LAW COMMISSION CONSULTATION PAPER

CAPITAL AND INCOME IN TRUSTS: CLASSIFICATION AND APPORTIONMENT

EXECUTIVE SUMMARY

1. The Lord Chancellor has asked the Law Commission to examine:

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

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

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

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

2. This Consultation Paper ((2004) Law Com CP No 175) sets out the current law and outlines previous proposals for reform in England and Wales and in Scotland. It makes proposals for a new scheme for the classification and apportionment of trust receipts and expenses and invites the views of interested parties on these proposals. All proposals in the Consultation Paper are provisional only and do not represent the final views of the Law Commission.

PRIVATE TRUSTS

Classification

3. The classification of trust receipts and expenses as income or capital is particularly important in the context of private trusts for the benefit of persons in succession. In the most common example a life tenant is entitled to trust income (for the duration of his or her life) and a remainderman is interested in the trust capital.

4. The current rules by which investment returns are classified can give rise to arbitrary and illogical results. Some of these rules are complex and their application to novel factual situations is uncertain.

5. The rules work least well in relation to distributions by companies to shareholders who are trustees. We therefore propose that cash distributions to trustee-shareholders by corporate entities (or distributions which could have been taken in cash) should be classified as income. All other distributions by corporate entities should be classified as capital.

6. We do not propose any further reform of the rules for the classification of trust receipts and expenses. We do, however, ask consultees whether it would be useful to place the existing rules governing the classification of non-corporate receipts and expenses on a statutory footing.

Allocating receipts and expenses to balance competing interests

7. The current duty of trustees to balance the competing interests of income and capital beneficiaries ("the duty to balance") rests on the fundamental equitable principle of impartiality. The existing equitable rules of apportionment are underpinned by this fundamental principle and exist in order to achieve a balance in the limited circumstances in which they apply.

8. We consider that the duty to balance should continue to be recognised as fundamental and we ask consultees whether or not the duty should be placed on a statutory footing. By this we mean whether its existence should be laid down in statute: we do not propose that statute should set out a list of factors relevant to the meaning of "balance". We propose that the duty to balance should, in any event, continue to be capable of exclusion or modification by the terms of the trust (either expressly or by necessary implication).

9. Under the law as it stands, the duty to balance is of primary significance to trustees when they exercise their powers of investment. In order to discharge the duty to balance, trustees must select investments which they reasonably expect to deliver investment returns in a form which balances the interests of income and capital beneficiaries. Trustees would, in many cases, be able to achieve increased investment returns (to the advantage of all the beneficiaries) if they could select investments without concern for the form which returns were likely to take (that is to say, whether those returns would be classified as income or capital).

10. This "total return" approach to investment can be achieved by giving trustees the power to allocate investment returns, subsequent to their receipt, between income and capital. We therefore propose that a new statutory power of allocation should be made available to trustees, exercisable by them insofar as it is necessary to discharge the duty to balance (and for no other purpose).

11. We recognise that some settlors and trustees might be concerned about the administrative burdens inherent in such a power and also that, if the power were implied into all trusts by default, some trustees might not be aware of its availability. We therefore ask consultees whether the power of allocation should be available on an "opt-in" or "opt-out" basis.

12. Where the power of allocation is available the rules of classification would only operate by default. A power of allocation would therefore also have the advantage of allowing trustees to adjust the classification of trust receipts and expenses if the proposed rules of classification produced an unjust or illogical result.

13. The effect of trustees exercising the statutory power would be to allocate particular receipts or expenses to income or capital. The power of allocation would only be available for a specified period after the date of the particular receipt or expense. If trustees failed to make a decision to allocate within that time limit, then the default classification, based upon the rules we have outlined above, would become final and conclusive.

14. The proposed power of allocation would be an administrative power. It is intended to facilitate the internal administration of the trust and to enable trustees to discharge their overriding duty to balance. We therefore consider that trustees should not be entitled to take into account the personal circumstances of the beneficiaries when deciding where a proper balance lies in order to exercise the power of allocation. We believe that allowing the meaning of balance to be influenced by personal circumstances would provoke legal uncertainty, increase the likelihood of litigation by beneficiaries against trustees and have a potentially adverse impact on the tax treatment of trusts containing the power of allocation.

15. We accept that this approach to the personal circumstances of beneficiaries sits somewhat uneasily with the prevailing judicial guidance on the meaning of the duty to balance in the context of trustee investment (see *Nestle v National Westminster Bank* [1993] 1 WLR 1260 (CA); [2000] WTLR 795 (Hoffmann J)). We therefore discuss whether it is necessary to distinguish the duties relevant when investment policy is being formulated from those applicable when investment returns are being allocated to income or capital.

16. We propose that an action for breach of trust should, in principle, lie against defaulting trustees in the event of a failure to discharge the duty to balance. The exercise or non-exercise of the statutory power of allocation should also be subject to review by the courts on the same basis as any other discretionary power conferred upon trustees. We consider, however, that the likelihood of a trustee being fixed with personal liability for breach of trust in this context is low. We anticipate that most disagreements would be resolved through further exercise of the power of allocation to restore a balance, without resort to formal methods of dispute resolution.

Rules of apportionment

17. The existing equitable rules of apportionment are intended to give effect to the general equitable principle of impartiality. Although the rules largely achieve a defensible result in the limited circumstances where they do apply, they do not apply in every situation where apportionment would be necessary to balance the interests of income and capital beneficiaries. They are also unduly rigid and technical. We believe the potential availability of a statutory power of allocation for trust receipts and expenses informed by the duty to balance would render recourse to the equitable rules unnecessary. We therefore propose that all the existing equitable rules of apportionment should be abrogated.

18. The rule set out in section 2 of the Apportionment Act 1870 has long been criticised as being inconvenient and unfair in its application to trusts. Insofar as this statutory rule applies to trusts, we provisionally propose (unless a contrary intention is expressed in the terms of the trust) that it should be replaced by a statutory power to apportion to the extent that the trustees, in their absolute discretion, deem it just and expedient.

Scope of provisional proposals

19. We consider that the provisional proposals set out above should apply to all private (that is non-charitable) trusts governed by the law of England and Wales in which the interests in income and capital are divided. We ask consultees whether there are any specific types or categories of private trust to which the scheme should not apply, or to which it should apply in modified form.

20. We ask consultees whether all our proposals should apply to trusts created before any implementing legislation comes into force. We propose that any legislative reform should take effect on the first day of the tax year immediately following the enactment of any implementing legislation so that trustees may have the opportunity to adjust their accounting practices.

Tax implications

21. We have held initial discussions with the Inland Revenue about the tax implications of our provisional proposals and will continue to work with them to find a workable and fair tax treatment for trusts subject to any new apportionment and classification regime.

CHARITIES

22. The problems affecting charities are clearly different from those facing private trusts in succession and merit separate consideration. While classification of trust receipts and expenses is of equal concern to charities, the requirement that trustees achieve and maintain a balance between competing interests does not translate exactly into the charitable context. We therefore propose that charity trustees should not be subject to the duty to balance (as it applies to private trusts) and, as a result, that the proposed statutory power of allocation should not be available to charitable trusts. We do, however, ask consultees whether the existing duty of charity trustees to consider the present and future needs of the charity and its objects should be placed on a statutory footing.

23. We propose that the rules for classification of receipts and expenses proposed for private trusts should also apply to charitable trusts. However, since the private trust power of allocation would be unavailable, this classification would apply conclusively to all charitable trusts.

24. The vital concerns of charity trustees relate to the expenditure of permanent endowment for current charitable purposes and the possible adoption of a total return approach to investment.

25. The Government has recently published a draft Charities Bill, which includes provisions dealing with the circumstances in which trustees should be entitled to distribute a charity's permanent endowment. As a result, we have not made proposals of our own in this respect.

26. We do, however, consider the machinery for the authorisation of total return investment by charities. We invite the views of consultees on a number of alternative mechanisms, provisionally favouring the view that charity trustees should have a general statutory power to invest on a total return basis. Trustees who exercised this power would be required to report the fact and submit the charity's accounts to the Charity Commission each year.

Law Commission
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