Law
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Capital and Income in Trusts: Classification and Apportionment
Executive Summary

Law Com No 315 (Summary)

CAPITAL AND INCOME IN TRUSTS: CLASSIFICATION AND APPORTIONMENT

EXECUTIVE SUMMARY

INTRODUCTION

1. Trusts pervade English law, and offer the potential for flexible management of property and of financial relationships. They range from the relatively simple trusts that arise automatically from co-ownership of the family home, to pension funds, unit trusts as investment vehicles, and the arrangements set up to safeguard property belonging to minors or to those suffering from mental incapacity. As well as private trusts there are also thousands of charitable trusts playing an important role in our society.

2. This Report is the outcome of the latest in a number of Law Commission projects on trust law.[1] The trusts that are most relevant to this project are of two kinds. First, there are private trusts for interests in succession. Such trusts make it possible to share property and its income over time; property can be held upon trust for one person (often referred to as the "life tenant") for his or her lifetime and then for another (the "remainderman") after that person's death. A gift of investments upon trust "for A for life, with remainder to B" means that trustees will pay the income arising on the investments to A until A dies, and then transfer the investments to B. Secondly, there are charitable trusts with a permanent endowment. A permanent endowment is a protected fund which cannot freely be spent on the charity's purposes, save in the limited circumstances that statute allows (and in many cases only with the agreement of the Charity Commission).

3. The common feature of these trusts is that their trustees have to distinguish between capital and income in their management of the trust property, and are under duties to balance those competing interests. The Law Commission's project seeks to address concerns arising from two sets of trust law rules intrinsically linked to the distinction between capital and income, and widely regarded as problematic: the rules governing the classification of receipts and expenses as capital or as income, and the so-called "rules of apportionment".

BACKGROUND TO THE REPORT

4. Concerns about the law governing the treatment of capital and income in trusts were raised in 2000 during the Parliamentary debates on the Trustee Bill. In response, the Lord Chancellor undertook to refer the matter to the Law Commission for consideration. The terms of the formal reference for the Law Commission's project listed the following specific issues:

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

[1] See Trustees' Powers and Duties (1999) Law Com No 260; Scot Law Com No 172 and Trustee Exemption Clauses (2006) Law Com No 301.

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

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

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

5. Two general concerns underlie these individual issues: fairness between trust beneficiaries and the efficient administration of trusts. In seeking to meet these concerns, the Law Commission has also been mindful of its statutory function to simplify and modernise the law.

6. The Law Commission commenced work on the project in 2003, and published a Consultation Paper ("the CP") in 2004.[2] The project was then put on hold as a result of other priorities, and work recommenced in January 2008. The Commission has benefited not only from the detailed responses to the CP received in 2004, but also from discussions in the course of 2008 with trust practitioners. We are particularly grateful for the assistance of an advisory group of experts in trust law and practice representing the leading organisations with an interest in this project, for the contribution of the Trust Law Committee, and for the co-operation of officials at the Charity Commission, HMRC and HM Treasury.

THE CURRENT LAW

The classification of trust receipts

7. A trust fund may be invested in a wide range of investments, from shares to mines to works of art. Many of these will produce a return, regularly or otherwise. The courts have developed rules that determine whether various different forms of investment return are to be classified as capital or income for the purposes of the trust. If the item in question is classified as income then it is payable, in the context of a trust for successive interests, to the life tenant, and if it is classified as capital it is held for the remainderman. In the context of a charitable trust with permanent endowment, a receipt classified as capital will usually form part of that endowment and will not normally be available to be spent for charitable purposes.

8. We have examined the current rules governing the classification of receipts arising from property other than shares (for example, from loans, land and intellectual property). Consultees strongly supported the view expressed in the CP that those rules should be retained and should not be placed on a statutory footing, and consequently we make no recommendations for their reform. Consultees agreed that the most significant concerns relate to the treatment of receipts by trustee shareholders from companies, to which we refer as corporate receipts. Trust law classifies corporate receipts in accordance with the company law analysis, following the House of Lords' decision in *Bouch v Sproule*.[3] A corporate receipt will therefore only constitute capital for trust purposes if it represents the company's legal capital.

[2] Consultation Paper No 175.

[3] (1887) LR 12 App Cas 385; see also *Hill v Permanent Trustee Company of New South Wales* [1930] AC 720 (PC).

9. This can give rise to surprising results. For example, where an unusually large proportion of the value of a company is distributed to shareholders in the form of a dividend, it will be classified for trust law purposes as income. As a result it will benefit those interested in the income of the trust, even though the decrease in the company's value following the distribution will result in a diminution in the capital value of the trust fund. This problem is particularly marked when a company reorganises itself by carrying out a demerger. In a "direct demerger", a company transfers part of its business to a new subsidiary company, and distributes the new company's shares to its own shareholders in the form of a dividend. The demerger shares are classified in trust law as income, even though their value represents the capital value of the trust fund. This mismatch between the legal and economic effects of the distribution led the court in the case of *Sinclair v Lee*[4] to hold that shares distributed in the course of an indirect demerger (structured differently to a direct demerger) should be classified as capital. To classify the shares as income would, the court said, be "absurd" given the economic effect of the reorganisation.

10. In the case of private trusts, the effect of the current law is that value goes to the "wrong" beneficiary, and is likely to meet neither the beneficiaries' nor the settlors' expectations. Similar problems arise for charitable trusts where funds may be attributed, incorrectly from the charity's point of view, to income available for expenditure or to permanent endowment. In addition to these inappropriate results, the current law gives rise to issues of unpredictability and of complexity. The law can be extremely hard to apply in practice. It is likely that in many cases trustees will operate in ignorance of, or without regard to, the technical legal position.

11. A further difficulty arising from trust law's approach to the classification of receipts is the wider effect of that approach upon trustee investment. Trust law does not provide any general flexibility to adjust the legal classification of investment receipts. This means that trustees cannot overcome any inappropriate results produced by the classification rules. Perhaps more fundamentally, it means that trustees are obliged to select investments which are expected to yield returns in a form that balances the interests of income and capital beneficiaries, delivering income and capital growth in appropriate proportions.

12. Selecting investments with a view to the likely form of returns (in terms of capital or income), rather than the overall value of returns, has obvious disadvantages, in that it constrains investment choices. While some trustees may be able relatively easily to construct a portfolio that balances returns to the capital and income beneficiary, many trustees would prefer to invest without such restrictions, concentrating instead on the total return to the trust. Indeed, the need for charities to be able to invest on a total return basis was highlighted during the Parliamentary debate on the Trustee Bill in 2000. Total return investment is not an unusual investment method. The introduction of total return investment for trusts would simply enable trustees to select investments without any requirement to produce particular forms of return, and so, broadly, approach investment in the same way that an individual would do.

13. Total return investment is possible if trustees have a power to allocate the global

[4] [1993] Ch 497 (Sir Donald Nicholls VC).

investment return received by the trust to the income and capital beneficiaries according to what the beneficiaries might expect to enjoy in the light of their respective interests in the fund. The absence of a general power in private trusts for interests in succession to allocate investment returns means that investment choices are restricted. Similarly, charitable trusts with a permanent endowment have to distinguish income and capital in investment returns and therefore cannot invest on a total return basis.

14. However, the effect of the classification rules for charitable trusts is now far less problematic than it was at the time of the Parliamentary debates that led to the reference of this project. For some years now it has been possible for a charity with permanent endowment to obtain an order from the Charity Commission authorising the operation of total return investment. Investment is authorised on the terms of a scheme devised by the Charity Commission, using its powers under section 26 of the Charities Act 1993. Moreover, issues surrounding the meaning of "permanent endowment", and a charity's powers to deal with it, were re-examined by Parliament in the debates preceding the enactment of the Charities Act 2006. Consultees with whom we have held discussions during 2008 agreed with our view that in making recommendations for reform now, we should focus on the availability of the Charity Commission's scheme for total return investment, and on its terms and operation.

The rules of apportionment

15. Although trust law does not give trustees any general flexibility in classifying the returns from investments, it has developed rules which give rise to adjustments between capital and income. These rules of apportionment require the sharing of certain returns and outgoings between capital and income, and in some cases impose a duty to sell certain trust property. They operate in very limited circumstances in response to some narrowly defined consequences of the classification rules.

16. There are several equitable rules of apportionment. The first branch of the rule in *Howe v Earl of Dartmouth* creates an implied trust for sale, putting the trustees under a duty to convert (sell and reinvest) residuary personal estate, held on trust for persons in succession, if it is an unauthorised investment and of a wasting or hazardous nature. The second branch of the rule in *Howe v Earl of Dartmouth* compensates the capital beneficiary for loss pending conversion of trust investments. The rule in *Re Earl of Chesterfield's Trusts* compensates the income beneficiary for loss of present income from future property where trustees have exercised a power to defer sale. The rule in *Allhusen v Whittell* apportions debts, liabilities, legacies and other charges payable out of the residuary estate between capital and income beneficiaries. The rules in *Re Atkinson* and in *Re Bird* respectively apportion the loss caused to the trust by investments in loan stock where the borrower is unable to meet his obligations and there is insufficient security to make up the shortfall.

17. Section 2 of the Apportionment Act 1870 is a rule of time apportionment. The effect of the section is that income beneficiaries are entitled only to the proportion of income that is deemed to have accrued during their period of entitlement. The rule has long been criticised as being inconvenient and unfair in its application to

trusts. It is capable of causing hardship in certain circumstances to life tenants[5] and places an onerous burden on trustees to make difficult investigations into the precise periods for which dividends have been declared.

18. These rules are all based on the principle that no beneficiary should take a disproportionate benefit at the expense of another. They are logical developments of the classification rules and of the duty to balance the interests of beneficiaries interested in capital and income. The difficulty is that they were formulated many decades ago and in circumstances much less likely to arise today.[6] They are prescriptive, unclear in places and generally require complicated calculations relating to disproportionately small sums of money. Well-drafted trust instruments exclude these rules. In most trusts where they have not been excluded (particularly those that arise by implication) they are either ignored or cause considerable inconvenience.

Trust expenses

19. The general law of trust expenses determines, in the absence of express provision in the trust instrument, whether an expense incurred by a trust (such as accountancy fees or the cost of repairing buildings) is chargeable to income or to capital. The answer to that question has tax implications, because an expense that is properly chargeable to income reduces the income tax payable; tax law currently follows trust law for the purposes of the classification of expenses.

20. The Court of Appeal recently, in *Revenue and Customs Commissioners v Trustees of the Peter Clay Discretionary Trust*,[7] provided an authoritative interpretation of a number of important elements of the current law, considering in detail the leading House of Lords authority on the incidence of trust expenses.[8] The decision confirmed, first, the status of trustees' fees as expenses of the trust. Secondly, it clarified the proper classification of expenses which relate to both income and capital. It was held that only those expenses which relate wholly and exclusively to income can be attributed to income: an expense which relates both to income and to capital must be charged wholly to capital. However, where trustees can show that part of a single fee relates to work done for income alone, then the trustees can apportion the expense, detaching the income element and charging it to income. That is the case whether or not the invoice is itemised; apportionment is possible provided an evidence-based estimate can be made.

21. The *Peter Clay* decision has clarified a number of areas of ambiguity in the current law. In doing so, it has gone a long way towards ensuring that, so far as possible, the burden of an expense should rest with the beneficiary who benefits from it. Accordingly, the key policy concern regarding trust expenses outlined in the CP has been answered. As a result, and taking into account the views

[5] For example, if a testator bequeaths a life interest in his residuary estate to his widow; the widow will not receive income from dividends paid after the testator's death which accrued during his life as these receipts will be apportioned to capital.

[6] In particular, the technical concept of "unauthorised investment" has been rendered practically irrelevant for many trusts by the broadening of trustee investment powers introduced by the Trustee Act 2000.

[7] [2008] EWCA Civ 1441, [2009] STC 469.

[8] *Carver v Duncan* [1985] AC 1082.

expressed in consultation on the law in this area, we make no recommendations for reform of the classification of trust expenses.

RECOMMENDATIONS FOR REFORM

Classification of corporate receipts

22. The legal rules for the classification of corporate receipts are problematic and unpopular, and can cause significant difficulties in trust administration. The meaning of capital and income in trust law is unrelated to the technical meaning of capital for company law purposes, and it makes no economic sense to base the classification of receipts by trustees upon the company law concept. Our recommendation for reform of the classification rules focuses on the particularly difficult issues surrounding demergers. Demergers were specifically mentioned in the reference of this project to the Law Commission and are a clear instance of the disproportionate results that can arise under the current classification rules. In addition, the artificial distinction between direct and indirect demergers created by the decision in *Sinclair v Lee* is confusing and generally considered to be unprincipled. The consultation response of the UK Technical Committee of the Society of Trusts and Estates Practitioners identified demergers as an area in which specific legislation might be considered. The Trust Law Committee also developed targeted reform proposals for demergers during its own consideration of classification and apportionment in trusts.

23. We recommend that shares distributed in a tax-exempt demerger should be classified as capital for trust law purposes.[9] This would classify as capital shares received as a result both of direct and indirect demergers. We also recommend that when such a distribution is made, trustees should have a power to make a payment of capital to beneficiaries interested in income where otherwise there would be prejudice to those beneficiaries.[10] We do not anticipate that this power would be widely exercised but, following discussions with the Trust Law Committee, we consider such flexibility necessary in order to meet the rare situation in which a demerger gives rise to a loss of dividend income.

24. In the CP we proposed the replacement of the rules of classification for all corporate receipts. The fact that our recommended reform extends only to tax-exempt demergers is significant, and relates directly to the reasons why we are not able to make any broader recommendations for the reform of the classification rules. Trust administration would be made more straightforward by the introduction of classification rules based on the form of receipts, and we explain in Part 5 of the Report the way that we believe such a reform could be framed. It would also be helpful to facilitate trustee investment by providing trustees with a statutory power of allocation, as we provisionally proposed in the CP. Such a power would enable trustees not only to correct inappropriate classifications of individual receipts (which any rule will occasionally generate), but also to allocate global investment return to income and capital and so to invest on a total return basis.

25. However, neither of those steps can currently be achieved, because of the

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

[10] Draft Bill, cl 3.

taxation consequences of any such changes. As we explain in detail in Part 5 of our Report, the type of reform to the classification rules which we favour would lead to the disappearance of the interest in possession trust as a meaningful concept, in so far as the income taxation of corporate distributions is concerned. Such a move would be unacceptable to the trust industry and we cannot recommend it. Similar consequences, as well as adverse inheritance tax treatment, would also accompany any reform which enabled more flexible treatment of trust receipts.

26. Such tax issues do not arise in relation to shares received on a qualifying demerger. Despite their current classification as income, the income beneficiary does not have to pay income tax on the shares, because they are defined in tax legislation as exempt distributions. Accordingly, a change to the classification of such distributions has no tax implications. We would have preferred not to single out any particular form of distribution for reform, and it will be appreciated that we do so now only in the absence of other tax-neutral options. We are mindful of the constantly changing landscape of corporate distributions and of possible future changes in taxation. Accordingly, the draft Bill gives the Secretary of State power to extend this category, with the consent of HM Treasury, in the event that new forms of exemption - similar to that currently available for demergers - are devised in the future.[11]

27. Looking to longer term developments, the Report sets out our view of how the difficulties caused by the current classification rules might be addressed, to the extent that tax considerations allow. In particular, we outline the arguments in favour of, and consultees' support for, developments that would enable total return investment by trustees. This could be achieved by a power of allocation of the sort provisionally proposed in the CP and developed in the Report. The Report also outlines the support of notable consultees for percentage trusts,[12] and notes the likely removal of a significant impediment to the development of percentage trusts.[13]

28. Accordingly, we recommend that HMRC and HM Treasury in the longer term enter into discussions with the trust industry as to the feasibility and mechanics for total return investment for trusts within the parameters of current tax policy, to the extent that is possible, or in the event of future developments in policy. While we accept the views of consultees who argued that total return investment is not appropriate for many trusts, and consider that it is an approach to trustee investment that should be enabled rather than required, we remain of the view that its development is an important step for this jurisdiction. Aside from the increased stability and potential returns it can bring, total return investment offers the most satisfactory way to overcome the problems of balancing the interests of income and capital beneficiaries.

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

[12] A percentage trust enables total return investment by requiring trustees to distribute a certain percentage of the value of the trust to the income beneficiary each year, that percentage being determined either by the settlor or by legislation.

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

The rules of apportionment

29. These rules are the law's current rather archaic, and highly inconvenient, response to a number of factual situations in which investments do not give a balanced return to income and capital. We recommend reform that will prevent their automatic implication into trusts, without preventing settlors from incorporating them expressly.

30. We recommend that the first branch of the rule in *Howe v Earl of Dartmouth*, requiring certain residuary personalty to be sold, be abolished.[14] Underpinning this recommendation is the view that trustees should no longer be placed under a specific duty to sell the narrow range of investments to which that rule applies; rather, the sale and reinvestment of trust property ought to form part of a trustee's investment duties under the Trustee Act 2000. This recommendation would take effect for all trusts created after the implementation of our recommendations.

31. The CP provisionally proposed that all the equitable apportionment rules be abolished in their entirety. However, it did so in the context of its proposed provision of a statutory power of allocation. We have concluded that even without such a power, there is no sensible alternative to the abolition of the rules of apportionment because of the practical problems to which they give rise. The fact that they are generally excluded in express trusts speaks for itself. Accordingly, we recommend that the equitable rules of apportionment should not apply to any future trusts, subject to any contrary provision in the trust instrument.[15] It would remain open to future settlors to incorporate express provision in the trust deed if they wished to replicate the rules.

32. The statutory time apportionment rule contained in section 2 of the Apportionment Act 1870 is, likewise, routinely excluded in professionally drafted trust deeds, and when not excluded it is likely that trustees are either unaware of the rule or simply ignore it. Where it is applied, the rule operates against the interests of a life beneficiary, typically a widow or widower, and so in many cases the current default position would not accord with the wishes of the testator and the needs of the beneficiaries. We therefore recommend that section 2 of the Apportionment Act 1870 should not apply to any future trusts, subject to any contrary provision in the trust instrument.[16] Periodic payments such as dividends would therefore accrue to the income beneficiary at the date when they arise. In circumstances where it is important, settlors and testators can include a duty to apportion on a time basis.

Charitable trusts

33. As we have explained, the Charities Act 2006 addresses and resolves a number of concerns about the rules relating to permanent endowment, and the Charity Commission has developed its own scheme for total return investment by charities. However, it remains the case that charities wishing to invest on a total return basis must go to the trouble and expense of obtaining an order authorising them to do so, and must then follow the detailed requirements of the Charity

[14] Draft Bill, cl 1(2)(a).

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

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

Commission's scheme.[17]

34. One of the consequences of the enactment of the Charities Act 2006 has been the potential opening of further routes to total return investment, via new sections 75 and 75A of the Charities Act 1993, which enable charities to free their endowment fund from restrictions. Larger charities must use the procedure in section 75A and obtain authorisation from the Charity Commission, while smaller ones can proceed without permission under section 75. Either route might be used to free permanent endowment from the restrictions that prevent charity trustees from operating total return investment. It is therefore no longer necessarily the case that the Charity Commission's scheme is the only route to total return investment for charities.

35. Nevertheless, we take the view that the Charity Commission's scheme is advisable for most charitable trusts who wish to invest in this way, in the light of the detailed guidance and safeguards that it provides.

36. The Report therefore contains two recommendations relevant to charitable trusts. We recommend that a total return investment scheme regulated by the Charity Commission should be made available to all charities without the need to obtain specific authorisation from the Charity Commission. Instead, charity trustees should be able to adopt the scheme by resolution, thereby becoming subject to regulations to be made by the Charity Commission setting out the details of the scheme.[18]

37. Those regulations need not be in precisely the same terms as the Charity Commission's present rules for total return investment. We recommend that the Charity Commission conduct a further consultation exercise about the provisions of its total return investment scheme, in response to concerns expressed by a number of consultees about its requirements and the restrictions it imposes.

CONCLUSION

38. The Report explores some technical and complex aspects of trust law, which nevertheless have a significant effect upon people's lives and upon the funds available to charities. Our recommendations would effect some much-needed simplification and modernisation in these important areas. The Trust Law Committee has welcomed the draft Bill, stating:

> The Trust Law Committee gives its unqualified support for the recommendations in the Law Commission's report and for the Bill to implement those recommendations. We offer our whole-hearted congratulations to the Law Commission for having addressed an area which has been of major concern to trust practitioners for a very long period and for the manner in which that concern has been addressed.

[17] See Charity Commission, Operational Guidance 83 Endowed Charities: A Total Return Approach to Investment.

[18] Draft Bill, cl 4.