee (P8 - Moore & Blatch) noted that this should be subject to contrary provision in the terms of the trust.

Not in agreement with the provisional proposal: 3 (43%): O11, O4, A2

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.

A few consultees noted that the trustees should only be bound by a single over-arching consideration

343. T2 (Association of Corporate Trustees) and T3 (HSBC) commented that:

> … we do not think there are any other factors which are relevant except the need to hold a reasonable balance between the different classes of beneficiary. Of necessity, this involves consideration of the

> returns available from the different investments available in the market.

344. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) did not think it was "worthwhile" speculating about relevant factors at this stage. The consultees commented, however, that:

> … if personal circumstances are to be removed from the calculation … then one must only be left with a generalised concept of fairness in looking at the returns produced by the investment policy. It follows that all that the trustee can do is look at what is a reasonable division of return. To us this suggests that a trustee is going to be guided by market levels of return which may result in a decision not too far removed from the actual returns obtained under the present system.

One consultee thought that the settlor's views should be brought into account

345. I3 (Ed Kisby) considered that the "views of the settlor as to the purpose and possibly lifespan of the fund at the time of establishing the trust/settling funds, should be considered".

One consultee suggested that trustees should specifically not be required to consider the previous equitable and/or statutory rules of apportionment

346. P10 (Charles Russell) thought that:

> … the new legislation should stipulate that trustees are not under any duty to have regard to any of the (previous) equitable or statutory rules of apportionment (which represent the traditional views of the court on fairness between capital and income).

347. One consultee thought that trustees should have a wide discretion

348. O10 (UK STEP Technical Committee) thought that "… in our view it would be preferable for trustees to have an overriding ability to take into account all of the circumstances of the case, including factoring in the relevant tax, when dividing and determining the total return".

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?

349. This question was answered by 27 consultees (64%).

In agreement with the provisional proposal: 27 (100%): P1, J1, J2, I1, J3, O2, J4, A2, T2, T3, O6, O7, T4, I2, T5, I3, P4, O8, P7, A3, P8, O10, O11, O4, P10, A4, P11

350. J1 (Association of District Judges) were of the firm opinion that "a beneficiary who feels that he has been treated inequitably as a result of the exercise of the power of allocation must be entitled to seek the assistance of the courts".

351. O6 (Association of Contentious Trust and Probate Specialists) agreed, noting that "although this particular power may be characterised as an administrative power, it would seem illogical if the court's jurisdiction were ousted" (reference being made to *re Wynn's Will Trusts* [1952] Ch 271).

Several consultees noted that there was no need to make specific provision on this point

352. J4 (The Hon Mr Justice Lloyd) stated that "unless some other provision is made, the court would be able to review the position, and to grant a remedy for breach of duty, as with any other breach of trust".

353. A2 (W A Lee) stated: "Yes, as in the case of any other power".

One consultee highlighted the relationship between the courts having the power to review the exercise of the new power and encouraging a change in trustee behaviour

354. I2 (Toby Harris) noted that "there is a strong tendency for trustees to carry on as if no new law had been enacted, and the judicial power of review would force trustees to adapt to a more modern approach".

A few consultees considered whether trustees should be given statutory protection or immunity

355. P8 (Moore & Blatch) commented that "outside advice should be required if trustees are to be given immunity".

356. O11 (Wills and Equity Committee of the Law Society) thought that:

> … there may be a case for providing statutory protection for trustees so that they will only be liable for breach of trust in circumstances where it can be shown that trustees have breached their duty to balance by the exercise or non exercise of the statutory power.

A few consultees related this question to their opposition to the introduction of the power of allocation

357. T2 (Association of Corporate Trustees) and T3 (HSBC) explained that "we opposed the introduction of a Power of Allocation because we anticipate problems between beneficiaries and Trustees arising from the exercise of the power".

358. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) emphasised that:

> … the frequency (and seriousness) of disputes between beneficiaries with different interests does appear to be seriously underestimated by [the Consultation Paper]. Such disputes occur with regularity and only financial common sense keeps them from the courts. Any addition avenue for a party to such a dispute to impose his views on the trustees is very unwelcome.

One consultee noted an ambiguity in the provisional proposal

359. A4 (Simon Gardner) thought that:

> … the provisional recommendation ... is worded so as to imply that a *non*-exercise of the power would be reviewable in the same way as an exercise. Is that right? In para 5.43 and in the second provisional recommendation in para 5.48, you say that the power would lapse if not exercised in the allowed period; and para 5.12 makes it even clearer that this could be as much because exercise is (however wrongfully) not even considered, as because a decision is taken not to exercise. This latter analysis is the conventional one, I think: see *Re Allen-Meyrick's Will Trusts*. (It is compatible with the view that the unthinking trustees are in breach and so liable for any loss, because so to hold would not be to "review" the non-exercise – though I don't quite see how the relevant loss could be established.) But I don wonder whether *Re Allen-Meyrick's Will Trusts* has had its day – whether it doesn't overlook the *duty* the trustees have to consider exercising the power which remains unperformed even if the period for its proper performance has expired. *Re Locker's Settlement Trusts* seems to take this point, and in a broad way it seems to me immanent in the thinking in *Mettoy Pensions Trustees v Evans*. However: all this is about control of trustees' powers generally, rather than specific to the present context. In para 5.79 you express a preference not to have to deal with that issue just now – very understandably. So all I would suggest for the moment is that you take care not to make *assumptions* about the issue in what you say in the present context. In particular: I would delete the last nine words ("after which time …" etc) of the second provisional recommendation in para 5.48 (recommendation 7.17): leaving the consequences of a wrongful failure to consider timely exercise for the (evolving?) general law on the reviewability of trustees' discretionary decisions.

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?

360. This question was answered by 24 consultees (57%).

In agreement with the provisional proposal: 23 (96%): P1, J2, I1, J3, O2, J4, P2, T2, T3, O6, O7, T4, I2, T5, I3, P4, O8, P7, A3, P8, O10, O11, P11

A few consultees who agreed with the proposal nevertheless endorsed the Commission's view that disputes regarding the exercise of the power of allocation should generally be resolved without resort to the courts

361. P11 (Edward Nugee QC) did not expect:

> … there to be a significant amount of litigation on the point - the court is notoriously reluctant to criticise trustees who have exercised their powers in good faith, and I think it most unlikely that it will wish to encourage still further the litigation culture that seems increasingly to pervade the legal world, here and in other common law countries.

362. J2 (The Hon Mr Justice Etherton) considered that:

> Generally speaking, there seems to be no sound reason, in terms of what would constitute a breach of trust and when the Court will exercise its power of review, to treat the duty to balance or an improper exercise of the power of allocation differently from any other trust duty and power. Equally I consider that it would be dangerous to introduce or modify section 61 of the Trustee Act specifically in relation to the duty to balance and the power of allocation.
>
> On the other hand, I strongly support and endorse the sentiment (reflected in paras 5.81 and 5.82 of the Paper) that, where a beneficiary is aggrieved by an alleged improper exercise of the power to allocate, the primary relief should be to compensate by making fair adjustments between the beneficiaries retrospectively or prospectively, rather than ordering money compensation to be paid by the trustees (which should be a last resort, only if such adjustment cannot be made or cannot be made in such a way as fairly to compensate for a past breach). If there were a statutory provision to that effect, it would encourage settlement of disputes and minimise contentious litigation.

One consultee expressed doubts over whether specific provision should be made for the resolution of disputes without resort to the courts

363. J4 (The Hon Mr Justice Lloyd) noted the:

> … view that the remedy should be defined as lying primarily by way of later adjustment, rather than compensation order to be paid by the trustees, unless adjustment is impossible. This may be worth considering, but I am not sure that it would be appropriate to make an express statutory provision about this in relation to this particular duty.

One consultee noted that correcting an imbalance by exercising the power of allocation in respect of future receipts might not always be possible

364. J4 (The Hon Mr Justice Lloyd) suggested that the future adjustment approach to dispute resolution would not apply where, for example, "a life or other income interest has come to an end in the meantime".

One consultee thought that trustees might need additional protection from disappointed beneficiaries

365. P2 (Christopher McCall QC) considered that the power of allocation should not be exercisable

> … unless the trustees are satisfied that in all the circumstances of the case it is appropriate to do so. It cannot be right that every disappointed beneficiary should be able to question a failure to reallocate by which he is disappointed. The law should give the trustees the protection of saying that they do not have to exercise their power unless they see good reason.

One consultee noted that this proposal interacted closely with the trustee exemption clauses project

366. P7 (Herbert Smith).

In qualified agreement with the provisional proposal: 1 (4%): P10

One consultee thought that there should be a specific statutory exculpatory provision

367. P10 (Charles Russell) commented that:

> … there should be specific provision that trustees will not be in breach of trust provided that in exercising or failing to exercise their new power of apportionment they have acted in good faith and/or unless the circumstances are exceptional. We appreciate that the drafting may be problematical but we believe it is important in order to ensure that trustees do not spend inordinate amounts of time deliberating the exercise or non-exercise of the power in circumstances which are otherwise extremely straightforward.

Other comments:

One consultee thought that this proposal was problematic

368. A2 (W A Lee) stated that:

> … if trustees insist on sticking to an unbalanced portfolio and by so doing cause loss to the fund, they will no doubt be committing a breach of trust. But an unbalanced portfolio will not necessarily cause loss and the trustees may exercise the power to allocate to rectify the imbalance in which case no-one would have the incentive to bring an action for breach. I would think that a failure to exercise the power to allocate when needed, would be a greater cause for concern.

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.

369. This question was answered by 18 consultees (43%).

In favour of a pre-action protocol: 10 (56%): J2, O6, I2, T5, I3, P4, O8, P7, P8, O4

370. O6 (Association of Contentious Trust and Probate Specialists) stated that:

> … a pre-action trust protocol would be of benefit generally not just with regard to disputes regarding allocation … . A suggested Pre-action Protocol for the Resolution of Probate and Trust disputes is available in draft for the guidance of practitioners on the ACTAPS website at www.actaps.com.

371. T5 (Paul Saunders) commented that:

> … whilst disputes … arise due to relationship issues amongst the beneficiaries [eg second wife and children of a first marriage], the

> introduction of a pre-action protocol might help beneficiaries and trustees focus on the key issues, without the need for such matters to come before the courts.

372. O4 (Law Reform Committee of the General Council of the Bar) expressed disappointment that:

> ACTAPS' attempt to secure the adoption of a pre-action protocol for trust and probate disputes was rejected recently by the Chancery bench, and would very much welcome the Law Commission's influence on this issue generally.

373. J2 (The Hon Mr Justice Etherton) stated:

> In addition, there could be a pre-action protocol under the CPR to provide that, before litigation, the aggrieved beneficiary should set out in writing to the proposed defendants the precise nature of the grievance and should state how best it could be remedied by any such adjustment or as to why it could not be so remedied. I appreciate that the Chancery judges have previously rejected the proposal of a pre-action protocol for the resolution of probate and trust disputes generally, but I see no reason why the point, if proposed by the Commission, should not be reconsidered either generally in relation to trust disputes or specifically in relation to disputes over the exercise of the duty to balance or the power of allocation.

One consultee briefly considered the possible content of such a protocol

374. I2 (Toby Harris) suggested that the:

> … requirements [of the protocol] should be relatively informal, similar to arbitration. A specialist body such as the Society of Trust and Estate Practitioners might be able to supply a panel of referees to deal with this particular issue.

One consultee considered alternatives to a protocol

375. O8 (Trust Law Committee) commented that "while protocols are always helpful, a speedy short-cut procedure, possibly with the Master having full jurisdiction, might be of more utility".

Not in favour of a pre-action protocol: 8 (44%): O2, J4, T2, T3, O7, T4, O10, O11

One consultee suggested that protocols were not appropriate in trust law

376. O2 (City of Westminster and Holborn Law Society) stated that "a protocol belongs to the field of dispute resolution and litigation … not in trust law".

One consultee considered that disputes would not be sufficiently common or homogeneous to justify a pre-action protocol

377. O2 (City of Westminster and Holborn Law Society) considered that:

> … a protocol is suitable in situations where a number of similar claims arise, so that facts and arguments can be usefully co-ordinated and assembled before being put to a defendant. Disputes over classification of trust receipts are virtually non-existent. Any that might arise in future are likely to be wholly diverse, as indeed is the case with almost all trust litigation.

A few consultees thought that a pre-action protocol was likely to encourage rather than discourage litigation

378. T2 (Association of Corporate Trustees) and T3 (HSBC) commented that "such a protocol would be more likely to provide ammunition for disputes between Trustees and beneficiaries".

A few consultees thought that a pre-action protocol would not succeed in resolving disputes without resort to litigation

379. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) thought that "the existence of a protocol is more likely to produce greater caution in trustees in the exercise of their power, but at the same time raise the expectations of the beneficiaries in winning compensation (much as ombudsman schemes have done)".

One consultee thought that the policy of the reforms should focus on preventing disputes rather than introducing a protocol to deal with disputes which do arise

380. O11 (Wills and Equity Committee of the Law Society) commented that:

> … the suggestion that there might be a special protocol for disputes implies that introducing a power of allocation is likely to give rise to an increased number of disputes. This is probably true, hence the need for statutory protection for the trustees. The policy should be to try and prevent disputes arising rather than to introduce a protocol to deal with disputes.

THE EQUITABLE RULES OF APPORTIONMENT

7.28 We provisionally propose that all the existing equitable rules of apportionment should be abrogated. Do consultees agree?

381. This question was answered by 24 consultees (57%).

In agreement with the provisional proposal: 18 (75%): P1, J1, J2, J3, O2, J4, A2, A3, P3, I2, I3, O8, P7, P8, O10, O11, O4, P10

382. I2 (Toby Harris) stated:

> Yes. This is what Americans would call a "no brainer".

383. J1 (Association of District Judges) commented that:

> … the equitable powers of apportionment in our experience only apply by default, ie where the will or trust has failed to exclude them, exclusion being the norm. They have thus outlived their usefulness.

384. J4 (The Hon Mr Justice Lloyd) suggested that the rules "serve little useful purpose already, and would be wholly unnecessary if a statutory power of allocation were introduced".

Several consultees noted, however, that the objective of the apportionment rules remains valid

385. A2 (W A Lee) commented that "the old rules of apportionment were all set in [the context of list investing] and are now pretty well totally irrelevant, although the general objective, of ensuring fairness between capital and income accounts, is the same".

386. P3 (Geoffrey Shindler) stated that:

> … all the rules of apportionment should be abrogated but subject to a proviso that the duty to balance which was at the heart of the equitable rules of apportionment remains a duty of trustees. The problem with the equitable rules of apportionment is not the nature of the rules but the cost of implementing them in practice … . At the heart of apportionment is fairness and balance and that remains one of the key duties of trustees, which must not be abrogated.

In qualified agreement with the provisional proposal: 6 (25%): T2, T3, O7, T4, P11, T5

A few consultees would not agree with the proposal if it led to the introduction of the power of allocation

387. T2 (Association of Corporate Trustees) and T3 (HSBC) agreed with the provisional proposal "but not if it means that the Power of Allocation becomes statutory".

A few consultees were concerned that the gap left by the abolition of the rule in Re Chesterfields Trusts *should be filled by the trustees' discretion*

388. O7 (British Bankers Association) and T4 (Barclays Bank Trust Company) commented "… the paper does not address the application of *Re Chesterfield* (1883) 24 Ch D 643 to reversionary interests. We would be most unhappy to see the division of such proceeds left at the discretion of the trustee as there are potentially very large sums involved".

389. P11 (Edward Nugee QC) commented that

> I agree with the proposal to abrogate all the existing equitable rules of apportionment – they are commonly excluded in a solicitor-drawn will for the sake of convenience of administration – *provided that* there is no doubt that the power of allocation can be used in appropriate circumstances where the rules now apply. The rules in *Howe v Lord Dartmouth* are largely obsolete with the wide powers of investment now available to trustees, since there are few investments that are unauthorised. The rule in *Re Earl of Chesterfield's Trusts* stands on a rather different footing. Where assets subject to a trust include a reversionary interest, it may well be imprudent for trustees to try to sell it during the life tenant's lifetime; but when it falls into possession

> the life tenant may justifiably say that s/he should be compensated for having had no enjoyment if it while it was in reversion. The calculation in [paragraph] 3.33 [of the Consultation Paper] demonstrates that there can be quite a large sum to which the life tenant has a justifiable claim ... . It need to be made clear in some way that the trustees' duty to act fairly entitles them, and may require them, to carry out a *Chesterfield* type of apportionment when a reversionary interest falls in.

One consultee thought that it should still be possible to opt-in to the existing equitable rules of apportionment

390. T5 (Paul Saunders) agreed that "there would seem merit in most cases for such rules being abrogated, although the option to opt-in to them should be available".

Other comments:

One consultee disagreed that the equitable rules of apportionment require complex calculations

391. I1 (Tim Smith) took issue with our suggestion in the Consultation Paper that the apportionment rules require complex calculations.

A few consultees noted that the Commission should take care to ensure that its proposals for reform do not fall into the same trap as the existing equitable apportionment rules

392. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) stated that:

> [In] practical terms we agree, as any usefulness that [the equitable rules of apportionment] have … has been lost in the almost invariable practice of negating their application (and the widespread practice of ignoring them if the deed does not negate them). However, it is worth considering that they arose out of the court's views on maintaining a balance, but because of their complex and often onerous nature the practice has been to reject them at the possible expense of balance. A similar view may well be taken of the Commission's new proposals.

One consultee pointed out that the rules of apportionment apply automatically in the context of intestacy

393. P7 (Herbert Smith) said:

> Although it is correct to say, as you do in paragraph 1.15, that in practice the apportionment rules are often excluded, they do, of course apply "automatically" in the context of an intestacy.

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 consultee agree?

394. This question was answered by 25 consultees (60%).

In agreement with the provisional proposal: 22 (88%): P1, J1, J2, J3, O2, J4, P3, T2, T3, I2, T5, I3, P4, O8, P7, A3, P8, O10, O11, O4, P10, P11

395. J1 (Association of District Judges) stated:

> We support that proposal to exclude the use of the statutory apportionment rule found in the Apportionment Act 1870 s. 2 so far as trust income is concerned, since it may cause unintended hardship, except where the settlor has specifically incorporated the apportionment requirement … .

One consultee noted that there might be some difficulties over establishing when a particular payment becomes due

396. P11 (Edward Nugee QC) gave the examples of dividends – are these due when paid or when they become due? – and interim dividends.

> I agree too that s.2 of the Apportionment Act 1870 should be excluded in relation to trusts. There is not much point in apportioning post-death income to a deceased life tenant in most cases; and again the power of allocation will presumably enable fairness to be achieved in most cases; and again the power of allocation will presumably enable fairness to be achieved in cases where the abrogation of the rule is thought to work injustice. I therefore agree with the proposal in 5.88 but I don't agree with the reasoning. The fact that the life tenant has dies does not mean that there are no competing interests: the life tenant's estate is still a beneficiary under the trust to the extent that income has arisen during his/her life, and I do not think that the exclusion of s.2 would alter this (s.2 is not being repealed) - or at all events, if it is thought that it would, the proposal in 5.88 will enable trustees to act fairly in such a situation.

Not in agreement with the provisional proposal: 3 (12%): A2, O7, T4

A few consultees saw no reason to change the existing statutory apportionment rule

397. A2 (W A Lee) stated:

> The legislature can hardly repeal the Apportionment Act because in principle there is nothing wrong with it; but a reform provision could allow trustees in their discretion to characterise all receipts of income in the year following the death of the testator to income, and all receipts of income in the year following the termination of the trust to capital. If there is a change of successive beneficiaries income could be allowed to lie where it falls, without apportionment.

> Another way of simplifying Apportionment Act calculations might be to *allow* trustees to attribute 50% of income during relevant apportionable periods to capital and 50% to income. This is justifiable as an averaging principle, mentioned in para 3.46. For example if L5,000 is received after 3 months, three fourths would go to capital and one fourth to income. If a further £5,000 is received after 9 months, one fourth would go to capital and three fourths to income. The trust is that half goes to capital and half to income, ie the average. Although in the case of many receipts an averaging calculation would not produce exactly the same results as a daily calculation no-one could say that averaging as such favours capital or income.

398. The consultee went on to note that

> … the total return attributable to income should be divided between *successive* income beneficiaries within the accounting period on a daily basis, calculated by reference to the date when the entitlement to the interests changes … . This is not difficult and there should be no need to confer a discretion on the trustees [see question 7.30] to depart from it.

399. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) noted that the statutory apportionment rule and, in particular, the outcome of *Re Joel* was "manifestly fair" and that "it does at least have the virtue of being mathematically certain".

One consultee noted that in some circumstances the provisional proposal might have an effect on death duties

400. A2 (W A Lee) posed the following example:

> Suppose that two months after the death, income of £120,000 arrives, being interest relative to the previous 12 months. Under the Apportionment Act, £100,000 of that would be attributable to capital. I do not know whether the intention to abolish section 2 would have the result that the £100,000 would not longer be characterised as capital … ?

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?

401. This question was answered by 23 consultees (55%).

In agreement with the provisional proposal: 14 (61%): I2, P1, J1, J3, I3, P4, O8, P7, A3, P8, O10, P10, P11, O11

A few consultees noted that this power should only apply by default subject to contrary intention expressed in the trust instrument

402. P8 (Moore & Blatch) and O11 (Wills and Equity Committee of the Law Society).

One consultee expressed his disagreement with the reasoning of the Law Commission despite agreeing with the proposal

403. P11 (Edward Nugee QC) commented that:

> … the fact that the life tenant has died does not mean that there are no competing interests: the life tenant estate is still a beneficiary under the trust to the extent that income has arisen during his/her life, and I do not think that the exclusion of section 2 would alter this ... - or at all events, if it is thought that it would, the proposal in [paragraph 5.88] will enable trustees to act fairly in such a situation.

One consultee emphasised the need for the power to be in trustees' absolute discretion to minimise the chances of litigation

404. I2 (Toby Harris) agreed that trustees should have a discretion to apportion in this situation, but that the power should be at "the absolute discretion" of the trustees "to minimise the chances of litigation".

Not in agreement with the provisional proposal: 9 (39%): J2, O2, J4, A2, T2, T3, O7, T4, T5

Two consultees had concerns over the extent of the proposed power

405. J2 (The Hon Mr Justice Etherton) thought that our provisional proposals would arguably confer a new discretionary dispositive power on trustees. The effect of the proposal would be that:

> … the trustees could make their decision entirely on their own whim and preferences. If that is correct, or arguably so, the proposal is not one with which I feel entirely comfortable. The proposed power does not sit comfortably with a fixed interest trust. Further what is now clear and certain… would be replaced with uncertainty and the increased potential for capriciousness and litigation.

406. This point was taken up by another consultee. J4 (The Hon Mr Justice Lloyd) said:

> I do not see why the power to allocate, in order to perform the duty to balance between capital and income, should not also extend to a power to allocate in order to preserve a balance between the interests of those entitled in succession to income.

407. J4 (The Hon Mr Justice Lloyd) also considered that the power of allocation should remain available for a "transitional period" after the end of a life interest to allow receipts from the same tax year to be allocated to the (now ended) life interest.

A few consultees were concerned that the costs of such a power would outweigh any benefits

408. T2 (Association of Corporate Trustees) and T3 (HSBC) argued that "trustees will [not] use this power" whilst "the mere existence of the Power may provide grounds for further disputes between Trustees and beneficiaries".

409. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) concluded that

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

One consultee considered that apportionment between successive life interests could be accommodated within its alternative model of classification

410. O2 (City of Westminster and Holborn Law Society) considered that apportionment between successive life interests:

> … should be treated in exactly the same way as classification of trust receipts. Trustees should be required to apportion receipts – and outgoings – between successive interest at their discretion and in accordance with good accountancy practice.

One consultee was concerned that the new power would be applied to pre-existing trusts

411. T5 (Paul Saunders) commented that "there is no authority to amend the application of the Apportionment Acts in existing trusts".

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?

412. This question was answered by 22 consultees (52%).

In agreement with the provisional proposal: 13 (59%): J1, J2, J4, I2, I3, P4, O8, P7, O10, O11, P10, J3, A3

Not in agreement with the provisional proposal: 9 (41%): P1, O2, A2, T2, T3, O7, T4, P8, O4

One consultee stressed the importance of settlor intention

413. O4 (Law Reform Committee of the General Council of the Bar) commented:

> We do not agree that the imposition of a trust for sale should necessarily impose a duty to convert and reinvest. We would be surprised if the express duty to convert is ever wittingly imposed on trustees by a settlor, with the intention that they should sell as soon as they have the asset. If the Settlor wants the trustees to do that, then he can always state that explicitly.

One consultee saw no place for trusts for sale under portfolio investment theory

414. A2 (W A Lee) asked:

> Convert into what? Authorised securities? This proposition is driven by list investment thinking. There can only be a duty to "convert" where a total portfolio does not comply, for example as to diversity, with the requirements of the Trustee Act. Then the "conversion" should take the form of reconstructing the whole portfolio.

A few consultees saw no reason why there should not be a power to postpone sale

415. T2 (Association of Corporate Trustees) and T3 (HSBC) doubted "whether most Trustees understand their duties under a Trust for sale" and saw "no reason why there should not be a power to postpone sale".

416. Similar comments were made by O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company). The consultees suggested that:

> … there is little point in not reforming this entire area with trustees being given statutory powers to postpone sale unless the settlor expressly directs immediate sale (and not by the formulaic trust for sale which he does not understand but by clear and specific direction).

417. P8 (Moore & Blatch) thought that:

> … it would seem more helpful to imply a power to postpone subject to contrary intention. This would allow realisation of the asset to be postponed, say, in the light of market circumstances.

Other comments:

One consultee was concerned with the implications of our proposals for express trusts for sale of land under the TLATA 1996

418. I1 (Tim Smith) drew the Commission's attention to section 4 of the Trusts of Land and Appointment of Trustees Act 1996. In particular, he referred to the provision that a trustee should not be liable "in any way" for postponing the sale of land which is subject to an express trust for sale.

419. I1 (Tim Smith) suggested that the separate treatment of realty and personalty as a result of section 4 of the Trusts of Land and Appointment of Trustees Act 1996 may cause problems for our proposals in a trust which includes a mixture of realty or personalty.

A few consultees doubted whether there was any usefulness in the trust for sale concept

420. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) commented that:

> [Trusts for sale] have nothing to do with settlor freedom of choice. We [have] not previously encountered any settlors who knew about,

> understood or even had had explained to them, the implications of a trust for sale. We would further suggest that a substantial part of the legal profession is unaware of its implications … There is little point in not reforming this entire area with trustees being given statutory powers to postpone sale unless the settlor expressly directs immediate sale (and not by the formulaic trust for sale which he does not understand) but by clear and specific direction.

One consultee favoured a rule on trusts for sale which brought personalty and realty together.

421. T5 (Paul Saunders) commented that:

> … the distinction between personalty and realty is an historic division which was reduced to some degree by the 1925 legislation. The provisions of the *Trusts of Land and Appointment of Trustees Act 1996*, and subsequent legislation developing "trusts of land", have pushed the rules relating to personalty trusts and trusts of realty apart again. I believe that it is in the interests of all parties for the rules relating to the operation of both types of trust to converge, rather than diverge. Accordingly, I would favour a common rule on the imposition of the trust for sale.

One consultee emphasised that a settlor should be able to create trust for sale without a power to postpone

422. J1 (Association of District Judges) stated "we can see no valid reason to remove from a settlor the right expressly to impose a trust for sale without power to postpone".

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

423. This question was answered by 23 consultees (55%).

In agreement with the provisional proposal: 23 (100%): P1, J1, J2, J3, O2, J4, A2, T2, T3, O7, T4, I2, T5, I3, P4, O8, P7, P8, O10, O11, O4, P10, A3

One consultee noted that the rule could not co-exist with modern portfolio investment

424. A2 (W A Lee) commented that:

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

SCOPE OF THE PROVISIONAL PROPOSALS

7.33 We provisionally propose that the scheme set out in this Part [ie Part V of the Consultation Paper] 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?

425. This question was answered by 20 consultees (48%).

In agreement with the provisional proposal: 19 (95%): P1, J1, J2, O2, J4, A2, O7, T4, I2, I3, P4, P6, O8, P7, P8, O10, O11, P10, A3

One consultee suggested that the Law Commission should look at trusts set up under foreign law but which are administered by trustees resident in England and Wales

426. P1 (Richards Butler) added:

> … I believe the private international law principle is that administrative facets of the trusteeship are to be, or may be, conducted under the law of the country in which the administration of the trust is conducted or the trustees reside, even though the "proper law" of the trust may be that of another jurisdiction. The new powers proposed in the consultation paper are expressed to be of an administrative nature so the question of … their extension to "UK administration" but foreign proper law trusts might need consideration.

One consultee thought that clarification of the scope of the proposals was required

427. P6 (Bircham Dyson Bell) noted that:

> … at various places in the paper it is noted that the new power of allocation will apply to all trusts with successive interests. It would be helpful to have explicit clarification that it will apply to all types of family trust including, for example discretionary trusts.

One consultee also noted the relevance of the balancing process to contingent trusts

428. P7 (Herbert Smith) commented that:

> … similar issues can arise with regard to a contingent trust, in particular where minor interests are involved and there may not immediately be any fixed interest in income. The income of such trusts will often fall to be dealt with pursuant to section 31 [of the] Trustee Act 1925, which gives trustees powers of accumulation, thus enabling them to convert income to capital, and in some cases, take the capital back as income. Clearly the operation of any power of allocation will need to be reviewed in the context of its interrelationship with such powers of accumulation.

One consultee pointed out that the scheme should in practice apply to all trusts except charitable trusts, bare trusts for an adult beneficiary and joint property trusts

429. J4 (The Hon Mr Justice Lloyd) stated that he:

> … agreed that the proposed scheme should apply to all trusts governed by the law of England and Wales, other than charitable trusts, in which there are separate beneficial interests in income and capital. In practice that means all private trusts other than bare trusts for an adult beneficiary and trusts for two or more persons absolutely (such as joint property trusts).

One consultee pointed out that fixed trusts may arise in the charitable context

430. P7 (Herbert Smith) stated:

> In paragraph 1.18 you suggest that "charitable trusts on the other hand always further the same charitable purpose". While that may often be the case, there is, I would suggest, no reason why fixed interest trusts could not arise in a charitable context with the capital and income interests vested in different charities or different groups of charities.

Another consultee outlined other circumstances in which apportionment issues are relevant to charities

P11 (Edward Nugee QC) commented:

> I agree that the proposals should apply to all private trusts; but why not also, at least to some extent to charitable trusts? If a charity has power to accumulate income for 21 years, and *a fortiori* if it has a duty to do so, the need to apportion under s 2 of the 1870 Act may arise; and there may be cases in which a reversionary interest falls in a trustees who have no power to expend capital would like to treat part of it as income under *Chesterfield* - should they not be permitted to do so? Charities are probably entitled to more reversionary interests than non-charitable trusts.

In qualified disagreement with the provisional proposal: 1 (5%): T5

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 [ie Part V of the Consultation Paper] should not apply (or to which they should apply in modified form).

One consultee noted that the proposals should not be applied to certain discretionary trusts

431. A2 (W A Lee) thought the proposals "should not apply to trusts that are discretionary as to both income and capital with respect to the same beneficiaries or classes of beneficiaries, or to charitable purposes".

A few consultees thought that the new regime might be inappropriate for certain types of trust

432. O10 (UK STEP Technical Committee) commented that "certain types of trusts, such as maintenance funds for historic houses, would seem to be inherently unsuited to the new regime".

433. Similarly O11 (Wills and Equity Committee of the Law Society) suggested that "where there are special trusts with their own statutory regime such as maintenance funds, these should be outside the scope of these proposals".

Pension funds

434. O1 (The Society of Pension Consultants) commented:

> We do not think that the issues covered in the consultation paper are relevant to occupational pension schemes or personal pension schemes set up under trust because they do not provide benefits for persons in succession.

Bare trusts

435. I3 (Ed Kisby) said:

> It is possible that bare trusts might need to be subject to modification or exclusion of certain rules, eg regarding the requirement to ignore the interests of beneficiaries.

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.

436. This question was answered by 21 consultees (50%).

In favour of applying the statutory power of allocation automatically to pre-existing trusts: 8 (38%): P1, P2, A2, I3, O8, P8, O11, A4

437. See question 7.20 for comments on O10 (UK STEP Technical Committee) on opting in.

A few consultees noted that the power of allocation must apply automatically to pre-existing trusts in order to be effective

438. O8 (Trust Law Committee) noted that "a duty to balance, albeit a more limited one, already exists" and believed that "if pre-existing trusts are not included, it will take a generation before much needed new rules will apply generally".

439. A4 (Simon Gardner) made similar comments.

One consultee agreed with this proposal subject to a power (presumably of the trustees) to opt out

440. I3 (Ed Kisby).

A few consultees thought that the trustees of pre-existing trusts might be excused from the duty to consider whether to exercise the power of allocation

441. O8 (Trust Law Committee) suggested that it might be "appropriate for trustees of pre-existing trusts to be relieved of any duty to consider exercise of the power, of which in some cases ... they might remain in ignorance".

442. A4 (Simon Gardner) commented that

> … if you think a special indulgence should be set up in advance for trustees of pre-existing trusts, you could enact that in these cases, the power created by the new rule is a non-fiduciary one: so that such trustees could validly use it if they knew about it, but would not be in breach if, being unaware of it, they failed to think about using it.

One consultee noted that the regime should not apply to pre-existing trusts where it is inconsistent with the terms of the trust

443. O11 (Wills and Equity Committee of the Law Society).

In favour of applying the statutory power of allocation to pre-existing trusts *if* the power of allocation is introduced at all: 2 (10%): O7, T4

444. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) thought that:

> … if the Commission are convinced that the proposals are manifestly to the advantage of trustees then it seems that they should be available to all trustees. This comment is made from a general point of view and does not admit that the proposals are, in fact, a good idea.

445. In relation to the suggestion that trustees of pre-existing trusts could retire or resign if they are not happy to take on the burdens of the proposed regime, O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) noted:

> Any trustee who is not prepared to undertake the office and act fairly and honestly should resign. However, to impose a greater burden, for a benefit to the trust, that I am not persuaded is there, is a different issue. Trustees are only as useful as they are honest and capable. If the role is made too onerous or complex it will not be performed properly … . The burden imposed by these proposals will discourage people from taking on the role of trustee.

446. T2 (Association of Corporate Trustees) and T3 (HSBC) made a similar point.

Not in favour of applying the statutory power of allocation automatically to pre-existing trusts: 10 (48%): J2, T2, T3, T5, P4, P6, P7, A3, O4, J4

A few consultees highlighted the discrepancy between the reasonable expectations of the settlor at the time of creating the trust and the reality following automatic application of the new allocation regime to pre-existing trusts

447. J2 (The Hon Mr Justice Etherton) suggested that:

> … it is good policy, in the case of pre-existing trusts (when the settlor had the opportunity expressly to vary the application of the existing rules but chose not to do so), to exclude the automatic application of the proposed new allocation regime. To apply the proposed new regime automatically to existing trusts has an element of retrospectivity in changing, albeit for the future, the legal principles which the settlor (had he or she thought about it) believed applied when the trust instrument was executed.

448. J4 (The Hon Mr Justice Lloyd) thought it to be "sound policy for the application of the new rules (including the new rule as to the classification of corporate receipts) to existing trusts to be available only on the basis of opting in".

One consultee was concerned about the interaction of the provisional proposals with the terms of pre-existing "big" trusts

449. A3 (Richard Nolan) commented that "'Big trusts' often have detailed provisions about these issues, but the interaction of those provisions (which are all drafted against the background of the existing law) and the new law could raise all sorts of complicated construction points".

Unclear whether or not in favour: 1 (5%): I2

450. I2 (Toby Harris) commented in relation to this question: "Let the new rules apply even to old trusts but let them opt out if the trustees wish" and to question 7.36 "Old trusts should be allowed to opt in".

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.

451. This question was answered by 21 consultees (50%).

In favour of allowing the trustees of pre-existing trusts to opt in to the statutory power of allocation: 13 (62%): P1, J2, J4, I3, P4, P6, O8, A3, P8, O10, O11, O4, A2

(See question 7.20 for comments of O10 (UK STEP Technical Committee) on opting in).

One consultee questioned whether opting in to the power would have to be a "once-for-all" decision

452. P5 (Bircham Dyson Bell) wondered:

> … whether it is essential that any opt-in or opt-out should be a once-for-all decision, as we see possible problems. Trustees of a small trust with straightforward investments might reasonably decide to opt out to reduce their administrative burden. Unforeseen circumstances might mean that at a later stage this became a very substantial trust (experience shows that these changes of fortune to happen), but the power of allocation could not be available. The reverse situation … is perhaps more frequently encountered, and that would give rise to the

> lesser evil that trustees who had the power could not, in their reduced circumstances, opt out of the administrative burden.

Not in favour of allowing the trustees of pre-existing trusts to opt in to the statutory power of allocation: 7 (33%): J1, T2, T3, O7, T4, T5, P7

A few consultees thought that the power to opt in should be reserved to the settlor

453. T2 (Association of Corporate Trustees) and T3 (HSBC) commented that "opt in should be available to the Settlor when establishing the Trust, not Trustees of existing trusts".

A few consultees considered that this proposal would give rise to disputes between beneficiaries and trustees

454. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) commented that "this is simply going to give the trustees another potential bone of contention with the beneficiaries depending on how they approach their decision-making".

Unclear whether or not in favour: 1 (5%): I2

455. I2 (Toby Harris) commented in relation to question 7.35: "Let the new rules apply even to old trusts but let them opt out if the trustees wish" and to this question "Old trusts should be allowed to opt in".

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.

456. This question was answered by 16 consultees (38%).

In favour of requiring trustees to seek court approval: 5 (31%): J2, J4, P4, P7, O10

457. J2 (The Hon Mr Justice Etherton) commented:

> On balance, there is a fair argument that the change of an existing trust to the new regime should be effected by order of the Court – at least if there is any objection by a beneficiary – rather than merely by decision of the trustees, so as to enable actual or possible objections to any change in any particular case to be considered by the Court. It would also avoid the appearance of self-interested motivation in a case in which a trustee or a close relative of the trustee is beneficiary entitled to (say) capital.

A few consultees noted the procedure need not/should not be expensive

458. P4 (John Ross Martyn) saw "no reason why a paper procedure should not be used, with the Chancery Master to whom the application came being able to direct an oral hearing before him, or a Chancery judge, if he thought fit".

459. P7 (Herbert Smith) commented that "the [Variation of Trusts Act] would be available in any event but a streamlined low cost application procedure would be sensible".

A few consultees noted that no court order would be required if all the beneficiaries, absolutely entitled and sui juris*, consent*

460. J2 (The Hon Mr Justice Etherton):

> In a case where all the beneficiaries are of full age and capacity and consent, there is plainly no need for any direction or order of the Court.

461. See also J4 (The Hon Mr Justice Lloyd).

A few consultees considered the various ways in which the court might authorise a pre-existing trust to "convert" to the new regime

462. J2 (The Hon Mr Justice Etherton) stated that:

> … the change can be effected by an application under the Variation of Trusts Act or, more likely, on the basis that the new power of allocation is an administrative rather than a dispositive power, s 57 of the Trustee Act. To avoid any difficulties or doubt, the statute could provide expressly for application to be made under s 57.

463. J4 (The Hon Mr Justice Lloyd) considered that "it might be a good idea to draw on the analogy of section 57 of the Trustee Act 1925 to prescribe the circumstances in which the court could authorise the opting in".

One consultee considered the appropriate test which should be applied by a court before allowing a pre-existing trust to "convert" to the new regime

464. J2 (The Hon Mr Justice Etherton) noted that:

> … the test in [s 57 of the Trustee Act] is one of expediency. That test would seem to be suitable. If, however, a more liberal test is preferred, there could be a new free standing legislative provision specifically dealing with such applications, and providing for a rather more liberal test, such as "if the Court shall consider it appropriate in all the circumstances".

One consultee suggested that it should be possible to opt in to only part of the proposed regime

465. J4 (The Hon Mr Justice Lloyd) stated that "the trustees of an existing trust should be able to opt in to all or part of the regime".

Not in favour of requiring trustees to seek court approval: 11 (69%): P1, A2, I2, T5, I3, P6, O8, A3, P8, O11, O4

A few consultees commented on the expense of seeking court approval

466. A3 (Richard Nolan) suggested that "obliging a court application would be too expensive for 'small' trusts".

467. O4 (Law Reform Committee of the General Council of the Bar) commented that court approval would be "disproportionately expensive, and probably little more than a rubber stamp".

468. Similar comments were made by P8 (Moore & Blatch).

One consultee, although not in favour of allowing the trustees of pre-existing trusts to opt in to the proposed regime, thought, if such a power to opt in were to be introduced that it should be exercisable without an order of the court unless the beneficiaries of the trust veto the course of action

469. T5 (Paul Saunders) stated that:

> … if a power to allocate were to be introduced and made available to trustees of pre-existing trusts, such trustees should be entitled to opt in to the arrangement without the need to obtain the permission of the court. However, I suggest that they should give notice of their intention to the beneficiaries (or at least those of legal capacity), who should have a right of veto. Only if the trustees considers it is for the benefit of the trust overall that it should opt in, against the beneficiaries' wishes, should the court be asked to adjudicate.

Other comments on the provisional proposals for transitional provisions:

One consultee proposed a more sophisticated model for dealing with pre-existing trusts

470. A3 (Richard Nolan) thought that pre-existing trusts should have to opt in to the provisional proposals but agreed that "'small trusts' ... might benefit from access to the power immediately". Consequently, he suggested that:

> … to help those "small" trusts that don't opt in (most commonly because they don't know to) a jog to the court's arm to relieve any good faith breach of the old law by the trustees who acted in a manner that would have been permitted had they opted in.

One consultee thought that the need for transitional provisions militated against any reform

471. O2 (City of Westminster and Holborn Law Society) suggested that the need for transitional provisions suggests that the proposed power of allocation involves "some variation of the terms of the trust". The consultee considers that "this would seem a strange way to clarify the correct classification of trust receipts".

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?

472. This question was answered by 20 consultees (48%).

In agreement with the provisional proposal: 19 (95%): J1, J2, O2, A2, A3, T2, T3, O7, T4, I2, T5, I3, P4, O8, P7, O10, O11, O4, P10

Not in agreement with the provisional proposal: 1 (5%): J4

One consultee thought that the proposed regime should be brought into force as soon as possible

473. J4 (The Hon Mr Justice Lloyd) said that:

> … it seems to me desirable that new trusts should be able to take advantage of the new regime as soon as possible, subject only to a normal period of delay after commencement to allow for awareness of the position. Trustees of such trusts will not need to change their practices. Trustees of existing trusts may need to change their practices, but they will be opting in, and therefore have some control over the process.

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.

One consultee emphasised that the power of allocation will be properly categorised as an administrative power

474. O8 (Trust Law Committee) stated:

> We take the view that the power of allocation will rightly be categorised as an administrative as opposed to a dispositive power (as defined by Lord Dilhorne in *Pearson v IRC* [1981] AC 753 at 774).

A few consultees foresaw day-to-day difficulties for trustees in calculating trust tax liability

475. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) suggested that the proposed power of allocation would require the reform of trust taxation. It would also give rise to "the necessity to make an informed decision [in respect of the exercise or non-exercise of the power of allocation] will require recalculation of the income tax position on each exercise of the power".

Many consultees envisaged difficulties with integrating the proposed regime within the existing tax system for trusts and/or with persuading the Revenue to adopt a tax neutral approach to the provisional proposals

476. J3 (The Rt Hon Lord Walker of Gestingthorpe) stated that "in the past the Revenue have expected trust income to fit into the scheduler scheme, and tax law has discriminated (for income tax, capital gains tax and inheritance tax purposes) against trusts which have no interest in possession". His Lordship doubted whether the Revenue would accept our proposed power of allocation, enabling income receipts to be used to supplement capital, as being consistent with an interest in possession.

477. O7 (British Bankers' Association) and T4 (Barclays Bank Trust Company) commented that the provisional proposals would require "reform of trust taxation".

478. O2 (City of Westminster and Holborn Law Society) considered that problems might arise:

> … if a receipt were able to be reallocated in a later tax year. Would the revenue tax the "capital" element in year 2 as the life tenant's income; if the rate liability in year 1 was materially different from year 2 would the Revenue make adjustments, and if not would be beneficiary complain that the trustees discretion had been wrongly exercised? Does this mean that the trustees would have to know and take into account the beneficiary's tax rates in both years, though his personal circumstances are not otherwise taken into account?

Another consultee raised possible difficulties relating to the interaction of the provisional proposals with the proposed modernisation of the system of trust taxation

479. T5 (Paul Saunders) considered that:

> … if a power of allocation were to be introduced, I believe that it would be necessary for this to be at the same time as the trust tax system is reformed. The introduction of the trust tax reforms will have a major impact upon trustees, and to reorganise the system again shortly afterwards in order to facilitate the introduction of a power of allocation, is likely to have a severe negative impact upon the trust industry.

One consultee emphasised the need to have an understanding of the Revenue's approach

480. P7 (Herbert Smith) stated:

> In structuring returns of value to shareholders, companies utilize a variety of different routes (for example special dividends, share buybacks, accelerated share repurchases, B share schemes, reductions of capital, etc) taking into account, at least in part, the fiscal consequences to shareholders. Again, in order to balance the advantage of the flexibility that you propose against the ascertainable tax consequences, it will be important to have some understanding of the Revenue's likely approach.

The Inland Revenue expressed its general position in relation to the provisional proposals

481. G1 (Inland Revenue) commented that:

> … the Revenue's position is that changes to the classification and apportionment rules may open up avoidance opportunities for taxpayers, by allowing them to treat what we see as income receipts as capital, and what we see as capital expenses as income. Our overriding concern is to protect the exchequer by maintaining the current position for tax purposes. We understand the reasons for reforms proposed by the Law Commission and have no intention of seeking to obstruct the proposed reform in any way … . But we reserve the rights to respond to any trust law changes if necessary by way of tax legislation.

A few consultees commented on the tax effects of changing the rules of classification for trust receipts

482. G1 (Inland Revenue) asked whether "the new classification will affect the nature of the receipt as it arises to trustees or will it simply dictate which fund the receipt belongs to once it is in the hands of the trustees":

> If the effect will be to change the nature of the receipt as it arises to trustees (so that two identical corporate receipts, one going to an individual, one going to a trustee, will be categorise differently) this will operate contrary to one of the aims of the Revenue's Trust Modernisation programme, namely to lessen the distinction between assets being held by a trust and assets being held by an individual.

483. O11 (Wills and Equity Committee of the Law Society) commented:

> There seems no reason in principle why the proposal should change the way in which income and capital gains are taxed – ie: anything which is income for tax purposes should continue to be taxed as income whether it is paid to the income beneficiary or allocated to capital. The only difference is that, if [income] is allocated to capital, the trustees will pay tax on this income at the rate applicable to trusts instead of the income being taxed at the beneficiary's marginal rate. Similarly any receipts which are capital for tax purposes should continue to be taxed as capital gains even if those receipts are subsequently allocated to income. Capital gains which are allocated to income should not be taxed as income on the income beneficiary. Simplification and clarification of the way in which distributed capital is treated following *re Brodies' Will Trustees v IRC* and *Stevenson v Wishart* would be welcomed.
>
> There is nothing inherently objectionable in this approach. Anybody is free to invest their money as they see fit and they will pay income tax or capital gains tax depending on the nature of the return they receive. The fact that an individual invests for a capital return but then spends the proceeds on general living expenses does not turn it into income for tax purposes. There therefore seems no logical reason why the Revenue should object to this approach.
>
> The alternative of course is for the tax treatment to follow the allocation so that any capital receipt which is allocated to income is taxed as income and any income receipt which is allocated to capital is taxed as a capital gain. This would not however work very well if the capital receipt which is allocated to income represents the proceeds of sale of an investment sold at a loss. It would also not make sense if the suggestion made above that trustees should have power to allocate pure capital (as opposed to capital receipts) to income is adopted.
>
> The suggestion made above that income and capital continue to be taxed in the same way as at present and that any reallocation is ignored therefore seems to be the simplest (and perhaps the only workable solution).

484. G1 (Inland Revenue) commented in relation to the specific rule proposed for the classification of corporate receipts:

> The proposal to classify cash distributions, and distributions that could have been taken in cash as income would not cause us problems. But we would not want to be bound [for tax purposes] by the other part of this proposal, to classify all other corporate distributions as capital. The Revenue's point of view is that at present we have a tax statute to give us the result we want for most types of non-standard corporate distributions (that is, they are deemed to be income and taxed at the trust dividend rate). Depending on the nature of the proposed statute, we may want to review our legislation. We should emphasise that trustees have and will continue to have a duty to self-assess on the basis of tax law, not trust law.

A few consultees queried whether the proposals should have a significant impact on the tax position

485. I2 (Toby Harris) thought, in any event, that the proposals would be "broadly neutral in tax terms". He noted that "many of the changes are sufficiently small that the scope for arbitrage between, for example, income tax and capital gains tax will be limited".

486. P7 (Herbert Smith) noted that "while the proposals may give rise to opportunities for some tax flexibility, the reality is that situations exist at present where trustees have a choice of investment option and can select the most tax efficient route available". In particular, the consultee noted the increasing use of "some form of investment 'wrapper' (in particular a unit trust or the like) ... to enable investments to be bought and sold as necessary within the 'wrapper', without prejudicing the longer term capital gains tax taper relief available to the trustees".

487. P8 (Moore & Blatch) argued that:

> … the ideal is that the trust and tax provisions should be aligned. Receipts should be treated as of the same nature for both purposes. This would allow for 'horizontal and vertical equity'. The tax effect of reallocation will be the most difficult issue. Tax considerations should not be paramount as to the exercise of the power. It is not an obvious avoidance device. If it were thought otherwise, then a clearance mechanism might be the answer. Alternatively the approach in Statement of Practice 4/94 could be adopted and withholding applied.

Several consultees dealt with tax and trust expenses

488. G1 (Inland Revenue) stated, in relation to trust expenses, that "we depend to an extent on trust law … . So if there is a possibility of trust law on expenses changing, we will be watching developments very closely".

489. P2 (Christopher McCall QC) commented in relation to the proposed rules of classification that:

> … the Revenue may not share the view of the [legal] profession that radical reform is called for, and at least in the context of trust

> expenses I fear that a desire (which in itself no doubt may well be not without justification in the widespread use of trusts to minimise taxation) not to allow the fiscal burdens on trusts to be cut back may militate against sensible reform.

490. P2 (Christopher McCall QC) was concerned that the Revenue might cause the incidence of expenses for the purpose of tax law to diverge from that of trust law:

> If as appears possible that the Inland Revenue may be seeking to tax trusts on the footing that certain liabilities which are deductible against trust income under *Carver v Duncan* will not be allowed against income for the purpose of computing liability at the higher rate of tax applicable to income from trusts … .
>
> The logic must surely be that tax law should follow trust law not dictate it, and for my part I am utterly unable to see how it can be appropriate that a beneficiary (or the trustees) should be taxed on income which they are in law duty bound to see applied in discharging expenses so that the income cannot be enjoyed by the beneficiary(ies).

A few consultees were concerned over the tax consequences of the power of allocation

491. G1 (Inland Revenue) commented that:

> … the power to allocate receipts to a trust's income or capital fund, no matter that those receipts have an income or capital status as a matter of general law, would in our view be a dispositive power. So if, in the absence of such a power, a beneficiary would have an interest in possession, the existence of a power to divert income net of expenses away from such a beneficiary means that the beneficiary does not have an interest in possession. This would have significant implications for Inheritance Tax and income tax … . There is also a question of how this proposal will dovetail with the rules against perpetuities and accumulations.

492. T2 (Association of Corporate Trustees) and T3 (HSBC) and P10 (Charles Russell) expressed similar concerns.

493. P7 (Herbert Smith) commented that the "power of allocation may have Double Tax Treaty implications where foreign income or foreign beneficiaries are concerned".

494. P5 (Mr Justice Hayton) expressed concerns over the power of allocation being used to prevent an interest being an interest in possession:

> … the retroactive allocation of receipts and expenses can lead to a life tenant receiving significantly less or significantly more than would be justified under the default rules determining what is an income and what is a capital receipt or expense, thereby preventing an interest being an interest in possession (with very significant tax effects) or converting an indefeasible capital interest into a defeasible interest.

495. The consultee went on to link his tax concerns with the relevance of personal circumstances in determining the content of “balance”:

> Taking account of a life tenant being very poor and needy, while the capital beneficiary is wealth and not at all needy, can then lead to heavy bias toward receipts being allocated as income and expenses being allocated as capital – or the reverse if the life tenant is wealthy and not in need of income, while the remainderman is poor. The latter could well attract the Revenue’s attention as a machination to avoid tax that results in converting the life tenant’s interest from an interest in possession to a somewhat discretionary interest.

496. Whilst the consultee went on to note that the consultation paper provisionally proposed that personal circumstances should be ignored, he also noted that it may be unrealistic to believe that “trustees will ignore something well-known to them”. The consultee concluded that the Revenue would be required to develop a new “yardstick” for determining what is to count as a “balance” of income and capital, and that this yardstick would have to be based on a percentage of not less than 3% and not more than 5%. Moreover, “such a yardstick will definitely be required if, as I believe many respondents to your CP will submit, we retain the current position whereby trustees are under a duty to consider the beneficiaries’ personal circumstances when balancing capital and income”.

One consultee noted that it would be unlikely that the power of allocation would adopted if it had adverse tax consequences

497. O10 (UK STEP Technical Committee) stated:

> Without a sympathetic approach from the Inland Revenue that a “total return” approach and allocation of funds to income/capital will not cause existing life interest trusts to become discretionary, it is very unlikely that there will be substantial use made of the provisions. This is because the tax cost of moving from life interest to discretionary format would be so punitive (a 20% IHT charge on trust capital worth in excess of £263,000 with a possible additional exposure of up to a further 20% on the death of the life tenant within 7 years of the life interest termination) that it would in many cases vastly outweigh any benefits from a more flexible investment strategy.

CHARITIES

7.40 We provisionally propose that charity trustees should not be subject to any duty to balance. Do consultees agree?

498. This question was answered by 17 consultees (40%).

In agreement with the provisional proposal: 10 (59%): J2, A2, T2, T3, P5, P8, P9, O11, O4, G2

A few consultees considered the idea of “balance” to be inappropriate in the charitable context

499. P5 (Wrigleys) stated that:

> … whilst the needs and interests of current and future beneficiaries [of a charitable trust] should always be considered, this should not imply that they must always be regarded as equal, or even being in competition. It is not a question of balancing those needs, but of considering them and then doing whatever is right in the interests of the charitable purpose.

500. P9 (Hubert Picarda QC) commented that:

> … a duty to balance is explicable in the case of private trusts where the tension is between life tenants and remaindermen. A duty to balance does not necessarily make sense in the context of charitable trusts in an across the board way. Charity trustees are subject to a duty to consider the present and future needs of the charity or successive charities. This flows from the overriding duty to promote the best interest's of the charity's objects.

501. O11 (Wills and Equity Committee of the Law Society) stated:

> The interests to be balanced are clearly different from those of a private trust but interests to be balanced are nonetheless present in a charitable trust. There are present and future needs, the need to protect the charity's assets (especially if permanently endowed) and the duty to further the charity's objects.

One consultee drew attention to guidance from the Charity Commission

502. P5 (Wrigleys) noted that:

> … the Charity Commission's published guidance states that "trustees of charities that have assets held on trust for investment (capital) *must be even-handed* in the way they treat current and future beneficiaries". This implies hat there is a duty to balance. We think this is confusing.

One consultee emphasised that the inapplicability of the duty to balance should not detract from the general principle that a similar duty applies to charities

503. G2 (Charity Commission) commented that "the duty to balance is quite closely linked to the duty of even-handedness which *does* apply to charities ... ie the duty to consider the present and likely future needs of the charity before deciding what is in the charity's best interests".

In qualified agreement with the provisional proposal: 1 (6%): I3

504. I3 (Ed Kisby) expressed his agreement on the basis that no "non-charitable interests or interests of a second charity are involved".

Not in agreement with the provisional proposal: 6 (35%): P2, O5, O8, P7, P10, A4

A few consultees, while recognising a valid distinction between the private trust and charitable trust contexts, disagreed with the sharp distinction which was drawn in this question between the duty to balance (for private trusts) and the duty to consider present and future needs (for charitable trusts – see question 7.42).

505. O5 (Charity Law Association) commented that:

> … the concept of striking a balance between differing (conflicting) interests does not … apply in the manner in which it applies to the classic private trust with a life tenant and remainderman … . There is every reason, however, for charity trustees to look to future as well as current needs. Where a charitable trust has permanent endowment … the nature of the trustees' duty comes significantly closer to that of the trustees of a private trust … . In our view whilst this duty [to preserve the permanent endowment] is not one of balancing interests it does involve the exercise of judgment in order to distinguish between meeting the needs of the objects of the charity and preserving the capital … . There is, in a sense, an obligation to balance potentially conflicting duties.

506. O8 (Trust Law Committee) believed that:

> … so far as possible, charities should remain within the mainstream of the Law of Trusts. We see no reason why charitable trustees should not be under a duty to balance, where it is appropriate and they should be given the corresponding power to allocate.

507. The Committee considered that "the duty of charitable trustees to consider the present and future needs of the trust mirrors the duty to balance the interest of capital and income beneficiaries".

508. P10 (Charles Russell) and A4 (Simon Gardner) made similar comments.

A few consultees also drew attention to some charitable trusts where the duty to balance (in the private trust sense) is applicable

509. O8 (Trust Law Committee) gave the following examples of charitable trusts to which the duty to balance was relevant:

(1) A trust for charitable purpose A until a fixed date or an event has occurred and then for charitable purpose B.

(2) A time charity - a charitable purpose for 21 years, then a trust for the settlor's grandchildren.

(3) A will leaving the income to the testator's widow for her life with a charitable remainder.

(4) A trust which directs that half the income be applied to charity and the other half to family beneficiaries.

(5) An annuity to charity with the balance of income going to family beneficiaries.

510. Similar comments were made by P7 (Herbert Smith).

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?

511. This question was answered by 18 consultees (43%). It should be noted that a number of consultees who agreed with the provisional proposal at 7.40 disagreed with this provisional proposal, notwithstanding that the statutory power of allocation for private trusts rests on the duty to balance. In other words, some consultees wanted a power of allocation to apply akin to that proposed for private trusts. Levels of support should be read in the light of this.

In agreement with the provisional proposal: 7 (39%): J2, T2, T3, P5, P9, O4, G2

A few consultees agreed that this followed from the fact that charity trustees are not subject to the private law duty to balance

512. P9 (Hubert Picarda QC) explained that "in the absence of the duty to balance it is neither possible nor necessarily appropriate for charity trustees to exercise the proposed new statutory power of allocation planned for private trusts".

513. G2 (Charity Commission) commented that "the proposed statutory power of allocation appears simply part of the machinery for allowing trustees of private trusts to invest for total return, and as such has no application to charities".

One consultee addressed more practical issues

514. O4 (Law Reform Committee of the General Council of the Bar) saw "little advantage" in the power of allocation and noted that "the power could be included (without statutory intervention) in charities with no practical difficulty, due to their advantage tax status". Consequently, the consultee saw no need for the power to be applied by charities but also saw no reason why a "permissive power" should not apply to them.

In qualified agreement with the provisional proposal: 1 (6%): I3

515. I3 (Ed Kisby) agreed with this provisional proposal on the basis that no non-charitable interests or interests of a second charity were involved.

Not in agreement with the provisional proposal: 10 (56%): O3, P2, A2, O5, O8, P7, P8, O11, P10, A4

Several consultees were concerned that charities would be prevented from exercising a power which might have beneficial effects

516. O3 (London Endowed Charities Forum) encouraged the Commission "to extend [the] proposed 'power of allocation' to charities".

517. P2 (Christopher McCall QC) stated that:

> I do not … myself see the logic of denying to charities the improvement in their ability to balance between present and future needs which would follow from giving them the same duty to balance and the same power to reallocate as may be thought appropriate in the case of a private trust. It is after all by no means uncommon to find a charitable trust which does require no less strict a divide between income and capital than may be required in the case of a private trust, and I cannot see how it can be right while allowing scope to pre-empt an inappropriate division in the case of a family trust to hold a charity to that same inappropriate divide.

518. O5 (Charity Law Association) similarly commented that

> … the practical difficulties associated with the rules relating to permanent endowment are significant, and a power of allocation would greatly assist trustees in overcoming these, and enable them to make better use of the wider investment powers now available … . A power of allocation would add to the scope of the trustees' discretion in utilising the charity's assets in the best possible way to protect the economic interests of the charity, protects its capital value and achieve its objects in accordance with the donor's intentions.

519. O11 (Wills and Equity Committee of the Law Society) stated:

> We do not agree. Where a capital receipt would otherwise be classed as income undermining the capital base for future receipts, a statutory power of allocation would enable charity trustees to correct anomalies and to invest on a total return basis whilst giving them additional flexibility to achieve the charity's objective. Such a power of allocation would have to be subject to the particular constraints of permanent endowment and the need to distribute for the public benefit.

520. P8 (Moore & Blatch) did not see "any obvious reason why it should not be available subject to appropriate safeguards such as Charity Commission approval".

521. P10 (Charles Russell) commented that:

> … the statutory power of allocation should be available for charitable trusts as a partial solution to the problems arising from permanent endowment. Thus the power of allocation for charities should be broad enough to enable a proportion of capital profits to be expended rather than being added to permanent endowment.

522. A4 (Simon Gardner) made similar comments.

One consultee considered that the power of allocation should be available automatically to all charities with no possibility of a settlor opt out

523. O5 (Charity Law Association) stated that "it should [not] be necessary to opt in, or possible for a donor to opt out, of such a power".

One consultee noted that the power of allocation would not solve all the problems of permanently endowed charities

524. O5 (Charity Law Association) noted that:

> … the Law Commission's view is that the power [of allocation] would be an administrative power, not a dispositive power, and that the power would therefore be of relatively limited assistance to the trustees of permanent endowment charities in adopting a total return approach.

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.

525. This question was answered by 15 consultees (36%).

In favour of placing the duty to consider the present and future needs on a statutory footing: 6 (40%): J2, T2, T3, I3, O8, P8

526. P8 (Moore & Blatch) highlighted the benefits of placing the duty on a statutory footing:

> This could be helpful leading to greater clarity and certainty, and help to publicise the position.

Qualified agreement with placing the duty to consider the present and future needs on a statutory footing: 1 (7%): O5

One consultee thought that the duty should be placed on a statutory footing if the duty to balance for private trusts is also to be placed on a statutory footing

527. O5 (Charity Law Association) commented that:

> … if it is decided that the duty of private trustees to balance [income and capital] interests should be put in statutory form, we consider that a statutory duty should also be imposed in relation to charitable trusts, or at least those having a permanent endowment, but that it should be expressed as a duty to have regard to both present and future needs and to other relevant considerations rather than as a duty to balance. Where a charitable trust has permanent endowment … the nature of the trustees' duty comes significantly closer to that of the trustees of a private trust … . In our view whilst this duty [to preserve the permanent endowment] is not one of balancing interests it does involve the exercise of judgment in order to distinguish between meeting the needs of the objects of the charity and preserving the capital … . There is, in a sense, an obligation to balance potentially conflicting duties.

Not in favour of placing the duty to consider the present and future needs on a statutory footing: 8 (53%): P5, P7, P9, O11, O4, G2, P10, P11

One consultee did not consider that there would be much advantage in making this common law duty clear on the face of a statute

528. G2 (Charity Commission) did not think that "anything is to be gained by the statutory codification of this duty, except insofar as it is a duty which needs to be appended to a default power to invest on a total return basis".

One consultee would prefer the duty to be made clear in Charity Commission guidance

529. P5 (Wrigleys) stated that "we would prefer that the Charity Commission should make the duty (of all charity trustees) clear in its guidance".

One consultee considered that the duty would not apply to incorporated charities.

530. P5 (Wrigleys) commented that:

> … placing the duty on a statutory footing would … make a further distinction between the charity trustees of an unincorporated charity and the charity trustees of an incorporated charity. This would not be helpful.

One consultee was concerned about how the duty would be enforced

531. P5 (Wrigleys) commented that:

> … we are unsure about how such a statutory duty would be enforced. It is difficult to see how breach of such a subjective duty could be proved, except in extreme cases which are likely to occur rarely.

A few consultees thought that to give the duty a statutory basis would lend it artificial prominence

532. P7 (Herbert Smith) stated that "future needs is merely one factor that trustees (acting as prudent men of business) should take into account".

533. P9 (Hubert Picarda QC) noted that the duty to consider the present and future needs of the charity is "part only of an overriding duty to promote the best interests of the charity's objects" and that placing it on a statutory footing "will put the latter duty out of focus … . These matters should not be put into a statutory strait jacket."

534. O4 (Law Reform Committee of the General Council of the Bar) commented that the duty "should not be an overriding trust obligation".

535. P10 (Charles Russell) made similar comments.

One consultee expressly referred to the rigidity of statute

536. P11 (Edward Nugee QC) commented that:

> … circumstances differ enormously, and I doubt very much whether the draftsman could produce anything useful. If his wording was in

general terms, it would do no more than set out the well-recognised duty under the general law, with the added trap that trustees might have to construe the statute before applying the general principle. If he attempted to be more specific, it is almost certain that he would not succeed in covering every eventuality; and again trustees would have the additional burden of trying to interpret a statute instead of relying on what is essentially common sense.

Other comments:

One consultee noted the difficulties trustees might have in discharging this duty.

537. A2 (W A Lee) commented that

> … one knows of current difficulties faced by a charity but future needs may be quite impossible to forecast because the sustainability of a charity very often depends on the availability of voluntary labour and the continuing availability of that labour can never be predicted. Further than that, to the extent that a charity is dependent on donations from the public it is impossible to tell in advance whether donations will continue at any predictable rate. Is the duty to consider future needs simply an attempt to influence charities to shore up capital, just in case? Perhaps the duty to consider future needs should be restricted to presently foreseeable future needs.

One consultee attempted to define the scope of this duty.

538. O5 (Charity Law Association) stated that:

> … the "balance" to be struck by charity trustees is therefore a balance between present and future needs, seen in the context of the overall circumstances – including geographical or social variations in the incidence of the relevant needs, the impact of particular events or official policies.

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?

539. This question was answered by 14 consultees (33%).

In agreement with the provisional proposal: 6 (43%): J2, A2, T2, T3, P5, P8

540. P5 (Wrigleys) explained that:

> … the rules should be clear, comprehensive and consistent. The proposal to apply conclusive classifications follows if it is accepted that the statutory power of allocation proposed for private trusts should not be available for charitable trusts.

In qualified agreement with the provisional proposal: 2 (14%) I3, G2

A few consultees agreed, provided that the rules did not prevent a settlor from including overriding classification powers

541. I3 (Ed Kisby) and G2 (Charity Commission).

One consultee agreed subject to preserving the power of the court and/or the Charity Commission to re-allocate or authorise the reallocation of trust income or expenditure between income and endowment funds

542. G2 (Charity Commission).

Not in agreement with the provisional proposal: 6 (43%): O5, O8, P7, P9, O4, P10

A few consultees thought that the classification rules should apply on a default (rather than conclusive) basis for charitable trusts

543. O5 (Charity Law Association) thought that:

> … any rules for the classification of the investments should apply only where the power of allocation [however it applies to charities] is not exercised … . Greater clarity [in the rules of classification] would be highly desirable … . It should be recognised, however, that as matters stand, the proposed new rules of classification would on occasion make the trustees' position even more restricted, since a distribution treated as capital would be unavailable to them for application for the charity's objects. We would accordingly recommend that the proposed new rules of classification should apply to charitable trusts on a default basis as is already proposed for private trusts.

544. O8 (Trust Law Committee) and O11 (Wills and Equity Committee of the Law Society) made comments along similar lines.

One consultee doubted the value of consistency between private and charitable trusts

545. P9 (Hubert Picarda QC) noted that:

> Since these rules [of classification] are derived from a statutory power of allocation applicable only to private trusts it seems undesirable to pray in aid interests of consistency when there is no equality or consistency in the comparable trusts, charitable and private. This is an increasing mischief of seeing the need for tidiness and logical consistency when there is none.

One consultee doubted the value of any rules of classification in the charitable context

546. O4 (Law Reform Committee of the General Council of the Bar) commented that:

> … it would be much more straightforward, and we consider more sensible, if charities were entirely free to spend any such receipts (or apply any expenses) freely. We regard the income/capital dichotomy as entirely unhelpful in this context.

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?

547. This question was answered by 18 consultees (43%). It should be noted that a number of consultees agreed with this proposal having previously argued for a power of allocation for charitable trusts.

In agreement with the provisional view: 11 (61%): J2, T1, G1, P2, A2, T2, T3, P5, O8, P8, O11

548. T1 (David Palfreyman) agreed with the proposal, "but possibly with even further safeguards". He commented that:

> … it is indeed appropriate to consider an efficient method by which trustees could adopt "total return policies", subject to important safeguards … . Hence, the proposal of the Law Commissioners to "clarify the mechanism by which permanently endowed charities may invest on a 'total return basis'" is welcomed.

549. P2 (Christopher McCall QC) thought that "there is little doubt that the absence of [a] power [to invest on a total return basis] has damaged some charities without apparent justification".

One consultee was concerned about the administrative burden on small charities of providing accounts

550. O8 (Trust Law Committee) agreed with the provisional proposal, provided that "the present limited requirements for small charities to submit accounts should not be increased as the burden for a small charity would then outweigh any advantage from the new investment freedom".

One consultee still envisaged a role for the Charity Commission in authorising "total return" investment by charities

551. P5 (Wrigleys) assumed that "the Charity Commission would still retain the power to authorise total return under its scheme-making powers and that the introduction of a statutory power would not imply that the Commission's previous authorisations are in some way invalid".

One consultee considered how the monitoring role of the Charity Commission would work under this proposal

552. P5 (Wrigleys) stated that they were

> … unconcerned as to whether the Charity Commission should receive annual accounts … (ie any requirement to file accounts over and above those which already apply) although this could be dealt with through the charity SORP. We do recognise the need for some oversight, and for guidance to be available on what can be a very complex issue, and therefore we agree that the Charity Commission needs to be made aware of the fact that trustees have adopted a total

> return basis of investment so that it can check compliance with the statutory requirements.

One consultee would have given trustees a right to opt into the general power with the consent of the settlor.

553. P5 (Wrigleys) stated that:

> … the statutory power should be subject to any contrary express provision in the trust instrument, but we would like to see the charity trustees given the power to remove such a provision (with the consent of the settlor) if they consider that to be expedient in the interests of the charity - it is sometimes the case that a settlor who imposes restrictions has second thoughts when the consequences become apparent within their lifetime.

One consultee (O11 – Wills and Equity Committee of the Law Society) agreed "subject to appropriate protection for charities with permanent endowment".

One consultee who agreed with the proposal nevertheless expressed doubts over the utility of the "total return" model of investment.

554. T1 (David Palfreyman) suggested that the paper:

> … exaggerates the degree to which trustees are constrained by a traditional investment policy and does not address the potential weaknesses of following "total return policies" at certain times during the long-run investment cycle" (eg realising capital assets for several years in succession during a slide in values). The consultee adds that "it is also an exaggeration to say that the 'present confinement in the management of portfolios" leads "to much lower capital and income returns over a long period of time".

555. T1 (David Palfreyman) considered that:

> … a charity pursuing a judicious balance of UK dividend income, property income and fixed-interest income, combined with low-yielding assets such as overseas equity, venture capital and hedge funds… may well get to a very sound result without needing to invoke a total return power. Indeed assuming a sensibly modest spend-rate (say, 3.75%/4%), it is not now that difficult to achieve the annual yield on the basis of a traditional income/capital division, especially if there is an appropriate diversification amongst asset classes (the problem arises where there is an inappropriate dependency on low-yielding or "no automatic yield" assets such a venture capital and hedge funds). In short, … the Law Commissioners may be addressing yesterday's investment management problem!

556. T1 (David Palfreyman) concluded that "it may yet transpire that there is more life left in the income/capital tortoise approach to investment strategy than those backing the total return hare give credit!"

One consultee was concerned about the consequences of eroding permanent endowment and noted that the misuse of a power to invest on a total return basis could have the same practical effect as a power to expend permanent endowment

557. T1 (David Palfreyman) commented "… permanent endowment does indeed provide 'a unique opportunity to set up a perpetual memorial' and it should be seen as 'a gift of income in perpetuity', both of which make it an attractive vehicle for donors to charities. It would not be helpful if potential donors got the impression that 'perpetuity' might be reduced significantly depending on the incompetence of trustees in working out what is a viable long-term 'spend-rate'!"

One consultee thought that it might be useful to give guidance detailed guidance as to, amongst other things, an appropriate "spend-rate" for trustees investing on a total return basis

558. T1 (David Palfreyman) asked whether:

> … any legislation, or firm guidance, concerning the distribution from capital should give a suggested range ("spend-rate"). Surely, less than 3% and more than 5% would indicate, respectively, under-spending and over-spending, other than in a period of very exceptional market volatility. This begs a further question as to whether some sort of "smoothing" calculation is used to adjust the spend-rate over the medium-term.

559. T1 (David Palfreyman) referred to the spend-rates of permanently endowed US charities and concluded that "by implication, therefore, there seems to be acceptance that a 5% spend-rate is not compatible in the very long-term, with the maintenance of permanent endowment". The consultee added that:

> … the ability of certain US universities to maintain a spend-rate at the higher end of [the 3% to 5%] range is not only because of a more adventurous investment strategy (notably the use of venture capital as an asset class), but also because of the institution being able reasonably to rely on a constant stream of annual-giving to enhance endowment capital. In the case of UK charities, and certainly UK universities/colleges, we have not yet reached the position that such reliance could be placed on alumni-giving, and because hitherto we have not had the reliability of tuition fee income which characterises US private universities/colleges not could we have taken the risk of substantially investing in venture capital as an asset class.

560. T1 (David Palfreyman) referred to "the need for trustees to really understand what they are doing when adopting a total return policy" if they are to adopt an appropriate "spending policy". The consultee added that:

> … at all costs the danger must be avoided of encouraging trustees of permanently endowed charities to believe that a total return investment policy is their salvation, especially if in adopting it they set a spending policy which is unsustainably high and rely on a disproportionate allocation to asset classes such as high risk venture capital and relatively untested hedge funds.

561. T1 (David Palfreyman), therefore, concluded that

> I trust the Law Commission will give serious consideration to incorporating into any statutory power to invest on a total return basis the need to refer in some way back to detailed guidance notes/criteria which bring in for trustees a comprehensible explanation of such concepts as "spending policy", "spend-rate", "imputed return" and "moving averages" so that they can make an informed judgment about their use of the new power … .

One consultee considered that a charity trustee should never be exposed to liability for breach of trust for failing to make use of the "total return" power

562. T1 (David Palfreyman) stated that:

> … it certainly should not be the case that failure to make use of the "total return" power, should in any way be deemed a breach of trust, given that the case against permanent endowment and the income/capital division is *not* as overwhelming as some might assert, and is possibly now less overwhelming than might have been the case prior to the recent bout of volatility.

In qualified agreement with the provisional proposal: 3 (17%): O4, G2, I3

A few consultees would not require charity trustees to report their decision to invest on a total return basis

563. O4 (Law Reform Committee of the General Council of the Bar) agreed with the proposal subject to their being no "increase in reporting powers - we do not see that extra regulatory burden having any real practical advantage, and very much doubt whether the Charity Commission could usefully police such returns".

564. G2 (Charity Commission) thought that it would be:

> … an unnecessary burden on small charities who would not otherwise have to send reports and accounts. The issue is not of such special regulatory significance to justify extending the usual statutory duties to supply reports/accounts to the Commission.

One consultee expressed disagreement with the proposed "ring-fencing" of a certain proportion of the unapplied total return in order to protect the value of the endowment fund in real terms

565. G2 (Charity Commission) commented that:

> … no indication is given in the Consultation Paper as to the method by which this ["ring-fenced"] element [of the unapplied total return] might be identified. When [the Charity Commission] considered this possibility in connection with the development of the policy on authorising the total return approach to investment, we came to the conclusion that it was impossible to devise a suitable formula which would have a rational effect in all the wide variety of circumstances which might be encountered. So it was thought preferable to extend the trustees' discretion to the whole of the unapplied total return, but,

of course, at the same time to subject the use of that discretion to the duty of even-handedness.

566. I3 (Ed Kisby) stated:

> Agreed unless this resulted in undesirable limitation on usage or overusage of funds vis a vis the recognised intention of the settlor or provisions in the trust deed, as a result of relative changes in respective levels of income and capital growth generation.

Not in agreement with the provisional proposal: 4 (22%): P9, P11, P7, A4

One consultee thought that the general power to invest on a total return basis was too risky

567. P9 (Hubert Picarda QC) commented that:

> … a statutory power to invest on a total return basis is [not] necessarily a desirable advance. It is too early to follow Canadian legislation in this field and potentially too risky. My own personal view is that if the current system of individual authorisations by the Charity Commission is maintained on an optional *procedure* for applying for and obtaining authorisation could be placed on a statutory footing. Each case should nevertheless be considered on its own individual merits.

One consultee recommended an alternative scheme under which charities might adopt total return investment policies (which the consultee also recommended in relation to private trusts - see above at question 7.15).

568. P11 (Edward Nugee QC) referred to percentage trusts under which:

> … at the end of each year ... the total value of the trust assets ... is ascertained, and the trustees determine what percentage of that total can prudently be treated as income ... . This is a true total return approach and avoids all the awkwardness of the Charity Commission's scheme, which requires a separate account to be kept of unapplied total return and involves the risk of there being no income at all available for the purposes of the charity in some years.

569. The consultee countered allegations that this form of trust undermines the concept of permanent endowment thus:

> (1) trustees have such wide powers of investment that they can in effect favour capital over income or vice versa under the current law, and the proposed power of allocation is going to make this more readily available to non-charitable trustees, and (2) it is, one hopes, not going to be all that often that the total return on the charity's trust fund will be less than 4% in a year, and, if it is, it is likely that the "loss" will be made up in a future year ... there is obviously a risk that trustees may be too optimistic in determining what percentage of their total assets can be prudently treated as income, but in view of the wide discretions that trustees enjoy already, it is in my view a risk worth taking - and it is no greater than the risk which the OG83

> scheme accepts, that the trustees may not leave sufficient total return unapplied to make up for the fall in the value of money.

One consultee was concerned about the potential need for some charitable trusts to build up capital

570. A4 (Simon Gardner) commented:

> The Paper's discussion of charitable trusts focuses solely on the "capital rich, income poor" phenomenon. … I don't see why charitable trusts can't encounter the converse problem, that their trustees have reason to want to apply some or all of (what the default rules classify as) the trust's *income* not to its purposes, but to bolstering *capital*.

The consultee went on to give a number of examples in which it would be sensible to boost capital reserves out of income. The consultee concludes that charitable trustees should be given a power of allocation akin to the proposed for private trusts.

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.

571. This question was answered by 16 consultees (38%).

If retained, the current system of Charity Commission authorisations should be placed on a statutory footing: 12 (75%): T1, A2, T2, T3, O5, I3, P5, P8, P9, O11, G2, P10

One consultee suggested that it would be appropriate to introduce further safeguards into the procedure

572. T1 (David Palfreyman) stated that if this approach is adopted it should be "subject to additional safeguards".

One consultee highlighted two particular benefits of putting the procedure for gaining authorisations on a statutory footing

573. P10 (Charles Russell) thought that the procedure should be placed on a statutory footing "with a view to both streamlining the procedure itself and clarifying the circumstances in which the authorisation would be given".

One consultee submitted that the Charity Commission's current approach to authorising "total return" investment policies was ultra vires

574. O5 (Charity Law Association) commented that:

> … the [Charity] Commission's previous view was that it could not authorise the expenditure of permanent endowment in any circumstances except for the acquisition of property of a permanent nature … or on terms of recoupment. Their current view is that it is open to them to authorise the expenditure of capital by order under s 26(4) of the [Charities Act 1993] to enable the trustees to adopt a total return policy in managing the charity's investments.

575. The consultee concluded that "an order under s 26 is [not] legally sufficient to enable capital to be expended where the original gift was only one of income". The consultee added that:

> … where the restriction on expenditure merely confines the expenditure of capital to specified purposes which are not identical to those for which income is applicable [ie "purposive" or "administrative" restrictions], there is no reason in principle why a scheme should not be made to alter the relevant purposes.

576. O11 (Wills and Equity Committee of the Law Society) stated:

> A statutory footing would clarify the current position. At the moment there is disagreement as to the Charity Commission's jurisdiction to vary. A statutory footing would clarify disagreement over the Charity Commission's jurisdiction.

One consultee thought confirmation of the vires *of the current system would be helpful*

577. G2 (Charity Commission) thought that:

> … the procedure is already on a statutory footing. What would be useful is a statutory provision which confirms the *vires*, in the view of the legal reservations expressed in some quarters.

If retained, the current system of Charity Commission authorisations should not be placed on a statutory footing: 4 (25%): J2, O3, 08, O4

One consultee criticised the current system of Charity Commission authorisations

578. O3 (London Endowed Charities Forum) stated that "the Charity Commission's 'total return' machinery is not in practice seen as terribly workable or attractive".

One consultee thought Operational Guidance was more appropriate

579. O8 (Trust Law Committee) commented that "the present system of Operational Guidance, which can be readily altered to suit changing circumstances, is preferable to legislation".

Other comments relating to charities:

A few consultees criticised the Charity Commission's current system of authorising total return investment

580. O5 (Charity Law Association) considered that the:

> … Charity Commission's current practice is dangerous. It is clearly unworkable where the value of the investments decreases and in addition there are several other respects in which it operates in an arbitrary way, which may appear reasonable at the time of the order but may lead to unforeseen or unintended consequences.

581. P11 (Edward Nugee QC) commented that:

The Charity Commission's scheme for investment on the basis of total return is seriously defective since (a) it does not cater for the case (by no means uncommon in recent years) where there is a negative total return and no unapplied total return to fall back on; and (b) it does not allow for capital appreciation which is due to the natural effects of inflation (even at 2% p.a. the value of a trust fund halves in 35 years). (a) is recognised in OG83 C4:

“If there is no ‘unapplied total return’ there will be nothing to apply for the purposes of the charity (except where a charity has a power to spend part of its investment fund). In the case of a new charity which is operating a total return approach to investment, if there is a fall in the value of investments in the first year, and that fall exceeds the “income” that the investments have produced, there would be nothing to apply. However, this is an essential feature of the total return approach to investment.”

(b) appears not to be recognised at all, except in so far as trustees determine that part of their unapplied total return shall remain unapplied; but the historical basis of accounting has long been abandoned for company accounts, and should not be adopted for charity accounts. There appears to be a danger that the permanent endowment will remain fixed at its historic value when the trustees adopt the Charity Commission’s model scheme, which is not, so far as I can see, sufficiently emphasised in the Operational Guidance.

This half-hearted scheme is not the kind of total return policy that has been adopted by a number of large charities (eg the Church Commissioners and a number of Oxford and Cambridge Colleges). In their case the scheme adopted is a true total return policy. As in the Charity Commissioners’ scheme, no distinction is made between income return and capital appreciation. The difference lies in the treatment of the investments in the accounts. At the end of each year (or quarter or whatever accounting period is convenient for this purpose), the total value of the trust assets (investments and cash, and in some cases land) is ascertained, and the trustees determine what percentage of that total can prudently be treated as income (a figure of between 3% and 4% is usual at the present time). The percentage so determined is applied as income of the trust (or in the case of the Oxford and Cambridge University and College trust pools, as the income of the various trusts participating in the pools). The balance is capital. The scheme may contain refinements: land, for example, may be valued every five years, to minimise expense, the appropriate professionals certifying each year that its value does not differ significantly from its value at the last quinquennial valuation. New special trusts can join the pool at the annual or quarterly valuation date, with provision for income arising between two valuation dates being held in a temporary fund. Capital distributions can be made to trusts whose terms permit the expenditure of capital (most scholarship funds do not). Schemes of this kind have been approved by the Privy Council for a number of Colleges, I believe after consultation with the Charity Commission; and they demonstrate

that the last sentence in the quotation above from OG83 C4 is not true as a general proposition - though it is true of, and a ground for powerful criticism of, the Charity Commission's OG83 scheme.

The Church Commissioners have a limited and temporary power to spend capital; but their basic approach is to determine each year, on actuarial advice, what proportion of their assets can prudently be applied as income. The Oxford and Cambridge Colleges with which I have been concerned do the same, with or without actuarial advice (some of them have financial experts among their Fellows). This is a true total return approach, and avoids all the awkwardness of the Charity Commission's scheme, which requires a separate account to be kept of unapplied total return and involves the risk of there being no income at all available for the purposes of the charity in some years. I think the Charity Commission are to be commended for their innovative approach to investment; but they have not taken it to its logical conclusion, which would result in a simpler scheme for trustees to administer and would avoid any question of allocation as between capital and income. The true total return scheme is also more in line with modern accounting principles, which tend to minimise the distinction between profits and capital appreciation. It is similar to the percentage trust, considered briefly at 5.35-5.38, with the vital difference that (a) no problems arise as regards taxation, and (b) the percentage is not fixed but is determined by the trustees each year in the light of prevailing circumstances.

If it is said that the adoption of what I have called a true total return policy enables money forming part of the capital of the original endowment to be spent as income (which the Charity Commission's OG83 scheme appears to avoid - at the cost of sometimes depriving charity trustees of any income capable of being applied to meet the needs of their charity - though the avoidance is more nominal than real in view of the continuing fall in the value of money), the answer is that (1) trustees have such wide powers of investment that they can in effect favour capital over income or vice versa under the current law, and the proposed power of allocation is going to make this more readily available to non-charitable trustees, and (2) it is, one hopes, not going to be all that often that the total return on the charity's trust fund will be less than 4% in a year, and, if it is, it is likely that the "loss" will be made up in a future year.

The total return policy is, of course, possible only for charities under the present law because they are not subject to tax on capital gains or on income, so that it makes no difference to them in what form the return is received. If it were to be made available to non-charitable trustees, the limits within which trustees could operate it would have to be agreed with the Revenue.

I do not find it clear from para. 6.61 and the discussion in the preceding paragraphs what form of total return policy is being suggested. If it is that which is explained in OG83, I do not consider this satisfactory (though, as I have said, it is a step in the right

> direction). If it is what I have called a true total return policy, avoiding the necessity to keep a separate account of unapplied total return, there is obviously a risk that trustees may be too optimistic in determining what percentage of their total assets can prudently be treated as income; but in view of the wide discretions that trustees enjoy already, it is in my view a risk worth taking - and it is no greater than the risk which the OG83 scheme accepts, that the trustees may not leave sufficient total return unapplied to make up for the fall in the value of money. Again I would be strongly opposed to putting anything in a statute which laid down detailed provisions for the way in which a total return policy might be operated by charity trustees, since this would tend to preclude developments (such as I consider are desirable from OG83 to the system adopted by the Oxford and Cambridge Colleges which I have described). There is no harm in providing that the Charity Commissioners may authorise the adoption of a total return policy, without spelling out how such a policy is to operate, but they can do this anyway under their general powers (as OG83 shows), so there is not much point in saying so specifically in a statute.

One consultee felt that the Consultation Paper gave too little respect to the importance of protecting a charity's permanent endowment

> T1 (David Palfreyman) stated that "it is an exaggeration to say that the rules preventing the expenditure of the capital of permanently endowed charitable trusts have become a 'severe incumbrance' for 'most charities'".

582. T1 (David Palfreyman) went on to level criticism at the wide scope of the powers to distribute original permanent endowment in the then draft Charities Bill

> In terms of providing reassurance to potential donors it is indeed worrying that … the proposed s 75A amendment [to the Charities Act 1993] would allow charity trustees to make the decision to distribute permanent endowment as if it were income merely "on the basis of the simple majority". Such a major decision should require a two-thirds majority (by way of a formal written/signed voting procedure, *and* the majority to be of all trustees, whether present or not at the particular meeting at which the decision is made. Certainly, at a minimum, additional safeguards such as you mention by way of a "Notice of Concurrence" procedure are needed.

A few consultees made submissions regarding the Government's proposals (contained in the then draft Charities Bill) for the expenditure of permanent endowment

583. O5 (Charity Law Association) took the view that "the subject cannot be fully considered without a close examination of the proposals relating to charities with permanent endowment which are contained in the draft Charities Bill". The consultee further noted that the expenditure of permanent endowment:

> … is not considered in the report of the Joint Committee on the draft Bill. Since the Government has not yet published a real Bill, and the

> Joint Committee … has made a number of suggested changes in its recent report, we would urge the Law Commission to consider the draft Charities Bill as well as the proposals for Capital and Income generally, so that the relevant provisions can be considered as a coherent whole.

584. Similar comments were made by O11 (Wills and Equity Committee of the Law Society).

585. O5 (Charity Law Association) is:

> … not opposed in principle to the proposition that the expenditure of permanent endowment should be permitted in more circumstances than at present, but believe that this should be carried out in a principled, rather than haphazard, way.

586. In furtherance of this objective, the consultee suggested that a power of allocation (similar to that proposed for private trusts):

> … would apply to the endowment funds of permanently endowed charities consisting of or including "designated land" … . This would be a significant improvement on the current proposals in that it would provide greater flexibility to more charities and avoid artificial distinctions.

587. Moreover, "charitable trusts founded by single individuals or institutions would not be excepted from the power of allocation". At the same time, the consultee considered that the Government's proposals were too wide in certain respects: a power of allocation would:

> … have the advantage that it would be exercisable only in relation to those profits which the trustees chose to allocate, not to the whole of the permanent endowment at once … . Further, it would preserve the duty of the trustees of charitable trusts with permanent endowment to treat as capital that which, looking at the overall position, is properly to be retained, and as expendable that which is properly regarded as income, and thereby enable the charity to continue indefinitely as intended by the donor … . We feel that this would achieve, rather more effectively than the draft Bill, the objective of protecting the wishes of individual donors, and thereby encouraging them.

588. O5 (Charity Law Association) appreciated, however, that the power of allocation was not a cure-all for the problems faced by permanently endowed charities if it is treated as an administrative, as opposed to dispositive, power. Once the power of allocation had been exercised to allocate a receipt or expense to capital, or the time limit for exercise of the power of allocation had expired, the default classification for the receipt or expense would become conclusive and would not be subject to the power of allocation (see the consultee's comments in relation to question 7.41).

589. O3 (London Endowed Charities Forum) opined that the "rather modest government proposals in the current Charities Bill as to possible distribution of endowment do not meet charities' needs for flexibility in this area".

590. O4 (Law Reform Committee for the General Council of the Bar) similarly commented that:

> … charitable assets can be tied up indefinitely. Permanent endowment, however, goes further than that: it means that certain charity capital *must* be tied up for all time. We cannot believe that is in the interest of charity generally ... . We do not believe that its abolition would have any appreciable effect on giving, or on the wishes of past donors. We are convinced that donors are attracted by the capability of funds to be tied up for long periods ... but not by the ossification of the funds.

One consultee thought that the Law Commission should look into the issue of permanently endowed charities in more detail

591. O5 (Charity Law Association) suggested that before making specific proposals relating to capital and income in the charitable context, the "Law Commission should… consider in more depth (i) the legal meaning of 'permanent endowment' and (ii) the circumstances in which permanent endowment may be expended, and whether with or without recoupment".

One consultee asked whether the there would be human rights issues for existing endowment charities

592. P7 (Herbert Smith) said that the provisional proposal "may reduce the burden on the Charity Commission – but would there be [human rights] issues for existing endowment charities, for example?"

Comments on the statutory definition of "permanent endowment"

593. O5 (Charity Law Association) made the following points in relation to the statutory definition of permanent endowment (contained in Charities Act 1993, s 96(3)):

(1) The only provisions of the Charities Act 1993 which refer to "permanent endowment" are sections 3(5)(c)(i), 75(1)(a) and 97(1). The concept is, however, also relevant to sections 26(4) and 74(9)(a)(ii).

(2) The statutory definition includes a "presumption" in favour of permanent endowment. The consultee commented that "because of the 'deeming' provision [in section 96(3)] there are cases where it is presumed that a charity has a permanent endowment when the donor may not have had a specific intention that capital should be preserved but has not expressly provided that it is to be expendable as income".

(3) The consultee also noted that "the definition is not confined to the typical case where the original gift creates a perpetual trust … . It also applies to any case where the specific purposes for which funds may be applied differ according to whether they are capital or income". That is, whenever there is *any* restriction on the expenditure of capital as opposed to income.

(4) Moreover, "the definition … appears to include both 'dispositive' restrictions, where the subject matter of the gift itself is confined to income, and 'purposive' or 'administrative' restrictions".

594. In relation to the definition of "permanent endowment", O5 (Charity Law Association) suggested the following amendments:

(1) The definition should be of general application and not confined to questions arising under the Charities Act 1993.

(2) Creation of a presumption *against* the existence of permanent endowment (ie requiring clear words to create a perpetual trust).

(3) Removal of "purposive" or "administrative" restrictions on the expenditure of capital from the definition of "permanent endowment".

Comments on authorisation of expenditure of permanent endowment, whether or not subject to recoupment

595. O5 (Charity Law Association) considered the circumstances in which the Charity Commission currently requires expenditure of capital to be recouped from income.

> There … appears to have been a development of the Charity Commission's policy relating to the type of expenditure which needs to be recouped. Whereas formerly any expenditure on 'bricks and mortars' (as opposed to the purchase of land on which buildings were already standing) was subject to recoupment, if the land is held as an investment the Commission are now much more sympathetic to the argument that the expenditure will enhance the value of the property, and will not therefore require recoupment. They do not normally accept this argument, however, in the more usual situation where the land on which the expenditure is undertaken is held on trust, or has been appropriate, for use for charitable purposes.

596. O5 (Charity Law Association) also discussed the current approach of the Charity Commission to recoupment orders:

> … there is no statutory provision or case law specifying the method or approach to be adopted. In fact the Charity Commission has changed its policy over the years. In the 1960s or 1970s it used a formula which sought to make an allowance for inflation and required trustees to set up a sinking fund of which the income was not available for application until the end of a specified period. Nowadays it requires only the historical sum expended to be recouped, and enables the sums set aside annually to be contributed immediately to the charity's income-producing endowment.

597. O5 (Charity Law Association) recommended that "consideration should be given to the enactment of a general principle that a charity's permanent endowment may be expended for purposes which increase, or are intended to increase, the value of a capital asset on a long term basis". The consultee suggested that the Charity Commission should take "a more flexible approach to the question of what expenditure constitutes an 'investment' and what expenditure requires recoupment" and that the Charity Commission should follow "the general pattern laid down for settled land in the [Schedule 2 of the Settled Land Act 1925]".

APPENDIX A
NUMERICAL LIST OF RESPONDENTS TO THE CONSULTATION PAPER

This is a numerical list of respondents to the Consultation Paper.

(1)	A1	Professor John Langbein
(2)	P1	Richards Butler
(3)	J1	Association of District Judges
(4)	O1	Society of Pension Consultants
(5)	J2	The Hon Mr Justice Etherton
(6)	I1	Tim Smith
(7)	J3	The Rt Hon Lord Walker of Gestingthorpe
(8)	O2	City of Westminster and Holborn Law Society
(9)	J4	The Hon Mr Justice Lloyd
(10)	O3	London Endowed Charities Forum
(11)	T1	David Palfreyman
(12)	G1	Inland Revenue
(13)	P2	Christopher McCall QC
(14)	A2	W A Lee
(15)	P3	Geoffrey Shindler
(16)	T2	Association of Corporate Trustees
(17)	T3	HSBC
(18)	O5	Charity Law Association
(19)	O6	Association of Contentious Trust and Probate Specialists
(20)	O7	British Bankers Association
(21)	T4	Barclays Bank Trust Company
(22)	I2	Toby Harris
(23)	T5	Paul Saunders
(24)	I3	Ed Kisby

(25)	P4	John Ross Martyn
(26)	P5	Wrigleys
(27)	P6	Bircham Dyson Bell
(28)	O8	Trust Law Committee
(29)	P7	Herbert Smith
(30)	A3	Richard Nolan
(31)	P8	Moore & Blatch
(32)	P9	Hubert Picarda QC
(33)	O9	Notaries Society
(34)	O10	Society of Trust and Estates Practitioners Technical Committee
(35)	O11	Wills and Equity Committee of the Law Society
(36)	O4	Law Reform Committee of the General Council of the Bar
(37)	G2	Charity Commission
(38)	P10	Charles Russell
(39)	A4	Simon Gardner
(40)	P11	Edward Nugee QC
(41)	A5	Professor Catherine Brown
(42)	J5	The Hon Mr Justice Hayton

APPENDIX B
RESPONDENTS TO THE CONSULTATION PAPER SORTED BY GROUP

This is a list of the respondents to the Consultation Paper sorted by group.

JUDGES (J)

J1. Association of District Judges

J2. The Hon Mr Justice Etherton

J3. The Rt Hon Lord Walker of Gestingthorpe

J4. The Hon Mr Justice Lloyd

J5. The Hon Mr Justice Hayton

LEGAL PRACTITIONERS (P)

P1. Richards Butler

P2. Christopher McCall QC

P3. Geoffrey Shindler

P4. John Ross Martyn

P5. Wrigleys

P6. Bircham Dyson Bell

P7. Herbert Smith

P8. Moore & Blatch

P9. Hubert Picarda QC

P10. Charles Russell

P11. Edward Nugee QC

ACADEMICS (A)

A1. Professor John Langbein

A2. W A Lee

A3. Richard Nolan

A4. Simon Gardner

A5. Professor Catherine Brown

ORGANISATIONS (O)

O1. Society of Pension Consultants

O2. City of Westminster & Holborn Law Society

O3. London Endowed Charities Forum

O4. Law Reform Committee of the General Council of the Bar

O5. Charity Law Association

O6. Association of Contentious Trust and Probate Specialists

O7. British Bankers Association

O8. Trust Law Committee

O9. Notaries Society

O10. Society of Trust and Estates Practitioners Technical Committee

O11. Wills and Equity Committee of the Law Society

INDIVIDUALS (I)

I1. Tim Smith

I2. Toby Harris

I3. Ed Kisby

TRUSTEES AND TRUST COMPANIES (T)

T1. David Palfreyman

T2. Association of Corporate Trustees

T3. HSBC Trust Company Ltd

T4. Barclays Bank Trust Company

T5. Paul Saunders

GOVERNMENT DEPARTMENTS AND AGENCIES (G)

G1. Inland Revenue

G2. Charity Commission