



**Law
Commission**
Reforming the law

Capital and Income in Trusts: Classification and Apportionment Impact Assessment

Summary: Intervention & Options

Department /Agency: Law Commission	Title: Impact Assessment of the capital and income in trusts: classification and apportionment project	
Stage: Final Report	Version: 4	Date: 30 April 2009
Related Publications: Law Com CP No 175 (2004) and Report No 315 (2009) on Capital and Income in Trusts: Classification and Apportionment		

Available to view or download at:

<http://www.lawcom.gov.uk>

Contact for enquiries: Property, Family and Trust Law Team

Telephone: 020 3334 0291

What is the problem under consideration? Why is government intervention necessary?

This Report considers the current law governing trustee investment and trust administration, relevant to private and charitable trusts. Government intervention is necessary because many of the the rules are outdated and redundant, no longer relevant to trust practice and investment theory, prevent trustees carrying out the most efficient administration of the trust and cause unfairness between income and capital beneficiaries.

Government intervention is necessary because legislation is needed to give effect to the recommendations.

What are the policy objectives and the intended effects?

Policy objectives are: (1) to abolish all arcane and redundant rules of apportionment; (2) reassess the classification rules in accordance with the principle of balance; (3) facilitate the promotion of total return investment policies for private trusts; and (4) streamline the availability and operation of total return investment in the context of charitable trusts.

The intended effect is to reduce administrative burdens on trustees in relation to classification and apportionment and to create a more satisfactory classification of corporate receipts between income and capital beneficiaries.

What policy options have been considered? Please justify any preferred option.

- (1) Do nothing.
- (2) Comprehensive reform of classification and apportionment rules, introduction of total return investment powers and revision of Charity Commission's total return investment scheme.
- (3) Targeted tax-neutral reform package reducing administrative burden on trustees, improving classification of receipts made pursuant to a demerger, encouraging total return investment for private trusts and revising Charity Commission's total return investment scheme. Option 3 preferred on basis of that it offers tax-neutral improvements to trust administration and investment.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? The policy is expected to be reviewed three years after legislation has been enacted.

Summary: Analysis & Evidence

Policy Option: 2	Description: Comprehensive reform package
-------------------------	--------------------------------------------------

COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups' Cost to the government of introducing new legislation. Trust lawyers and advisors will need to become familiar with the new classification rule requiring some training. Administrative costs associated with reclaiming tax credits following change in trust and classification rules. Amendments to Charity Commission guidance.		
	One-off (Transition) Yrs		£ Insignificant	
	Average Annual Cost (excluding one-off)		£ Moderate	
	Total Cost (PV)		£	
Other key non-monetised costs by 'main affected groups'				

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups' Increase in annual revenue for charitable trusts with permanent endowment and reduced administrative burden for Charity Commission and charities. Simplified classification rules and removal of need for complex apportionment calculations easing the administrative burden on trusts.		
	One-off Yrs		£ Insignificant	
	Average Annual Benefit (excluding one-off)		£ 2,028,500 to £3,653,500	
	Total Benefit (PV)		£	
Other key non-monetised benefits by 'main affected groups' More appropriate classification of trust receipts between income and capital beneficiaries. Favourable comparison of UK trust law with other trust providers by the international trust community.				

Key Assumptions/Sensitivities/Risks Current tax policy remains unchanged leading HMRC to amend deeming provisions; no trusts opt into the total return power due to adverse tax consequences; 5% uptake of total return scheme among charitable trusts with permanent endowment; assumed average value of trusts with permanent endowment.

Price Base Year	Time Period Years	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £
--------------------	----------------------	-------------------------------------	---------------------------------------------

What is the geographic coverage of the policy/option?	England and Wales			
On what date will the policy be implemented?	ASAP			
Which organisation(s) will enforce the policy?	Courts			
What is the total annual cost of enforcement for these organisations?	£ Insignificant			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	Yes/No			
What is the value of the proposed offsetting measure per year?	£ N/A			
What is the value of changes in greenhouse gas emissions?	£ N/A			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)				(Increase - Decrease)
Increase	£	Decrease	£	Net £

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Summary: Analysis & Evidence

Policy Option: 3	Description: A restricted range of tax neutral reforms.
-------------------------	----------------------------------------------------------------

COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups' The cost to the government of introducing new legislation. Trust lawyers and advisory firms will need to become familiar with the change in law requiring some training. Changes to Charity Commission guidance.		
	One-off (Transition) Yrs		£ Insignificant	
	Average Annual Cost (excluding one-off)		£ Insignificant	
	Total Cost (PV)		£	
Other key non-monetised costs by 'main affected groups'				

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups' Increase in annual revenue for charitable trusts with permanent endowment and reduced administrative burden for Charity Commission and charities. Simplified classification rules for demergers and removal of need for complex apportionment calculations easing the administrative burden on trusts.		
	One-off Yrs		£ Insignificant	
	Average Annual Benefit (excluding one-off)		£ 2,028,500 to £3,653,500	
	Total Benefit (PV)		£	
Other key non-monetised benefits by 'main affected groups' Simplification of trust administration. More appropriate classification of receipts from direct and indirect demergers as capital.				

Key Assumptions/Sensitivities/Risks Reform does not give rise to tax consequences. 5% uptake of total return scheme among charitable trusts with permanent endowment, assumed average value of trusts with permanent endowment.

Price Base Year	Time Period Years	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £
--------------------	----------------------	-------------------------------------	---------------------------------------------

What is the geographic coverage of the policy/option?		England and Wales			
On what date will the policy be implemented?		ASAP			
Which organisation(s) will enforce the policy?		Courts			
What is the total annual cost of enforcement for these organisations?		£ Insignificant			
Does enforcement comply with Hampton principles?		Yes			
Will implementation go beyond minimum EU requirements?		N/A			
What is the value of the proposed offsetting measure per year?		£ N/A			
What is the value of changes in greenhouse gas emissions?		£ N/A			
Will the proposal have a significant impact on competition?		No			
Annual cost (£-£) per organisation (excluding one-off)		Micro	Small	Medium	Large
Are any of these organisations exempt?		No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)				(Increase - Decrease)	
Increase	£	Decrease	£	Net	£

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Evidence Base (for summary sheets)

[Use this space (with a recommended maximum of 30 pages) to set out the evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Ensure that the information is organised in such a way as to explain clearly the summary information on the preceding pages of this form.]

PROBLEMS UNDER CONSIDERATION

1. The Capital and Income in Trusts: Classification and Apportionment project was referred to the Commission as a consequence of a concerns expressed during the passage of the Trustee Act 2000 through Parliament that there are problems with the following areas of law:
 - (1) the circumstances in which trustees must convert and re-invest trust property;
 - (2) the circumstances in which trustees may or must make apportionments between the income and capital of the trust fund;
 - (3) the rules which determine whether money or other property received by trustees is to be treated as income or capital; and
 - (4) the rights and duties of charity trustees in relation to investment returns on a charity's permanent endowment.
2. The nature of these problems is discussed in more detail in paragraphs 1.5 to 1.16 below.

RATIONALE FOR GOVERNMENT INTERVENTION

3. Government intervention is required to:
 - (1) remove outdated rules which require trustees to (a) sell property and/or (b) carry out apportionments, and so simplify trust administration;
 - (2) clarify the rules governing the classification of trust receipts as income or capital so that they achieve economically appropriate outcomes;
 - (3) enable trusts to invest as efficiently as possible offering an investment product already available in competing jurisdictions; and
 - (4) improve and make more widely available efficient investment by charitable trusts.
4. The problems under consideration are highly technical and to a large degree interrelated. It is therefore necessary to explain these issues in more detail in order to expand on the rationale for Government intervention.

1(a). Remove outdated rule (“the rule in *Howe v Earl of Dartmouth*”) which requires trustees to sell property

5. A trust for sale is a trust where the trustee is under a duty to sell and convert trust assets into authorised investments. Such a trust may be express (contained in the terms of the trust) or implied under the first limb of the rule in *Howe v Earl of Dartmouth*. We are concerned with the latter. The rule in *Howe v Earl of Dartmouth* imposes a duty to convert in the following circumstances: where, following death, there is residuary personal estate held on trust for persons in succession, the investment is

unauthorised and of a wasting or hazardous nature. The rule was therefore very much linked to the requirement to maintain a balance between successive beneficiaries, by imposing a duty on trustees to convert unauthorised investments into authorised investments.

6. The rule was very limited as it only applied to personal property (ie not land) in the residuary estate (ie not specifically bequeathed), and therefore only applied to testamentary trusts. It also only applied to unauthorised investments. However, since the Trustee Act 2000 there will be very few unauthorised investments. Even before the Trustee Act 2000, the duty was excluded by most well-drafted trust instruments and where it was not excluded it was honoured more in its breach than its compliance. Government intervention is required to remove this outdated trust law rule to improve trust administration.

1(b). Remove outdated rules which require trustees to carry out apportionments

7. There are a number of apportionment rules which require trustees to apportion income to capital or capital to income in order to enforce a fair balance between trust beneficiaries:
 - (1) *Wasting and unauthorised investments: the second limb of the rule in Howe v Earl of Dartmouth.* This rule applies to all trusts for sale, express or implied, where hazardous or wasting property is held for persons in succession. Its scope is therefore wider than that of the first branch of the rule. It states that the life tenant is not to be paid the actual income that arises before sale; instead the life tenant is to receive a sum calculated by applying a specified level of interest (usually 4 per cent) to the estimated value of the property. This sum is intended to reflect a fair income from the property, leaving the excessive income supposed to be produced by such an investment to be treated as capital. The effect of the disapplication of the rule is that the income beneficiary will be entitled to income from such investments as it arises.
 - (2) *Reversionary interests: the rule in Re Earl of Chesterfields Trusts.* This rule complements the second limb of the rule in *Howe v Earl of Dartmouth* by compensating the loss to the life tenant, or preventing the remainderman from unfairly benefiting from the gain, arising from a failure to convert reversionary interests into authorised investments. It requires the payment of a sum to the life tenant on the conversion of future or reversionary interests, such as life insurance, which yield no income.
 - (3) *Debts, legacies and annuities: the rule in Allhusen v Whittell.* This rule apportions debts, liabilities, legacies, annuities, and other charges which are usually required to be paid out of the residuary estate (capital), so that such debts are payable in part by both income and capital.
 - (4) *Deficient securities: the rules in Re Atkinson and Re Bird.* These rules require the apportionment of losses arising from investment in authorised and unauthorised loan stock, respectively, where the security proves to be insufficient to meet the shortfall where the borrower defaults. The rule in *Re Atkinson* requires the life tenant and remainderman to bear the losses rateably, whereas the rule in *Re Bird* requires the deficit to be apportioned according to the beneficiaries' respective rights at the time the investment was made.

- (5) *Time apportionment: section 2 of the Apportionment Act 1870.* Unlike the equitable apportionment rules outlined in 1 to 4, this rule requires trustees to apportion periodical income receipts between successive income beneficiaries. Such payments are deemed to arise from day to day, and are apportioned as such. It also applies in relation to trusts for the maintenance out of capital of a class of minors who are contingently entitled to the trust capital on attaining a specified age; a new member of the class is only entitled to be maintained out of income arising after they entered the class.
8. All of the rules are mechanical in nature and require complex calculations to be made by trustees, often in relation to very small sums of money. As with the implied trust for sale considered above, they are often excluded in well-drafted trust instruments or honoured in the breach rather than the compliance.
9. The second limb of *Howe v Earl of Dartmouth* and the rule in *Re Earl of Chesterfield's Trusts* are the most problematic as they are both intimately related to the old list-investment theory requiring a balance to be struck between income and capital through investment in authorised investments; the rules operated to enforce a fair balance during the period when the investments remained unauthorised. The focus was necessarily on individual investments. However, most investments will now be authorised, and the focus is now on a balanced portfolio rather than balanced investments. The consequence is that these two rules are no longer appropriate. Government intervention is therefore required to remove these outdated and redundant rules and bring trust administration into the twenty-first century.

2. Clarify the rules governing the classification of trust receipts as income or capital so that they achieve appropriate outcomes

10. Unless expressed otherwise in the trust instrument, the life tenant is entitled to the 'income' from the trust assets as it arises to the trust, and the remainderman is entitled to 'capital' receipts, including capital gains. The rules classifying receipts from companies as 'income' and 'capital' are based on company law concepts of income and capital. In *Bouch v Sproule*, as interpreted by the Privy Council in *Hill v Permanent Trustee Company of New South Wales*, it was held that profits distributed by way of dividend are received as income by trustee-shareholders, and that shares allotted following capitalisation are received as capital.
11. The consultation paper and the Report provide further details as to the problematic results caused by the rule in *Bouch v Sproule*. One of the main problems identified in the CP related to the classification of receipts pursuant to direct and indirect demergers. A demerger involves the transfer of part of Company A's business to a new Company B, with the shareholders of the demerged company (Company A) receiving shares in the new company by way of a declaration of dividend. In a direct demerger the dividend is satisfied by Company A issuing its shareholders shares in Company B. In an indirect demerger the shares in Company B are transferred to a separate holding company, Company C, owned by Company A, which satisfies the dividend by transferring to its shareholders the shares in Company C. In both cases the shares are received as income under the rule in *Bouch v Sproule*, as in company law terms there has been a distribution by Company A; in both cases the value of the transferred business is not retained by Company A. However, nothing has materially changed from the perspective of the trust. Nevertheless, the classification of such receipts as income means that the remainderman's interest is significantly reduced and the life tenant receives a windfall. In *Sinclair v Lee* it was held that in the case of an indirect demerger the shares are properly classified as capital. However, this was only a decision of the Chancery Division, and it did not extend to direct demergers.

12. In each of the situations outlined, the actions of the company will significantly impact on the beneficial interests, but there is no obligation on companies to have regard to trustee-shareholders. Not only does the classification often provide a result which causes an imbalance between the beneficiaries, but there are no rules requiring, or allowing, an apportionment to be made between beneficiaries where such an imbalance arises. Moreover, the lack of information available to trustee-shareholders means that it will often be unclear whether the receipt is properly classified as income or capital in the first place. Government intervention is therefore required in order to make the rules clearer for trustees and fairer between successive beneficiaries.

3. Enable trusts to invest as efficiently as possible offering an investment product already available in competing jurisdictions

13. As mentioned above, the Trustee Act 2000 changed the general law of trustee investment by allowing trustees to invest in a wider range of investments and requiring trustees to consider the need to diversify. In choosing investments, the likely form of the return is an unnecessary distraction skewing trustees' investment decisions; for individual investors this is not a factor as they will simultaneously own both the income and capital, whereas in trusts with successive beneficiaries income and capital define separate entitlements altogether. As a result, trustees are forced to make investment decisions which may not improve the overall return to the trust, but rather secure reasonable income receipts for the life tenant while maintaining sufficient capital growth for the remainderman.
14. It was in relation to charitable trusts that the problem of total return investment was brought to our attention. However, given the objectives of the Trustee Act 2000 the Law Commission considered it necessary to consider the operation of total return investment for private trusts. In the US total return investment has been widely implemented for private trusts through the introduction of a statutory power to adjust and statutory unitrusts, the driving force being The National Conference of Commissioners on Uniform State Laws who promulgated the Uniform Principal and Income Act (2000). Government intervention is necessary as the income/capital dichotomy is central to current trust and tax law. If the UK is to remain a key location of trust law, practice and investment it is absolutely necessary that trust investment law and practice keeps up with developments in other, competing jurisdictions.

4. Improve and make more widely available efficient investment by charitable trusts

15. The Charity Commission published Operational Guidance in May 2001 for charitable trusts with endowed gifts whereby charity trustees could, on an individual basis, apply for authority to undertake total return investment under section 26(1) of the Charities Act 1993.
16. The Charity Commission's current scheme for total return investment is relatively complex, requires individual authorisation in every case, and does not allow access to the endowed fund in any circumstances. Government intervention is therefore necessary in order to promote the efficient and most beneficial administration of charities for their charitable purposes.

POLICY OBJECTIVES

17. Government intervention is therefore necessary in order to bring trust administration into the twenty-first century and fulfil the policy objectives of the Trustee Act 2000. The Law Commission's policy objectives in formulating its recommendations in this project have been:

- (1) abolish, with or without replacement, all arcane and redundant rules;
- (2) assess classification rules against the underlying principle of fair balance between income and capital beneficiaries and provide alternative classification rules in accordance with this principle insofar as it is possible to do so in a tax neutral manner;
- (3) facilitate the enhancement of trust investment through total return investment for private trusts as far as possible in a tax neutral manner; and
- (4) streamline the availability of total return investment to charitable trusts insofar as it is possible and desired by charitable trusts and the Charity Commission.

SCALE AND CONTEXT

18. As we have seen, the implied trust for sale only arises in limited circumstances. The apportionment rules and classification rules in principle apply to all trusts. Most well-drafted trusts will exclude the apportionment rules and will provide detailed classification provisions in place of the default provisions. However, settlors and testators will rarely consider every eventuality regarding classification.
19. There are hundreds of thousands of trusts operating in England and Wales today for family, charitable, social, commercial and other purposes. Many trusts are implied by law. Central control over trusts is, in the UK, limited. Without a central registry system, aggregate data on trusts is difficult to come by. However an indication of the scale of the application of the apportionment and classification rules, and potential for total return investment, can be gauged from the following:
 - 208,000 trusts were known to HM Revenue and Customs in 2005/06. More than half of these were discretionary, maintenance or accumulation trusts. However HMRC only had data for those trusts that filled in a self-assessment tax return, which may exclude a number of trusts at the lower end of the income scale.¹ Total income for interest in possession trusts was £1,355 million, generating income tax of £220 million. Of that, £935 million was created by higher value trusts with a total income of £100,000 or more.² Dividend income for interest in possession trusts was £570 million.
 - Assets held in life assurance and pension funds were £2,070 billion in 2006.
 - 210,920 wills were proved by probate registry in 2006.³ Anecdotal evidence suggests that many of these create trusts.
 - At the end of June 2008 there were 169,498 “main” charities on the Charity Commission’s register with a total annual income of £46.16 billion.⁴ The Hayton Report puts the number of charitable trusts at 8,793 in 1996/7, with an income of 2,402million and an asset base of £22,942million.⁵

¹ HM Revenue and Customs, Table 13.1 – Trusts and Estates which Make a Full Self-Assessment Return. Available at www.hmrc.gov.uk/stats/trusts/table13-1.pdf.

² HM Revenue and Customs, Table 13.2 – Trusts and Estates which Make a Full Self-Assessment Return. Available at www.hmrc.gov.uk/stats/trusts/table13-2.pdf.

³ Ministry of Justice, Judicial and Court Statistics 2006 (November 2007), page 84.

⁴ Charity Commission, Facts and Figures. Available at <http://www.charity-commission.gov.uk/registeredcharities/factfigures.asp>.

⁵ David Hayton, *Trusts and their Commercial Counterparts in Continental Europe* (January 2002).

- The Charity Commission made 38 total return investment orders under section 26 of the Charities Act 1993 between 2001 and July 2008.⁶
 - As of 18 December 2008 the Charity Commission indicated that 13,884 charitable trusts are registered with a permanent endowment.⁷
20. Trusts therefore contribute significantly to the wealth of the country, and provide an important mechanism in providing for future generations. Although the recommendations contained in the Report will impact on all private trusts (where the settler or testator has not expressly provided otherwise), the recommendations will only substantially impact on trusts with successive beneficial interests and charitable trusts with permanent endowment.

EVIDENCE AND CONSULTATION

Related publications

21. These issues have been considered by three other bodies in the recent years:
- (1) The Powers and Duties of Trustees (1982) 23rd Report of the Law Reform Committee, Cmnd 8733.
 - (2) Capital and Income of Trusts (1999) Trust Law Committee Consultation Paper.
 - (3) Apportionment of Trust Receipts and Outgoings (2003) Scottish Law Commission Discussion Paper No 124.

Consultation paper

22. The Law Commission published a consultation paper in July 2004 which received 42 detailed responses from key stakeholders, including judges, legal practitioners, academics, organisations (Charity Law Association, Association of Contentious Trust and Probate Specialists, British Bankers Association, Trust Law Committee, Society of Trust and Estates Practitioners, Law Society, Bar Council), trust and trust companies and Government departments and agencies (Inland Revenue and Charity Commission). A full list of consultees is available as an appendix to the Report.
23. The consultation broadly provided the options of no reform and comprehensive reform, although questions were structured so that it was possible to agree to reform of the apportionment rules and not the classification rules and so on. However, the comprehensive reform proposals were an holistic package, abolishing the implied trust for sale, apportionment rules and classification rules for corporate receipts and in their place providing a default form-based classification rule, the harshness of which could be mitigated through the exercise of a new power of allocation so as to produce a fair balance between successive beneficiaries. The power of allocation not only replaced the apportionment rules, but also allowed trustees to invest on a total return basis. In relation to charitable trusts, the new classification rule would be conclusive and the proposed power of allocation would not be available. However, we provisionally proposed that charity trustees should have a general statutory power to invest on a total return basis rather than seeking individual authorisation from Charity Commission. Broadly speaking, consultees were in favour of comprehensive reform.

⁶ Information provided by the Charity Commission.

⁷ Information provided by the Charity Commission.

Further external consultation

24. A public seminar to discuss policy in this area was held at the Institute of Advanced Legal Studies on 5 October 2004.
25. After we had analysed consultation responses, the team convened a panel of experts in 2008 to discuss the benefits/costs and advantages/problems associated with specific reformulated policy proposals. The panel met four times on 7 February, 6 March, 18 March and 1 September 2008. The panel included representatives of ACTAPS, STEP, and TLC. A full list of members is provided in an appendix to the final Report.

Further internal Government consultation

26. The Law Commission also met with officials from HM Revenue and Customs, HM Treasury and the Charity Commission to discuss policy. During these meetings HM Revenue and Customs expressed concerns regarding our comprehensive reform package, in particular that it would be difficult for them to govern from a tax perspective and that it had the potential to decrease the overall tax-take. It was concluded that the comprehensive package would lead to more trusts being taxed at a higher rate, which would have a negative impact on trust industry in England and Wales. Further details are provided below and in the final Report.

POLICY OPTIONS

27. There were broadly three policy options available for the final Report:
 - (1) **Do nothing:** Retain existing classification and apportionment rules; take no steps to facilitate total return investment for private trusts; and leave Charity Commission individual total return investment authorisation system in current form.
 - (2) **Comprehensive reform package:** Introduce new classification rules for corporate receipts; abolish apportionment rules; introduce new power for total return investment for private trusts; and make generally available expanded total return investment scheme for charitable trusts.
 - (3) **Restricted range of reforms:** Revise classification rules for direct and indirect demergers; abolish apportionment rules; encourage dialogue between Government and trust industry for future facilitation of percentage trusts; and make generally available expanded total return investment scheme for charitable trusts.

OPTION 1: DO NOTHING

Benefits of option 1

28. The benefit of doing nothing can merely be seen as the fact we will not incur the costs of “doing something”.

Costs of option 1

29. There are many costs associated with doing nothing. Firstly, trustees are currently unwittingly placed under obligations for which they may be liable if they fail to fulfil them. However, in many cases settlors/testators, trustees and beneficiaries are all equally unaware of these obligations. It is inherently to the detriment of the legal system as a whole, and trust law in particular, for the law to impose liabilities where they are neither intended nor required.

30. Secondly, in order to exclude such rules, settlors/testators include standard exclusion clauses in trust instruments. Failure to abolish such obscure rules will lead to the continuation of the need for such clauses, which runs against pressures to simplify legal documentation. Failure to exclude the rules can lead to disproportionately high professional costs in applying them.
31. Thirdly, the classification rules as they are prevent the optimal economic scenario from being reached; the cost of not remedying this is that the value of the trust could escape to the income beneficiary in circumstances where the trust fund was intended for the long term benefit of the remainderman. The rules are complex and difficult to apply, leading to increased professional costs and increased trust management expenses.
32. Fourthly, with regard to charitable trusts, a failure to reform the system of authorisations for total return investment will maintain the administrative burdens on both charitable trustees and the Charity Commission.
33. Finally, by not implementing total return investment strategies in the context of both private and charitable trusts, the UK runs the risk of falling behind as a leading centre for investment and investment vehicles. Total return investment has the potential to maximise trust gains/minimise losses, with consequential increases in receipts by beneficiaries and the overall tax-take from private trusts.
34. Given these factors, the cost of doing nothing is significant, especially when (as we will see below) the costs associated with option 3 (and option 2 to a lesser extent) are very low.

OPTION 2: COMPREHENSIVE REFORM PACKAGE

Outline

35. The second option is to recommend comprehensive reform as provisionally proposed in the consultation paper:
 - (1) The abolition of the implied trust for sale without replacement and equitable apportionment rules without direct replacement.
 - (2) The non-application of the statutory time apportionment rule to trusts and replacement with a new statutory power to apportion when and in the manner in which the trustees, in their absolute discretion, deem just and expedient.
 - (3) The replacement of the classification rules for corporate receipts with a new form-based rule whereby cash distributions and distributions which could have been taken in cash are received as income, and all other distributions are received as capital. This rule would be subject to contrary provision in the trust, a 20 per cent threshold rule and an opt-in power of adjustment, and would be either conclusive or default depending on the availability of the power of allocation (below).
 - (4) The introduction of a new opt-in statutory power of allocation for trustees of private trusts to enable them to discharge their duty to balance. This power would constitute a replacement of the equitable apportionment rules with a flexible power underpinned by the principle of balance, and would also promote total return investment policies. The exercise of the power of allocation would be subject to a time limit, after which the default classification would become conclusive. The exercise of the power would be reviewable on the same basis as any other discretionary power conferred on trustees, and an action for

breach of trust would lie against trustees who failed to discharge their duty to balance.

- (5) Total return investment by charitable trusts with permanent endowments should be facilitated through a general statutory power to invest on a total return basis, with those who choose to invest on this basis being required to comply with new regulations provided by the Charity Commission. The default classification rule for private trusts would be conclusive and the statutory power of allocation would not be available.

36. The benefits and costs of the various components of option 2 are outlined below.

Components 2(1) and (2): Abolition of the implied trust for sale and equitable apportionment rules and non-application of statutory time apportionment

37. To the extent that these rules were applied, the abolition or non-application of the rules will save trustees the time of administering them which will in turn benefit the beneficiaries by reducing trust management expenses when exercised by professional trustees. When exercised by lay trustees, the abolition will remove a major complexity in the administration of trusts. To the extent that these rules were not excluded but not carried out, the abolition of the rules will remove the absurdity of the existence of a general law of trusts which anecdotal evidence suggests is not observed, thereby bring trust law into line with the way that lay trustees exercise their duties. It is not possible to make any realistic estimate of the extent of compliance given available information. To the extent that the rules were expressly excluded in the trust instrument, as had become widespread, the abolition of the rules will reduce the cost to settlors/testators in having such clauses included in the trust instrument, will reduce the time involved in drafting such instruments, and reduce the complexity and length of trust instruments.
38. The cost of abolishing the rules is that settlors and testators who wanted the results currently produced by those rules to be achieved would have to include express provision in the terms of the trust and are likely to incur professional fees in doing so.

Component 2(3): Cash/non-cash classification rule plus 20 per cent rule and power of adjustment

39. The benefit of the cash/non-cash rule is its simplicity in the administration of the trust, the operation of which does not require an investigation into the intention of the company or the substance of the transaction which gave rise to the receipt. It also provides a result which is considered economically fair in the case of direct and indirect demergers and scrip and enhanced scrip dividends (see Report, paras 2.23 to 2.34 and 5.38 to 5.66). The rule would benefit larger trusts in providing a rule which does not require the trustee to exercise judgement and would also be amenable to an automated (ie computerised) classification system which would speed up transactions and the distribution of income to income beneficiaries. The 20 per cent rule would allow for a fairer classification of special dividends, and the power of adjustment would allow for more nuanced classification.
40. The cost of these rules is that there may be certain tax consequences: the classification of certain non-cash distributions as capital which are currently classified as income may lead to an extension of the deeming provisions, creating a mismatch between trust and tax classification, and potentially leading to receipts being subject to the trust rates. The 20 per cent rule and power of adjustment would also have adverse income tax and inheritance tax consequences.

Component 2(4): Duty to balance and power of allocation

41. The power of allocation would allow trustees to make nuanced decisions in the administration of the trust, allowing trustees to conduct total return investment. The benefit would be that trustees could invest for the best overall return to the trust, without having to skew investments in order to obtain income and capital receipts. It would also be in accordance with trust practice to the extent that trustees already make apportionments between income and capital.
42. An indication of the possible financial benefits can be calculated as follows. STEP's consultation response indicated that if a fund were invested on a total return basis the return would increase by 1% to 2%. We will assume a conservative gain of 0.5%. If the average value of an interest in possession fund is £300,000, and this were increased 0.5%, this would be an increase of £1,500 per fund. Multiplied by a likely uptake by 25,000 to 30,000 trusts this created a rise in income of £37.5million to £45million.
43. There are a number of potential costs associated with the power of allocation. First, such a power may allow trustees to favour one beneficiary over another. However, this would be in breach of the duty of impartiality for which trustees would be liable. This would increase the burden on the court service. A related cost is that such a power would provide beneficiaries with an opportunity to complain to the trustees, placing trustees in a difficult position, and potentially increasing the number of cases brought by beneficiaries against trustees. However, in the majority of cases trustees would be able to remedy any defects by a further exercise of the power of allocation. Thirdly, such a power is likely to take trusts with the power available outside the income in possession tax regime into the discretionary trust tax regime which would significantly increase the tax liability of certain trusts. This is discussed in more detail in the Report.

Component 2(5): Charitable trusts with permanent endowments and total return investment

44. The benefit of providing a default power to invest on a total return basis is that it will encourage total return investment by charities with permanent endowment, thereby increasing the overall wealth of charitable trusts which will benefit the trust's charitable purposes. It will also reduce the burden on the Charity Commission in having to provide individual authorisations for total return investment. It will also reduce the administrative costs of applying for Charity Commission approval.
45. An indication of the possible financial benefits can be calculated for lower and higher value charitable trusts as follows. For a charitable trust who asset value is £250,000, investing on a total return basis might increase its revenue by 0.5%, equating to around £1,250 per annum. If only 5% of the charitable trusts with permanent endowment adopt the scheme for investment on a total return basis, around 650, and assuming an asset value or an average asset value of £250,000, that would provide an increased revenue for charitable purposes of around £812,500. If the asset value is taken to be £500,000 the increased revenue would be £1,625,000; and if the asset value is taken to be £750,00 the increased revenue would be £2,437,500.
46. On the basis that the average asset value of a higher value charitable trust is £30.5 million, a fund investing on a total return basis might increase its revenue by around £152,000. If only 1% of higher value trusts with permanent endowment adopted the scheme, around 8, that might provide an increased revenue of around £1,216,000.
47. The overall benefit to trusts with permanent endowment might therefore be in the region of £2,028,500 to £3,653,500.

Overall appraisal of the benefits and costs of option 2

48. There are therefore numerous potential benefits associated with the comprehensive reform package advocated in the consultation paper, if that could be achieved in a tax-neutral manner.
49. As noted above, similar proposals have been advocated by three other major studies. The responses to the consultation paper demonstrate a general consensus in relation to the abolition of the implied trust for sale and equitable apportionment rules and the non-application of the statutory time apportionment rules. Consultation responses also support the introduction of a discretionary power to enable apportionment in place of these rules in accordance with the general principle of balance. There was consensus that the current classification rules should be abolished, although there was less agreement as to what these rules should be replaced with. The cash/non-cash rule would have solved the problems relating to the classification of demergers and also scrip dividends. The power of allocation also provided for the apportionment of corporate receipts, thereby solving problems relating to the classification of special dividends. The power proposed in the consultation paper, however, went further than merely providing for discretionary apportionment but provided a basis for total return investment policies, which was also generally supported in consultation. The benefit of the power of allocation was that it provided an integrated means of both apportionment and total return investment, which allowed trustees to take decisions for the benefit of individual trusts and also increased the overall wealth of trusts without skewing investment decisions. We refer above to our assessment of the likely financial benefits of facilitating total return investment by trustees of private trusts and charitable trusts with permanent endowments.
50. Against these benefits, the costs associated with Option 2 identified in the Commission's consultation were relatively minor. However, HMRC has confirmed to us that the proposed powers of adjustment and allocation would transform interest in possession trusts into discretionary trusts for income tax and inheritance tax purposes. That would render the powers of allocation and adjustment not only undesirable for the vast majority of trusts but entirely redundant. The tax consequences would be such that trustees would not opt into the powers and so would not gain the benefits outlined.
51. As provisional proposals regarding the default cash/non-cash rule, and to a lesser extent the abolition/non-application of the apportionment rules, were premised on the availability of a new statutory power of allocation, its unavailability (either due to non-implementation or due to a lack of uptake by settlors/testators or trustees) would undermine those proposals. The proposed change to the classification rules would also give rise to administrative costs associated with reclaiming tax credits. The Commission has therefore concluded that since the existence and exercise of a power of allocation would not be tax neutral, it cannot recommend the comprehensive reform outlined in Option 2.

OPTION 3: RESTRICTED RANGE OF TAX NEUTRAL REFORMS

52. The Commission's preferred option is to provide a restricted range of tax neutral reforms. This coupled with recommendations that HM Revenue and Customs and HM Treasury undertake consultation with the trust industry regarding total return investment and percentage trusts, and the Charity Commission undertake consultation regarding their total return investment scheme. The costs and benefits associated with each component of Option 3 are outlined below.

Component 3(1): Abolish implied trust for sale, equitable apportionment rules and non-application of statutory time apportionment

53. These proposals equate to the proposals in the Options 2(1) and (2). The apportionment rules will no longer be partially replaced by any power of allocation or apportionment. It was considered that even without any such powers, there was sufficient support in consultation and subsequent advisory group meetings for the outright abolition and non-application of the equitable and statutory apportionment rules. The cost is that in certain circumstances the life tenant or remainderman will benefit at the expense of the other. However, it remains open to the settlor/testator to expressly provide for these circumstances in the trust instrument.

Component 3(2): Specific tax-neutral incursion into the classification of corporate receipts - direct and indirect demergers

54. The terms of reference specifically required the Commission to consider the classification of corporate receipts in relation to direct and indirect demergers as a consequence of the decision in *Sinclair v Lee*. The Commission considers it desirable to classify receipts made pursuant to direct and indirect demergers as capital for trust law purposes. It is possible to do this in a tax neutral manner through section 213 to 217 of the Income and Corporation Taxes Act 1988, which provides that such distributions are exempt distributions for the purposes of income tax. In certain circumstances the classification of such receipts as capital may deprive the life tenant of an income benefit, for example reducing the company's ability to maintain its dividend policy. In these circumstances the Commission considers it desirable to provide a power to the trustees to make a payment from trust capital to compensate the income beneficiary. The benefit of this recommendation is that it provides an economically fair classification of such receipts, with a power to redress any impact on the income beneficiaries, without any adverse tax consequences. Aside from legislation and implementation, there do not appear to be any general costs.

Component 3(3): Trust industry consultation with HM Treasury regarding total return investment

55. The power of allocation would have provided a means for private trusts to invest on a total return basis. Due to the costs to trust industry associated with a new statutory power of allocation, it has not been possible to make this recommendation. Nevertheless, the Commission continue to believe that total return investment strategies should be encouraged for trusts for which it is suitable. Investment decisions should not be taken according to the expected form of the receipt, but rather the risk associated with the investment and its liquidity balanced against its expected return. Total return investment strategies have been recommended in Canadian provinces and have been widely implemented in the US (see final Report). The power of allocation is one method for total return investment. A more pure approach to total return investment is the percentage trust. A percentage trust requires a certain percentage of a trusts annual (or averaged) overall return to be distributed to the life tenant with the remainder accumulated (see final Report). A number of consultees, including responses from bodies representing large numbers of trust practitioners, were positive about the introduction of percentage trusts. For example, the UK STEP Technical Committee commented that they have 'considerable merit' and the Wills and Equity Committee of the Law Society could see the benefit of percentage trusts for those trustees wishing to invest on a total return basis.

56. One option would be to recommend the introduction of percentage trusts. The benefit of percentage trusts is that they provide a method for total return investment, without the administrative burdens associated with the power of allocation and without the need for any underlying trust classification rules. They would also increase the wealth of the trust industry, and by providing a new trust product in England and Wales render English law more desirable internationally. However, as tax legislation currently stands the percentage trust would be taxed at the higher rates rendering them undesirable to the trust industry, with the consequence that uptake would not be sufficient to justify their implementation. Moreover, while it is clear that sectors within the trust industry desire the availability of a tax-neutral means of investing on a total return basis it is unclear that the percentage trust is the most appropriate means of achieving this. There are also a number of different forms that the percentage trust may take, the details of which would need to both benefit the trust industry and also satisfy HM Treasury and HM Revenue and Customs regarding tax consequences.
57. The Commission recommends that HM Revenue and Customs 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. The benefit of such a recommendation is that it does not require legislative action to be implemented. The cost is that associated with any consultative process.

Component 3(4): Enable total return investment by charitable trusts

58. The Commission is making two recommendations in relation to charitable trusts.

Component 3(4)(i): General statutory total return investment scheme

59. This recommendation broadly equates to Option 2(5), but with additional recommendations regarding charitable trusts' endowed gift. Since the consultation paper, in which Option 2(5) was discussed, section 43 of the Charities Act 2006 has considerably widened the scope for the trustees of a charity to spend permanent endowment. This section has substituted a new section 75 and 75A in the Charities Act 1993, which allow small charities to spend permanent endowment without Charity Commission authorisation and larger charities to do so with Charity Commission authorisation respectively. As outlined above (and in more detail in the Report), the Charity Commission's scheme for total return investment prohibits the expenditure of the endowed gift itself. However, section 75 (and to a lesser degree section 75A) may operate to undermine this absolute prohibition. Indeed, section 75 may allow smaller charities to invest on a total return basis outside of the Charity Commission's scheme altogether.
60. The Law Commission considers that it is desirable that charitable trustees operate total return investment through the Charity Commission's scheme. The Law Commission is therefore recommending that the Charity Commission's scheme is provided to all charitable trusts on a statutory basis without the need for individual authorisation.
61. We refer above to our assessment of the likely financial benefits of facilitating total return investment by trustees of charitable trusts with permanent endowment.
62. The benefit of this recommendation is that it will encourage charitable trustees to adopt the Charity Commission's scheme, thereby falling under the regulation of the Charity Commission, without the need for individual authorisation to do so. This will cut administrative costs for both the trust and the Charity Commission, while making available all the particular charity's funds for the fulfilment of its charitable purposes. The cost is that to the extent that permanent endowments are expended they will be unavailable to create returns for future charitable expenditure.

Component 3(4)(ii): Consultation by Charity Commission with charitable trust industry

63. Consultation responses relating to Option 2E brought to our attention dissatisfaction with the structural rigidity and complexity of the Charity Commission's total return investment scheme. The Law Commission does not wish to make recommendations as to the details of the Charity Commission's scheme. However, we recommend that the Charity Commission consult with charitable trustees as to ways in which the scheme can be improved with a view to reformulating the Charity Commission's Operational Guidance. The benefit of this is that it does not require legislative implementation, and can lead to the mutual improvement of the Charity Commission's scheme. The costs of this recommendation are those associated with undertaking a further consultation exercise.

KEY ASSUMPTIONS/SENSITIVITIES/RISKS

Option 1: Do nothing

64. Trends assumed to continue as they are now.

Option 2: Comprehensive reform package.

65. In providing estimated benefits of total return investment for private trusts, the following assumptions were made:
- (1) There are 100,000 interest in possession trusts in England and Wales. This was based on HMRC statistics, which indicate 89,500 interest in possession trusts self-assessed for tax in 2005-2006;⁸ the fact that many interest in possession trusts do not self-assess and there will be trusts classified for tax purposes as discretionary that do not have the requisite powers to operate total return investment.
 - (2) The average size of an income in possession trust fund is £300,000. This is a figure based on figures in an HMRC economic analysis of private trusts.⁹
 - (3) 25-30% of interest in possession trusts will opt to invest on a total return basis.
66. However, it was also assumed that if HMRC did not change its tax policy in relation to private trusts, no trusts would opt-in. In this regard, it was assumed that HMRC would not change its tax policy in relation to private trusts, and would amend legislation as necessary to maintain that policy (eg extending the deeming provisions).
67. In relation to charitable trusts:
- (1) According to Charity Commission figures, as at 29 April 2009 the average asset value of registered charities with permanent endowment with an income over £500,000 for the years 2007 and 2008 is £30.5 million.¹⁰ This figure was based on accounts from 786 higher value trusts that had completed accounts for 2007 and 2008.

⁸ <http://www.hmrc.gov.uk/stats/trusts/table13-1.xls>

⁹ HM Revenue and Customs Research Report 25, Research on Trusts Experience of Setting Up and Running Trusts (2006), p 33.

¹⁰ Information provided by the Charity Commission.

- (2) It has not been possible to find any statistics on the average size of charitable trust funds with permanent endowment with an income of less than £500,000. Consequently we assume a range of values as an example of the value of a trust fund with permanent endowment with an income less than £500,000, so as to indicate the benefits of our recommendations to lower value trusts. We take as our range an asset value of £250,000, £500,000 and £750,000. According to Charity Commission figures, as at 18 December 2008 there were 13,884 charitable trusts with permanent endowment. Deducting the higher value trusts, there are approximately 13,000 lower value charitable trusts with permanent endowment.
- (3) Given that there are alternative mechanisms by which charities can enable total return investment and the low number of charities applying for total return investment under the current scheme (albeit that our proposal removes the need for an application and enables the simplification and improvement of the scheme), 5% of lower value charitable trusts with permanent endowment will opt to invest on a total return basis and 1% of higher value trusts.
- (4) Higher value trusts have an average asset value of £30.5 million, and lower value trusts have an average value of £250,000, £500,000 and £750,000 for the purposes of calculating the increased revenue.
- (5) An increased return of 0.5% when trustees invest on a total return basis.

Option 3: Restricted reform package

68. It was assumed that the restricted range of reforms would have no tax consequences.
69. The assumptions in relation to charitable trusts are the same as outlined in Option 2.

HUMAN RIGHTS

70. We do not consider there to be any human rights implications.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	No	No
Small Firms Impact Test	No	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	Yes	No
Rural Proofing	No	No