

TRUST LAW COMMITTEE

CONSULTATION PAPER

CAPITAL AND INCOME OF TRUSTS

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1.0 Introduction

1.1 Under a great many wills and settlements, income of the trust fund goes to certain beneficiaries to start with and later the capital goes to others, while in the case of charitable trusts with permanent endowment capital, the income only is applicable for the purposes of the charity. This makes it important to know what receipts of the trustees are to be considered income and what receipts are to be considered capital of the trust, also what outgoings should be paid from the capital of the trust and what from its income. Moreover, under complex equitable apportionment rules certain income receipts have to be apportioned partly to capital of the trust, certain capital receipts have to be apportioned partly to income, and certain outgoings from estates have to be paid partly from capital and partly from income. The Apportionment Act 1870 also requires income to be apportioned on a time basis on changes in the beneficiaries entitled to it. The rules of law and equity on these topics are of importance to a great many capital and income beneficiaries and to trustees of charitable endowments, but the way in which some of the equitable rules ought to be applied is far from certain, and many of the rules have long been considered unsatisfactory in other ways. Indeed, because they are capable of forcing charitable trustees into making investment decisions which they would not otherwise have made, increasingly the Charity Commission is being asked under section 26 of the Charities Act 1993 to authorise departures from those rules so that resources can be used for charitable purposes as an alternative to re-investment.

1.2 One unsatisfactory rule applies when a company in which the trust fund is invested distributes to the trustees by way of dividend shares that it owns in a subsidiary company. The rule requires this distribution in specie to be treated as income of the trust, going to the current income beneficiary, even if it greatly reduces the value of the shares in the parent company which form the capital of the trust. In closely comparable circumstances such a result has been judicially described as absurd. Moreover, it is impossible to say whether the rule ought to be applied in other comparable circumstances which might arise in future.

1.3 The equitable apportionment rules have also been the subject of criticism. As long ago as 1982 these rules were criticized by the Lord Chancellor's Law Reform Committee,¹ which recommended the reforms outlined in section 6.0 below. These recommendations were well received by the profession, and the proposed reforms were not rejected, or criticized, by the Government, but they have not been enacted.

1.4 The Law Reform Committee criticized the way in which the Apportionment Act applies in the administration of trusts, and recommended that it should be amended to prevent it from doing so, but again nothing has been done.

1.5 This paper seeks views on the possible reform of the equitable and statutory rules. It begins in sections 2.0 to 4.0 by describing and examining the existing equitable rules and in section 5.0 the circumstances where they do not prescribe any apportionment. It goes on in section 6.0 to consider how these rules might be reformed. Then, in section 7.0, it describes and examines the statutory and equitable time apportionment rules and considers how these might be reformed. Finally, the questions on which consultants' views are sought are summarised in section 8.0.

2.0 Receipts from companies

2.1 Capital and income receipts more generally

The first topic to consider is the rules concerning what receipts of trustees are of the nature of income and what receipts are of the nature of capital. To a substantial extent this topic is covered by decided authority, and in a way which would generally be considered acceptable. For instance, the rents arising from lettings of trust land are obviously of the nature of income² and so are royalties received under a lease of a mine open at the commencement of the trust,³ whereas the proceeds of compulsory acquisition of trust property⁴ and money coming in by instalments from another trust⁵ are capital in the trustees' hands. The main difficulty arises with distributions from companies in which the trustees hold shares.

2.2 Distributions from companies: company principles apply

With distributions from companies, the courts have looked to the rules of company law to decide whether a distribution should be considered capital or income of a trust to whose trustees it is made. The courts have done this notwithstanding that the considerations affecting

¹ Twenty-Third Report (The Powers and Duties of Trustees) Cmnd. 8733.

² *Sinclair v. Lee* [1993] Ch. 497 at p. 506H.

³ *Earl Cowley v. Wellesley* (1866) 35 Beav. 635.

⁴ *Re Carr's Settlement* [1933] Ch. 928.

⁵ *Re Fisher* [1943] Ch. 377; *Re Hey's Settlement* [1945] Ch. 294. See too *Re Guinness's Settlement* [1966] 1 W.L.R. 1355 (income released and resulting to the settlor's estate).

a company, its creditors and shareholders are different from those affecting the capital and income beneficiaries of a trust. The general rule is what might be expected: money dividends which trustees receive on shares which they hold as trust property are income of the trust. But this applies even if the dividends are paid out of capital assets⁶ or capital profits⁷ of the company, which if they were held or realized inside a trust would normally be treated as capital. Likewise, the decision of the House of Lords in *Bouch v. Sproule*⁸ establishes that, as might be expected, where a company capitalizes its profits by paying up new shares which are then distributed to the existing shareholders, trustee shareholders receive this capitalization issue as capital, for none of the profits have left the company, and its assets remain intact. But the same applies where profits are “capitalized” by using them to pay up debenture stock redeemable by the company, which is then distributed to the shareholders,⁹ and it appears to be irrelevant that the company might well redeem the stock in a short time,¹⁰ with the result that the redemption money will leave the company. Even in the trust context the test applied is whether or not the company intended to capitalize the profits. For that reason, if shareholders are given the option either to take up a capitalization issue of new shares in the company or to receive a dividend in cash, trustees who opt to take the shares will receive them as capital of the trust fund if the real intent of the company, having regard to substance and not merely to form, was primarily to distribute shares, but if the company’s intent was in substance primarily to distribute cash then the trustees take the shares as income.¹¹ This means that the rights between capital and income beneficiaries of trustees who receive shares as dividends depends on an assessment of the substantial intent of the directors of the company. They will often be third parties whose intent it may well be difficult for the trustees to assess, and which is in any case somewhat remote from the relative interests of the capital and income beneficiaries.

2.3 Enhanced scrip dividends

Another example of the difficulties that have arisen concerns what are known as enhanced scrip dividends. Many companies routinely give their shareholders the option to take their normal dividends in bonus shares of corresponding value instead of in cash. These are ordinary scrip dividends. Since the primary intent of the company in such a case is to distribute the dividend in cash, trustees holding shares in the company receive these scrip dividends as income of their trusts and the position is fairly straightforward. It is different with enhanced scrip dividends. With these, the bonus shares are issued at a price below current market value. If shareholders elect to receive shares, they will receive assets of greater value than the cash dividend. The company may also arrange for a third party to be ready to

⁶ *Re Harrison's Will Trusts* [1949] Ch. 678.

⁷ *Re Doughty* [1947] Ch. 263.

⁸ (1887) 12 A.C. 385.

⁹ *Inland Revenue Commissioners v. Fisher's Executors* [1926] A.C. 395.

¹⁰ *Re Outen's Will Trusts* [1963] Ch. 291 and see *Inland Revenue Commissioners v. Fisher's Executors* above at p. 413 *per* Lord Sumner ("six weeks").

¹¹ *Re Taylor* [1926] Ch. 923.

purchase the bonus shares at market value, enabling shareholders quickly to realise this in money. In those circumstances it is unlikely that members will take the dividend in cash, and it would normally be a breach of trust for trustee shareholders to do so. If they take the shares and realize them through the arrangement provided by the company, they will be in a difficult position in deciding what to do with the proceeds. If the scrip issue causes a substantial fall in the market value of the original shares, it seems that the income beneficiary will be entitled to the amount of the cash dividend foregone and the rest of the value of the scrip will go to capital, on the basis that the scrip was bought partly for the cash foregone and partly by a diminution in the value of the original shares which form part of the capital,¹² but it is far from clear that this will always be correct as a matter of administration or that tax will always be exigible on the same basis. If the economic effects are less dramatic, the trustees will have to examine the circulars sent to shareholders, the resolutions passed, the company accounts and other relevant documents in order to discover the primary intention of the company, and this may not be easy. The fact that shareholders could not usually be expected to opt for the cash points towards the view that the scrip is capital, but such issues have usually been made (partly at least) in order to avoid the advance corporation tax (ACT) that would have been payable on a cash dividend, which pointed in the opposite direction. This is an example of the uncertainties surrounding the way in which the rules work as between capital and income beneficiaries. The abolition of ACT will not make the position any clearer. It and other tax changes may well breed new ways of making distributions to shareholders that will throw up new questions about whether they are capital or income of a trust, to which the existing principles will not prove strong or clear enough to give any certain answers.

2.4 Distributions of shares in other companies: direct demergers and the principle in *Hill's Case*

Serious anomalies have arisen where a company in which trustees hold shares has made to its shareholders, not a distribution of a mere capitalization issue, but a distribution in specie of shares that it owns in a subsidiary company.

2.4.1 The Privy Council held in the Australian appeal *Hill v. Permanent Trustee Co. of New South Wales Ltd.*¹³ that a distribution of such shares comes to trustee shareholders as income, and so goes to the current income beneficiary, unless the trust instrument provides otherwise. The decision is not formally binding on the House of Lords, but has been applied by the Court of Appeal¹⁴ and therefore binds that and inferior courts, and the House of Lords would also find it difficult to depart from it in view of the large amounts that have been distributed by trustees to income beneficiaries in reliance on it and the Court of Appeal decision, for instance following the demergers mentioned in the next paragraph.

2.4.2 The principle in *Hill's Case* applies even though the distribution is made out of a capital profit, and even though it represents a large proportion of the value of the company. For instance, the *Hill* principle was applied to a distribution of British Transport stock received by a company on the nationalization of its road transport and road haulage business

¹² *Re Malam* [1894] 3 Ch. 578.

¹³ [1930] A.C. 720.

¹⁴ *Re Doughty* [1947] Ch. 263.

in 1949.¹⁵ The company declared a “special capital profits dividend” of the British Transport stock and distributed £5 of it to the holder of each £1 of ordinary stock in the company, whereupon the ordinary stock fell on the Stock Exchange from £6 4s. to £1 8s. It was held that the British Transport stock came to trustee shareholders as income and so went to the income beneficiaries, notwithstanding that it came from a capital profit of the company and that the value of the trust capital was reduced by more than three-quarters. In a subsequent case¹⁶ the decision was followed despite the disparity between the amount of the original capital of the company and the amount of the British Transport stock, recognized as “certainly very striking”, and the court declined to exercise any discretion it might have had to apportion the windfall between capital and income. The *Hill* principle was applied by the Revenue, and presumably by the trustee shareholders involved, in the Courtaulds/Courtaulds Textiles and BAT/Wiggins Teape Appleton demergers in 1990, the Racal/Vodafone and BAT/Argos demergers in 1991, the Racal/Chubb demerger in 1992 and Hanson’s demerger of U.S. subsidiaries in 1995. These were “direct demergers” in which the shares in the subsidiaries spun off were issued to the trustee shareholders by the original company, often leaving the shares in that company (forming the trust capital) substantially reduced in value. Very substantial amounts were involved.

2.4.3 Not only do income beneficiaries receive shares in subsidiary companies distributed in specie in the way described in the two previous paragraphs as income, but they take them free of income tax under what is now section 213 of the Income and Corporation Taxes Act 1988.

2.4.4 Indirect demergers

The principle in *Hill’s Case* above has been held not to apply to what is known as an indirect demerger. Here, the new shares distributed are not owned by the company in which the trust fund is invested, but are allotted by a different company as part of a major reorganization in return for a payment made to it by the company in which the trust fund is invested. Such shares are capital of the trust.¹⁷

2.4.5 Share premium account

The principle in *Hill’s Case* has also been held by the Court of Appeal not to apply to a distribution made from the company’s share premium account,¹⁸ which was considered to be similar to an authorized reduction of capital.¹⁹

¹⁵ *Re Sechiari* (1950) 66 (Pt. 1) T.L.R. 531; [1950] 1 All E. R. 417.

¹⁶ *Re Kleinwort’s Settlement Trusts* [1951] Ch. 860.

¹⁷ *Sinclair v. Lee* [1993] Ch. 497 above, see further 2.5.2 below. The decision was referred to in the circular distributed to shareholders in connection with the indirect demerger of Centrica plc from British Gas in 1997.

¹⁸ *Re Duff’s Settlements* [1951] Ch. 923.

¹⁹ See point (2) in the quotation from *Hill’s Case* below.

2.4.6 Unit Trusts

Where trustees hold units in a unit trust as part of their trust property, they have been held to be under a duty to inquire in any case of doubt into the source of any distribution by the managers of the unit trust which is labelled a capital distribution and treat it as income or capital just as if they were direct holders of the shares included in the portfolio of the unit, applying the rules explained in the previous paragraphs.²⁰ This would involve an assessment by the trustees of the substantial intentions of the directors of the underlying companies, third parties at two removes from themselves. It is thought that the requirement is widely overlooked or ignored.

2.5 Criticism of the Hill principle

2.5.1 Sir Donald Nicholls V.-C. as he then was has criticized the way in which capital profits of the company, or large parts of its accumulated trading profits used as working capital, become tax-free income of the trust under the *Hill* principle. He said that this was far removed from the general principle requiring a fair balance to be maintained between capital and income beneficiaries.²¹ It can result in the transmission of the larger part of the value of the original shares from the capital of the trust to the current income beneficiary.²²

2.5.2 *Sinclair v. Lee*,²³ in which these criticisms were advanced, was a case similar to the *Hill* line of cases described in paragraph 2.4 above except that it concerned an indirect demerger, where the shares distributed to the trustees were not owned by the company in which the trust fund was invested as in a direct demerger, but by another company, not a subsidiary. Mainly on that ground, the Vice-Chancellor managed to distinguish the *Hill* line of authorities. The case arose from the indirect demerger of Zeneca Group Plc. from Imperial Chemical Industries Plc. in which a trust fund was invested. This demerger involved the distribution of newly created shares in Zeneca (not a subsidiary of I.C.I., but a company to which a large part of I.C.I.'s undertaking had previously been transferred) direct to the shareholders of I.C.I., in return for a payment by I.C.I. to Zeneca. The I.C.I. shareholders took one Zeneca share for each I.C.I. share that they held. The result of the payment by I.C.I. to Zeneca was a great reduction in the value of I.C.I., indeed if the life tenant of the trust had taken the shares under the *Hill* principle the value of the trust capital would have been more than halved.²⁴ The Vice-Chancellor said²⁵ that this “would produce a result in this case which

²⁰ *Re Whitehead's Will Trusts* [1959] Ch. 579.

²¹ *Sinclair v. Lee* above at pp. 511G 512D.

²² Paragraphs 2.4.1, 2.4.2 above.

²³ [1993] Ch. 497.

²⁴ See p. 506D of the report.

would, frankly, be nothing short of absurd.” It is difficult to escape the conclusion that the result of the decisions recounted in paragraph 2.4.2 above, where the British Transport stock distributed in specie to the trustees was held to be income and to go to the income beneficiaries, so reducing the value of the capital by more than three quarters, was absurd likewise.

2.5.3 The Privy Council reached its decision in *Hill’s Case*²⁶ by applying company law principles to decide what was capital and what was income of the trust. They drew attention²⁷ to five points, including the following,

“(1.) A limited company when it parts with moneys available for distribution among its shareholders is not concerned with the fate of those moneys in the hands of any shareholder. The company does not know and does not care whether a shareholder is a trustee of his shares or not. It is of no concern to a company which is parting with moneys to a shareholder whether that shareholder (if he be a trustee) will hold them as trustee for A. absolutely or as trustee for A. for life only.

(2.) A limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorized reduction of capital. Any other payment made by it by means of which it parts with moneys to its shareholders must and can only be made by way of dividing profits. Whether the payment is called “dividend” or “bonus,” or any other name, it still must remain a payment on division of profits.

(3.) Moneys so paid to a shareholder will (if he be a trustee) prima facie belong to the person beneficially entitled to the income of the trust estate. If such moneys or any part thereof are to be treated as part of the corpus of the trust estate there must be some provision in the trust deed which brings about that result. No statement by the company or its officers that moneys which are being paid away to shareholders out of profits are capital, or are to be treated as capital, can have any effect on the rights of beneficiaries under a trust instrument which comprises shares in the company.

(4.) Other considerations arise when a limited company with power to increase its capital and possessing a fund of undivided profits, so deals with it that no part of it leaves the possession of the company, but the whole is applied in paying up new shares which are issued and allotted proportionately to the shareholders...”

Though no method of deciding whether distributions from a company should be considered income or capital of a trust is wholly satisfactory, the use of company law criteria is open to criticism, and this has not been lacking, as Sir Donald Nicholls V.-C. pointed out in *Sinclair v. Lee* above,²⁸ where he also said,

“The principle of company law prohibiting payments by way of return of capital to its shareholders is concerned with the protection of the company’s creditors and others dealing with the company. That purpose is far removed from holding a fair balance

²⁵ at p. 515F.

²⁶ [1930] A.C.720.

²⁷ at pp. 730-732.

²⁸ [1993] Ch. 497 above at pp.511-512.

between income and capital beneficiaries. Paid up share capital, in the company sense, serves a very different purpose from the capital of a trust fund. To elide the two may be said to overlook the different functions each serves.

Furthermore, the *Hill* principles draw no distinction between capital profits and trading profits. So far as the company is concerned this is not surprising. Tax considerations apart, a company is not concerned with this distinction when distributing a dividend. To trustees and their beneficiaries, however, the distinction is of importance. Company law takes no cognisance of such trusts. A company may not enter notice of a trust on its register of members. It is perhaps surprising, therefore to find that the company law assimilation of capital and trading profits is allowed to dictate the treatment of such profits as between one trust beneficiary and another.”

2.5.4 Possibly more serious, there is no way of knowing how the court will treat distributions to trustees made by companies in connection with new kinds of demerger or other rearrangements of their capital and shareholdings. New types of rearrangement are devised from time to time to achieve companies’ financial or commercial needs and to cope with changing tax law. As has been seen in previous paragraphs, these can involve substantial capital values and throw up new questions as to whether large distributions by large numbers of companies are to be treated as capital or income of even larger numbers of trusts.²⁹ The decision in *Sinclair v. Lee* was based on rather narrow distinctions of fact between it and the *Hill* line of cases, which might or might not be available to escape the absurd *Hill* result with new kinds of rearrangement. Trustees would be left having to engineer another application to the court such as succeeded in *Sinclair v. Lee* but would not necessarily succeed for them, or else selling their holdings before the new type of rearrangement was carried out, as many did before the ICI/Zeneca demerger considered in *Sinclair v. Lee*.

3.0 Howe v. Lord Dartmouth and Re Chesterfield’s Trusts

3.1 The previous section concerned rules for ascertaining whether money or other assets received by trustees are to be considered capital or income receipts. This section concerns equitable apportionment rules under which in certain circumstances trustees are required to apportion what are income receipts partly to capital or what are capital receipts partly to income.

3.2 The first thing to consider is what is most correctly known as the second branch of the Rule in *Howe v. The Earl of Dartmouth*.³⁰ This second branch apportions income between a beneficiary presently entitled to income and beneficiaries who are to take the capital or income later on. Subject to any express and clear contrary provision, if the trust fund includes pure personalty that ought to have been sold, then as between the income beneficiary and those who are to take later it must be treated as if it had been sold and the proceeds invested in proper investments. The income beneficiary is entitled to the “fair equivalent” of the income that such investments would have yielded, no more or less. Any surplus is invested as part of

²⁹ Fortunately, the recent demutualisations of building societies and insurance companies do not appear to have raised capital and income questions for trustees, though they have caused them other difficulties.

³⁰ *Howe v. Earl of Dartmouth* (1802) 7 Ves. 137; 1 W. & Tu. L.C. 60; *Gibson v. Bott* (1802) Ves. 89.

the trust capital and the income beneficiary takes the income from those investments,³¹ or if the income before sale is not enough to pay the “fair equivalent” it is made up later out of the proceeds of the investments as and when realized. Trust investments ought to be sold for the purpose of this second branch of the rule if a trust for sale is expressly declared by the trust instrument³² or imposed by statute,³³ or by the first branch of the rule. This first branch imposes a trust for sale on wasting assets and unauthorised investments in a testator’s general residuary personal estate where the will leaves it to persons in succession without imposing an express trust for sale. The “fair equivalent” that the income beneficiary is entitled to is, on the most recent authority,³⁴ 4 per cent of the original value of the investments. Where they are in an estate, their value is taken at the first anniversary of the testator’s death³⁵ unless they are sold within the first year, when the sale price is used,³⁶ or unless there is a power to postpone sale, when for want of a better date the value at death is used.³⁷

3.3 The Rule in *Re Chesterfield’s Trusts*³⁸ is another equitable apportionment rule, in this case apportioning capital receipts between capital and income beneficiaries. It applies where a testator is entitled to future or reversionary property, pure personalty, not currently yielding income, and directs it to be sold, but leaves the time of sale to the discretion of the trustees, who decline to sell until it falls into possession. The rule requires a calculation to be made to ascertain the sum which, put out at interest on the day of the testator’s death, and accumulating at compound interest with yearly rests, would, together with such interest and accumulations, after deducting income tax, amount on the day when the reversion falls in or is realized to the sum actually received. Only the sum so ascertained is treated as capital, and the balance of the amount actually received goes to the income beneficiary. Again, in the latest authority the rate of interest used was 4 per cent. The rule has been applied to arrears of an annuity with interest, money payable on a life policy,³⁹ stock in a gas company at a premium,⁴⁰ a reversionary interest which had been retained unconverted although it happened

³¹ *Re Woods* [1904] 2 Ch. 4; *Re Fawcett* [1940] Ch. 402, especially at pp. 409, 410.

³² *Gibson v. Bott* (1802) 7 Ves. 89; *Dimes v. Scott* (1827) 4 Russ. 195, and see *Mehrtens v. Andrews* (1839) 3 Beav. 72; *Green v. Britten* (1873) 42 L.J. Ch. 187

³³ For instance Administration of Estates Act 1925, s. 35(1), and see *Re Fisher* [1943] Ch. 377.

³⁴ *Re Berry* [1962] Ch. 97.

³⁵ *Re Fawcett* [1940] Ch. 402, especially at pp. 407 and 409 para. (a).

³⁶ *Re Fawcett* [1940] Ch. 402, especially at p. 409 para. (b).

³⁷ *Re Parry* [1947] Ch. 23 and cases cited.

³⁸ *Re Earl of Chesterfield’s Trusts* (1883) 24 Ch. D. 643.

³⁹ *Re Morley* [1895] 2 Ch. 738.

⁴⁰ *Re Eaton* [1894] W.N. 95.

to be expectant on the death of the tenant for life of residue,⁴¹ instalments of purchase-money payable over a number of years,⁴² a debt recovered without interest,⁴³ and where settlement income went back on a resulting trust to the settlor's estate.⁴⁴ The rule does not apply to settlements by deed, and probably only applies to gifts by will of residuary personal estate as one fund to be enjoyed by persons in succession.⁴⁵ It can be excluded by an appropriate declaration in the will.

3.4 Turning now to consider the way in which the Rules in *Howe v. Lord Dartmouth* and *Re Chesterfield's Trusts* operate in practice at the present day, perhaps the first thing to note is that the sums involved are small. They are often, perhaps usually, so small as not to be worth the cost of the professional time involved in the calculations needed for the trustees or personal representatives to carry out their duties of apportionment.

3.5 A particular defect of the Rules in *Howe v. Dartmouth* and *Re Chesterfield's Trusts* is that, though the rate of interest to be used is a vitally important factor, trustees, personal representatives and beneficiaries are left in doubt as to what rate of interest should be used. As mentioned in paragraphs 3.2 and 3.3, in the latest authorities on each of the Rules the rate of interest used was 4 per cent. But the latest authority on *Howe v. Dartmouth* was in decided in 1961⁴⁶ and the latest authority on *Re Chesterfield's Trusts* was decided in 1940⁴⁷, the rate had been changed before, most recently from 4 to 3 per cent in 1895⁴⁸ and back to 4 per cent in 1920⁴⁹ and Romer J. indicated in 1947 that, if at the relevant time interest rates generally had changed so materially and for so long as to justify an alteration in the rate, the rate used would be altered.⁵⁰ The interest rates obtainable on government stocks have stood well above 4 per cent for decades, so it seems clear that an increase in the rate, even to as much as 6 per cent,⁵¹ would be justified, but no one has apparently sought a decision on the point, presumably because the amounts involved have not justified the cost. Trustees, personal representatives and beneficiaries are left in doubt, but the expense of applying to the court to determine the proper rate for trustees and personal representatives to use in carrying out their

⁴¹ *Re Hobson* (1885) 55 L.J. Ch. 422.

⁴² *Re Hollebone* [1919] 2 Ch. 93.

⁴³ *Re Duke of Cleveland's Estate* [1895] 2 Ch. 542.

⁴⁴ *Re Guinness's Settlement* [1966] 1 W.L.R. 1355.

⁴⁵ *Re Van Straubenzee* [1901] 2 Ch. 779 at p. 782; *Re Woodhouse* [1941] Ch. 332.

⁴⁶ *Re Berry* reported at [1962] Ch. 97.

⁴⁷ *Re Fawcett* [1940] Ch. 402.

⁴⁸ *Re Goodenough* [1895] 2 Ch. 537.

⁴⁹ *Re Beech* [1920] 1 Ch. 40; *Re Baker* [1924] 2 Ch.271.

⁵⁰ *Re Parry* [1947] Ch. 23 at pp. 46, 47.

⁵¹ The rate of interest on legacies under R.S.C. Ord. 44 r. 10 since 1983, cf. Trustee Act 1925 s.31(3) - where 5% is used for a not very different purpose.

duty to make an apportionment cannot be justified in view of the smallness of the sums involved.

3.6 The Rules in *Howe v. Dartmouth* and *Re Chesterfield's Trusts* are therefore of uncertain operation, but given a revised rate of interest would they produce justice and fairness at the present day? The *Howe v. Dartmouth* apportionment is generally regarded as intended to prevent the timing of mere administrative acts from affecting beneficial interests. *Howe v. Dartmouth*⁵² and *Gibson v. Bott*⁵³ were both heard in May 1802 when investments authorized by the general law and by most trust instruments consisted only of 3 per cent government securities and mortgages carrying not much greater interest. Apart from the then recent war years, there had been a long period of stability in the value of money. The unauthorized investments in question in these two cases were leaseholds, government *term* annuities, and Bank of England stock, yielding apparently more than 3 per cent. Against that background, the Rule (which was applied using the interest rate of 3 per cent available on authorized securities) probably produced justice, but circumstances have altered. Most professionally drawn wills now contain provisions which either expressly or impliedly exclude the Rules. For decades this has been generally considered to produce a fair result as between the income and other beneficiaries, as well as avoiding many small calculations. Where the Rules apply, they nearly always do so by accident rather than design; moreover, in such cases they are often overlooked.

3.7 Many residuary trusts are created by a will providing for the testator's spouse by means of a life interest. It is usually the testator's intention that the spouse should enjoy the same income as they have together enjoyed during their joint lifetime and not some artificially reduced figure, even though such a reduction would enable the capital to be sustained or enhanced. For the same reason, the Rule in *Re Chesterfield's Trusts* produces a result far from what any ordinary modern testator could expect. A testator would not expect reversionary property to yield an income to the surviving spouse for the period before it falls in, let alone that the income will arrive in a lump sum calculated in an artificial way, payable when the interest falls in, by which time the spouse may well be past enjoying it.

3.8 The rate of return on fixed-interest government stock is now far higher, generally speaking, than the dividend yield on equities. That is because the redemption price of the government stock is fixed at its nominal money amount but the value of equities is expected to increase over time and so to provide a hedge against future falls in the real value of money. As the price of that hedge, investors are willing to accept a far lower income yield. The dividend yield on the shares in the most regarded index of 100 leading equities has for years been far less than the interest yield obtainable on medium-dated fixed-interest government stock. In present-day circumstances, retaining unauthorized equities therefore tends to depress the life tenant's income, whereas when *Howe v. Dartmouth* was decided the effect was the opposite. It no longer makes sense to say that the income of a life tenant from a fund

⁵² (1802) 7 Ves. 137.

⁵³ (1802) 7 Ves. 89.

of unauthorized equities ought to be limited to the yield of government stocks, since that would usually be higher, not lower.

3.9 By the same token, in times of inflation and high interest rates and dividend yields, such as those prevailing in recent times, an apportionment at the conventional 4 per cent works unjustly against income beneficiaries. With a fund of unauthorized equities in those conditions, the life tenant's income is frozen at a fixed monetary amount, whereas the reversioner enjoys, not only the keying to real capital values inherent in equities, but also a growing surplus of trust income over the fixed monetary amount. Though it might well be possible to persuade the courts to change the traditional 4 per cent used to make the calculation under the Rules,⁵⁴ even to increase it to the 6 per cent obtainable by purchasing medium-dated government stock standing close to redemption value, this would not make things much better, as the shortfall would only be made good when the low-yielding investment was sold or redeemed.

3.10 The Rules have become erratic and uncertain in their application. Although short leaseholds are wasting assets, they were excluded by the fortuitous effect of s.28(2) of the Law of Property Act 1925 from the application of the Rule in *Howe v. Dartmouth* where residue is held (as it usually is) on an express or implied trust for sale.⁵⁵ (The repeal of s.28 by the Trusts of Land and Appointment of Trustees Act 1996 does not affect trusts created by testators who died before 1997.⁵⁶)

3.11 The above criticisms do not all apply to the Rule in *Re Chesterfield's Settlement*, but it is very artificial and the criticisms at 3.4, 3.5, 3.6 and 3.7 above apply and may be considered weighty.

4.0 Outgoings and the Rule in *Allhusen v. Whittell*

4.1 The allocation of outgoings of a trust between capital and income is not a topic that is well covered by authority. In *Carver v. Duncan*⁵⁷ Lord Templeman said,

“The general rule is that income must bear all ordinary outgoings of a recurrent nature, such as rates and taxes, and interest on charges and incumbrances. Capital must bear all costs, charges and expenses incurred for the benefit of the whole estate.”

The difficulty of applying that evidently sensible rule is immediately revealed, however, by considering one of the most fundamental cases, that of a trustee's charges, which may well be recurrent but may equally well, at least in part, be charges incurred for the benefit of the whole estate. In *Carver v. Duncan* the costs of investment advice were held to be recurrent

⁵⁴ See para. 3.5.

⁵⁵ *Re Berton* [1939] Ch. 200.

⁵⁶ See s.25(5)(a).

⁵⁷ [1985] A.C. 1082 at p.1120C.

but charged for the benefit of the whole estate and so chargeable to capital; and Lord Templeman cited with evident approval the long-standing authority of *Re Bennett*⁵⁸ to the effect that audit charges might be expected to be incurred on capital account, quoting in particular the remark of Lindley L.J.⁵⁹ that,

“By an “outgoing” [*sc.* an annual outgoing] is generally meant some payment which must be made in order to secure the income of the property.”

It is plain that a trustee’s charges may not all satisfy that test of what constitutes an outgoing which is to be charged to income. Yet it is equally clear that to a large extent the remuneration of a trustee has an income character in so far as it may be connected with an income benefit, and there are various cases which have held that an annual fee charged by a trust corporation by reference to the magnitude of the trust income should be charged to income.⁶⁰ But in any such case the contrast between income and capital is made by the existence of a separate capital fee charged on acceptance and withdrawal. The position of the fee charged annually where there is no such capital charge as well must be wide open to debate; for, given the lack of any such antithesis, it must be assumed that the annual charge is compensation for the work done for capital as well as that done for income. It is a testament to the difficulty of this area of the law of trusts that such an obvious and significant uncertainty should never had been resolved. That there is no overriding reason for charging all annual administration fees to income is apparent from the fact that the Public Trustee is authorised to charge (among other fees) an annual administration fee calculated by reference to the size of capital, and this is in general chargeable to capital.⁶¹ As the trustee is also entitled to charge a separate income collection fee (which is charged to income) the logic is obvious. But this merely serves to emphasise the difficulty of identifying any general principle as to the incidence of charges on the part of a trustee who has no such carefully structured scale of fees allowing the one type of charge to be clearly marked off from the other.

4.2 The Rule in *Allhusen v. Whittell*⁶² apportions outgoings (both of an income and of a capital nature) between capital and income of a testator’s residuary estate. The idea behind it is that the income beneficiary of the residuary estate is intended to take the income only of what is left after the debts, testamentary expenses and legacies have all been paid out of it, so should not take income earned by what is later paid out in debts, expenses or legacies. This intermediate income of what is eaten up before the ascertainment of residue cannot, it is said,⁶³ itself be income of residue, or payable as such to an income beneficiary of residue. To prevent this, under the Rule in *Allhusen v. Whittell*,⁶⁴

⁵⁸ [1896] 1 Ch. 778.

⁵⁹ At p. 784.

⁶⁰ *Re Hulton* [1936] Ch. 536; *Re Roberts' Will Trusts* [1937] Ch. 274; *Re Godwin* [1938] Ch. 341.

⁶¹ Public Trustee Fees Rules 1985 S.I. 373 of 1985.

⁶² (1867) L.R. 4 Eq. 295.

⁶³ *Re McEuen* [1913] 2 Ch. 704 at p. 714.

⁶⁴ (1867) L.R. 4 Eq. 295.

“For the purpose of adjusting rights as between the tenant for life and the remainderman of a residuary estate, debts, legacies, estate duties, probate duties and so forth are to be deemed to have been paid out of such capital of the testator’s estate as will be sufficient for that purpose, when to that capital is added interest on that capital from the date of the testator’s death to the date of the payment of the legacy or debt, or whatever it may have been, interest being calculated at the average rate of interest earned by the testator’s estate during the relevant period.”⁶⁵

The amount of interest calculated in that way is deducted from the income of the estate and added to capital. The rate of interest used in the calculation is the average overall yield, after deduction of income tax,⁶⁶ of the whole of residue for the year in question.⁶⁷ The rule extends to debts, legacies etc. paid after, as well as during, the first, or “executor’s” year. It also applies in an intestacy if the widow takes a life interest.⁶⁸ It will be seen that a separate calculation has to be made for each payment towards debts, legacies, inheritance tax or other liabilities, often involving very small amounts of income.

4.3 A branch of the Rule in *Allhusen v. Whittell* often involving even more minuscule amounts is sometimes known as the Rule in *Re Perkins*.⁶⁹ It applies where a testator covenants to pay an annuity and then dies, leaving the income of the residuary estate on trust for one beneficiary and then the capital to another. In such circumstances this rule requires each annuity payment (whether yearly or monthly) to be apportioned between the capital and the income of the settled fund. The mode of apportionment is in the discretion of the court,⁷⁰ but in the later cases capital has been charged with such part of each payment as together with simple interest from the testator’s death to the date of the payment would have yielded the amount of the payment, and the remainder of the payment has been charged on income.

4.4 A testator can exclude the Rule in *Allhusen v. Whittell* by an appropriate provision, but the usual clause excluding the Rule in *Howe v. Dartmouth* does not suffice, nor does a power to postpone sale, and nor do the two combined.⁷¹

4.5 The Rule is generally excluded by well-drawn wills because it produces very little fairness and calls for complex and fiddlesome adjustments involving very small sums. It

⁶⁵ *Corbett v. I.R.C.* [1938] 1 K.B. 567 at pp. 584-585. (The tax position established in *Re Corbett* was reversed by legislation now to be found in Part XVI of the Income and Corporation Taxes Act 1988.)

⁶⁶ *Re Oldham* [1927] W.N. 113.

⁶⁷ *Re Wills* [1915] 1 Ch. 769.

⁶⁸ See Administration of Estates Act 1925, s. 35(5), which allows for the application of the rule.

⁶⁹ [1907] 2 Ch. 596.

⁷⁰ *Re Poyser* [1910] 2 Ch. 444.

⁷¹ *Re Ullswater* [1952] Ch. 105.

generally only affects ill-drawn and home-made wills, in whose administration it must often be overlooked. Indeed it is often deliberately disregarded.⁷² The Rule has been abrogated by legislation in New Zealand⁷³ and in most of the States of Australia.⁷⁴

5.0 Where there is no apportionment

5.1 When a trustee changes investments, there is no apportionment of dividends.⁷⁵ If an investment is sold pregnant with a dividend just before it goes ex dividend and another is bought ex dividend, the income beneficiary therefore loses income. The dividend on the investment that is sold goes to its buyer, so increasing the price, which is paid into the trust capital. The dividend on the investment bought is kept by its seller, so reducing the price paid for it, which comes out of the trust capital. Capital beneficiaries profit at both ends of such transactions at the expense of the income beneficiaries. As the Lord Chancellor's Law Reform Committee pointed out,⁷⁶ this could in theory be used as a method of preventing an income beneficiary from receiving any income at all. In practice that is not so, because using the absence of any apportionment to prejudice income beneficiaries and prevent them from receiving any income would be a breach of the trustees' general duty to hold a fair balance among beneficiaries with different interests. But there is no guidance in the authorities as to how far trustees could properly go.

5.2 Trustees nowadays are able to choose between investments giving quite high and quite low yields of income. For instance, among the "narrower-range investments" permitted to all trustees by the Trustee Investments Act 1961 are two government stocks. The first is a medium-dated conventional gilt yielding over 9¾ per cent on its purchase price, for which the trustees would have to pay over 27 per cent more than the amount for which it will be redeemed,⁷⁷ so promising a loss to capital of 21 per cent of the price to be paid. The other is an index-linked gilt of a similar redemption date yielding an income of about 2½ per cent on its purchase price, but guaranteed by the government against inflation. It will be redeemed at a figure that will protect the purchase price against rises in the retail price index. If the trustees are advised that, considering the interests of their beneficiaries as a body, the second gilt will in the medium term be the more favourable investment, accept that advice and invest in the second gilt, no apportionment rule will apply. The trustees will be unable to make any payments out of capital to compensate the income beneficiary. Likewise, if they had bought the conventional gilt, they could not have set aside any of the high income yielded by it as a sinking fund to compensate the capital beneficiaries for the capital loss on redemption.

⁷² Law Reform Committee 23rd Report (The Powers and Duties of Trustees) 1982, Cmnd. 8733, para.3.31; Snell's Equity 29th Ed. p.348; confirmed by the experience of members of the Trust Law Committee.

⁷³ Trustee Act 1956 s. 84.

⁷⁴ New South Wales Wills, Probate and Administration Act 1898 s. 46D; Victoria Trustee Act 1958 s. 74, Queensland Trusts Act 1973 s. 78; Western Australia Trustees Act 1962 s.104.

⁷⁵ *Re Henderson* [1940] Ch. 368.

⁷⁶ Twenty-Third Report (The Powers and Duties of Trustees) Cmnd. 8733, para. 3.26 at (i).

⁷⁷ Section 2(1) of the Trustee Act 1925 allows them to buy at a premium.

5.3 Even where the equitable apportionment rules apply, they have to be applied mechanically, asset by asset, without regard to the income yield of other assets in the trust fund. Though it appears that in choosing investments trustees can have regard to the overall yield of the fund,⁷⁸ it is clear that they must shut their eyes to this when applying the apportionment rules. For instance, if the Rule in *Re Chesterfield's Trusts* above is applicable to a reversionary interest included in an estate, it has to be applied when the interest falls into possession so as to give some of the proceeds to the income beneficiary, notwithstanding that in the meantime the rest of the fund has been invested to yield an exceptionally high income. There is no rule that trustees have to take that into account, or allowing them to make any adjustment not required by the traditional mathematical rules, or to moderate their mechanical operation.

5.4 As described in paragraphs 2.2 to 2.4 above, profits of a company in which a trust fund is invested become capital of the trust fund if they are used to pay up new shares in the company which it then distributes as a capitalisation issue, but otherwise distributed profits are income of the trust, even though they are capital profits of the company and are distributed in the form of bonus shares, so greatly reducing the value of the original shares which form the capital of the trust. There is a stark dichotomy⁷⁹ here which, except perhaps where there has been a breach of trust, neither the court nor the trustees have any power to moderate by apportioning the distribution between capital and income.⁸⁰ And that is so notwithstanding that the profits used to capitalise the first type of issue would have been income if earned inside the trust, and notwithstanding that the proceeds of such capital assets or profits as were distributed in cash or shares in another company would have been capital of the trust if they had been realised inside the trust.

6.0 Possible reforms

6.1 This section considers possible reforms of the law described and criticised above. It is convenient to begin with the Rules in *Howe v. Dartmouth* and *Re Chesterfield's Settlement* considered in section 3.0 and the Rule in *Allhusen v. Whittell* considered in section 4.0. These rules are complex, calling for detailed calculations, yielding small amounts, there is no way of telling what rate of interest ought properly to be used in the first two without an expensive application to the court, and they are all routinely excluded by well-drawn wills and settlements, which indicates that they are generally considered unnecessary in giving effect to the wishes of testators and settlors and in producing fairness between income and capital beneficiaries. Seeing that they only apply to wills and settlements which have not been well drafted, and so only affect beneficiaries whose testators and settlors have not had the best advice, one possible reform would be to abolish these rules for everyone and leave it at that. In some circumstances, though, adjustments are needed in order to produce a fair balance between income and capital, for instance where trustees consider that it is in the best interest

⁷⁸ Per Hoffman J. in *Nestlé v. National Westminster Bank Plc.* (28th June 1988, reported (1996) Trust L.I. 112 - an appeal was dismissed on other considerations [1993] 1 W.L.R. 1260. Also in favour of modern portfolio theory looking at the overall yield see Lord Nicholls in (1995) Trust L.I. 71.

⁷⁹ *Sinclair v. Lee* [1993] Ch. 487 at p. 511B.

⁸⁰ *Re Kleinwort's Settlement Trusts* [1951] Ch. 860; *Re Macalaren's Settlement Trusts* [1951] 2 All E.R. 414; *Re Rudd's Will Trusts* [1952] 1 All E.R. 250.

of the beneficiaries as a body to leave the trust fund invested for the time being in a way that does not produce such a balance. An example might be where they consider that the sale of a reversionary interest would be improvident, as it usually is, or that the time is not ripe for the sale of a particularly high-yielding or low-yielding investment that is throwing out the balance. Instead of simply abolishing the Rules, it might be better to replace them with something which would require or enable trustees to restore a proper balance.

6.2 A method of dealing with the situation that appealed to the Lord Chancellor's Law Reform Committee in 1982 was to give to trustees a general statutory discretion to apportion incomings and outgoings so far as necessary to maintain an even hand between income and capital, and indeed to impose a duty to do so where necessary.⁸¹ Though the suggestion has not been implemented, this appears not to have been because it has been disapproved.

6.3 The Law Reform Committee pointed out that, as mentioned at 5.2 above, trustees already have a wide discretion regarding the income yield that they obtain from a trust fund, allowing them to favour capital or income to a substantial extent by their choice of investments. When trustees can already make such large adjustments between capital and income as are mentioned there, merely by choosing between narrower-range investments under the Trustee Investments Act 1961, it is no large step to give them a discretion to make similar adjustments by working directly on the income and capital in their hands.

6.4 In more detail, the suggestion that interested the Law Reform Committee was this. First, a new paragraph 6(1)(c) should be added to the Trustee Investments Act 1961, requiring trustees in exercising their powers of investment to have regard,

“(c) to the need to hold an even hand between beneficiaries with different interests”.

That only restates the existing law,⁸² but it needs emphasizing because of the wide range of investments open to trustees today, and it prepares the way for the main reform. That would be the abolition of the apportionment rules and the enactment in their place of a provision that, whenever the property held for successive beneficial interests is not (when considered as a whole) invested in such a way as to hold an even hand (or a fair balance⁸³) between beneficiaries interested in current income and other beneficiaries, or is subject to any liabilities the payment of which is substantially postponed, personal representatives and trustees should be under a statutory duty to apportion receipts and outgoings between capital and income so far (if at all) as they may consider necessary to restore an even hand (or fair treatment) among the beneficiaries.

6.5 In carrying out their duty under that enactment, trustees would be exercising a similar discretion to that involved in choosing investments. Cases very seldom reach court in which

⁸¹ 23rd Report (The Powers and Duties of Trustees), Cmnd. 8733.

⁸² See *Nestlé v. National Westminster Bank Plc* [1993] 1 W.L.R. 1260 at p. 1279 *per* Staughton L.J.

⁸³ See s.c. at pp. 1270G, 1279B.

beneficiaries claim that trustees have failed to hold a fair balance in choosing investments, and it could therefore be expected that the new statutory duty would be performed in a reasonably satisfactory way. The Law Reform Committee considered that the court should nonetheless be given an overriding statutory power to apportion receipts and outgoings, with a provision saving from personal liability a trustee who had exercised, or decided not to exercise, the statutory power in good faith, even though the court reached a different decision.

6.6 Section 104 of the adoptive Uniform Principal and Income Act 1997 approved and recommended for enactment in all the States of the American Union confers on a trustee a discretion to adjust between capital and income, acting impartially and in a way that is fair and reasonable to all of the beneficiaries. The State of New Jersey already has a section allowing a reallocation in extraordinary and unanticipated situations. In the Bahamas a section is proposed in the Trustee Bill presently before Parliament there, substantially adopting the view of the Lord Chancellor's Law Reform Committee as follows,

“90. (1) The rules of equitable apportionment known as the Rule in *Howe v. Earl of Dartmouth*, the Rule Re *Earl of Chesterfield's Trusts* and the Rule in *Allhusen v. Whittel* are abolished in all their branches.

(2) Whenever trustees in their discretion determine that property held by them for successive interests is not (when considered as a whole) so invested as to maintain a fair balance between beneficiaries interested in current income and other beneficiaries or that a particular receipt disturbs that balance, the trustees shall apportion income receipts to capital of the trust property or estate or apportion capital receipts to income of the trust property or estate so far (if at all) as they in their discretion consider necessary in order to restore such a balance.

(3) On the application of a beneficiary (whether or not under a disability) aggrieved by any act or failure to act by trustees under subsection (2) the Court may give such directions as the Court may think fit for the purpose of redressing such grievance.

(4) A trustee who has acted in good faith shall not be personally liable for the costs of any other party to any such application and the costs of such a trustee of such an application shall be provided for out of the trust property or its income.

(5) Subsections (2), (3) and (4) shall apply if and so far only as the contrary is not expressed in the trust instrument and shall have effect subject that instrument.”

6.7 Such a provision, if incorporated into English law, would enable trustees to correct unfair results which at present flow from the fact that under the existing law there is no apportionment in certain circumstances where it might be desirable, as recounted in section 5.0. For instance if an investment was sold pregnant with a dividend just before it went ex dividend and another was bought ex dividend, the income beneficiary could be compensated by distributing as income a small part of the proceeds of the investment that was sold. Likewise, if trustees bought a conventional gilt at a substantial premium, they could reallocate some of the interest from it to capital as a sinking fund to compensate the capital beneficiaries for the loss that they would suffer at redemption. Moreover, since the amount of any reallocation would be at the discretion of the trustees they would not be tied to any mechanical or mathematical formula. For instance, if the rest of the fund was invested for a high income, sufficiently compensating the income beneficiaries for the fact that part of the fund consisted of a reversionary interest yielding no income, the trustees could decide not to

make any apportionment when that interest fell in. Such a statutory provision could also help with the problem of the principle in *Hill's* case, as will be seen from what follows.

6.8 Then what reform is appropriate to deal with the principle in *Hill's* case? The way in which this principle characterises shares of a subsidiary company distributed in specie (though not capitalisation issues) as the income of a trust fund invested in the company, basing this on the nature of the distribution according to company law, is criticised in paragraph 2.5 above. It is easier, however, to criticize this basis of allocation than to find a better one. Sir Donald Nicholls V.-C. mentioned two other possible methods in *Sinclair v. Lee*.⁸⁴ One possibility would be to regard a reasonable return on the invested trust capital as income and to treat as income that part, and no more, of any exceptional distribution. Another possibility might be to treat all the trading profits of the company earned during the life of the trust as income.

6.9 The first of the alternative methods mentioned by the Vice-Chancellor could be brought about by legislation in one of two different ways. One would be to enact that a specified percentage (perhaps 6 or 7 per cent) of any distribution otherwise than in cash or in shares of the company making the distribution should be income of the trust, and the rest should be capital.⁸⁵ The other would be to adopt the Vice-Chancellor's words and enact in terms that the part of such a distribution representing a reasonable return on the invested trust capital should be treated as income and the rest as capital, or perhaps that only such part of the distribution should be treated as income as would leave the trust capital intact. Specifying a percentage would run into the same difficulties as have been encountered with the equitable apportionment rules when interest rates generally have risen or fallen.⁸⁶ More important, the percentage specified would at best be a rough kind of justice. With many demergers⁸⁷ it would be wrong to treat any part of the distribution as income, seeing that their only result is to make trustee shareholders into direct holders of shares in a subsidiary instead of holding their interest in it through the company making the distribution. Contrariwise, in some other cases the whole distribution, or most of it, might more appropriately be treated as income as in truth representing trading profits of the company, for instance where such profits had been spent by the company in purchasing the shares distributed. Moreover, successive distributions of 6 or 7 per cent of what really represented capital could over time greatly reduce the trust capital. The alternative method, enacting a duty to maintain the value of the trust capital, would require this value to be ascertained. It could be taken to be the value of the original shares at the formation of the trust, or when they were added to it, but that might well be an historical figure, made irrelevant by intervening inflation, and out of line with the true value of the investment at the time of the distribution. Similar objections would apply to an enactment treating as income such part of the distribution as represented "a reasonable return on the invested trust capital" in those terms. It would also leave a considerable amount to the judgement of the trustees.

⁸⁴ [1993] Ch. 487 above at p. 504.

⁸⁵ In New York *capitalisation* issues not exceeding 6 per cent of the existing shares are treated as income, but this does not apply to distributions of assets other than shares in the company making the distribution, see Scott on Trusts 4th Ed. By Fratcher Vol.IIIA, p.116.

⁸⁶ See paragraphs 3.5, 3.6 above.

⁸⁷ See paragraph 2.4 above.

6.10 The Vice-Chancellor's alternative suggestion⁸⁸ of treating all the trading profits of a company earned during the life of the trust as income, and other receipts as capital, though it has been adopted in certain of the United States of America,⁸⁹ would involve a detailed investigation of the accounts of the company. That would throw a disproportionate burden on trustees with comparatively small holdings and might well be incapable of any satisfactory conclusion in view of the difficulty of distinguishing between trading profits and capital profits, and indeed of attributing to any particular source any part of the accumulated reserves of a large trading company accumulated over many years.⁹⁰

6.11 It may be better instead to leave standing the principle in *Hill's Case* that shares in subsidiaries (though not capitalisation issues) are of the nature of income, but to extend the trustees' discretion recommended by the Law Reform Committee to enable them nonetheless to reallocate them to capital if they considered it appropriate. It will be seen⁹¹ that the proposed Bahamian legislation is extended in this way by making it cover any receipt that throws out the balance between capital and income. This does, however, confer a very large discretion on trustees and would in a British context raise an important tax question.

6.12 It is not thought that the reforms mooted above would have any unexpected consequences as far as ordinary income tax was concerned. Capital apportioned to income under the existing apportionment rules is normally treated as income of the beneficiary who receives it, and income apportioned to capital under those rules is not normally treated as taxable income of the income beneficiary who is deprived of it, and it is not thought that this would be any different under the reformed rules, notwithstanding that these would give the trustees a considerable amount of discretion,⁹² seeing that a similar treatment is afforded to discretionary trusts. This discretionary element could, however, be argued to affect the position of the trust for additional rate income tax and inheritance tax purposes. This could arise with the duty suggested above for trustees in certain circumstances to treat as capital of the trust any shares in another company distributed in specie by a company in which the trust is invested. If the principle in *Hill's Case* is left standing, so that these shares are legally speaking of the nature of income of the trust, then reallocating them to capital could be considered to have a similar economic effect to an accumulation of income. It could be argued that this would attract additional income tax on the trust income, and an unexpected and probably unwelcome change in the applicable regime of inheritance tax. For "income which is to be accumulated or which is payable at the discretion of the trustees..." is subject to additional rate income tax⁹³ and a duty⁹⁴ to accumulate income takes a trust out of the

⁸⁸ See *Sinclair v. Lee* [1993] Ch. 497 above at p. 508G.

⁸⁹ See Scott op. cit. at pp.108 ff.

⁹⁰ *Sinclair v. Lee* above at p.508 C-E.

⁹¹ See para. 6.5 above.

⁹² The Revenue apparently treat capitalisation issues and distributions in large indirect demergers as capital, and other distributions in specie within *Hill's Case* as income, in accordance with the authorities considered above, and they accept reasonable decisions of trustees about the destination of enhanced scrip issues, see Statement of Practice 4 /94 para. 6.

“interest in possession” regime for inheritance tax and puts it into the discretionary trust regime.⁹⁵ For this reason, it would not be entirely safe to require trustees to reallocate to capital any shares issued in specie which were income of a trust under the *Hill* principle without first ensuring that it would not have these tax consequences. This could be accomplished by appropriate provisions in a Finance Act, but it is to be hoped that the Revenue authorities might be able to give an assurance on the point without the need of legislation. What is proposed is that the trustees should be put under a duty to reallocate when appropriate to hold a fair balance between capital and income beneficiaries, and that the beneficiaries should be able to apply to the court to make the reallocation if the trustees fail to do so. Therefore this would not be like any ordinary discretionary trust. Moreover, since the object is to determine what is capital and what is income of the trust, rather than to shift what is income from the income beneficiaries to the capital beneficiaries, the reallocation could reasonably be considered to be an administrative act, not a true accumulation.⁹⁶

6.13 To facilitate acceptance of the view that the discretion over shares distributed in specie was merely administrative, or at any rate was not equivalent to an accumulation of income, it might be better to provide expressly for such receipts that they are to be treated as capital of the trust except if and so far as the trustees in their discretion consider that it is just to treat them as income with a view to the prevention of injustice to beneficiaries interested in income. This should obviate any additional income tax or inheritance tax problems, since it would be a diversion of capital to income, not a diversion of income to capital, which alone could be considered an accumulation. This provision would need to be tied in with the more general provision, or it might be better to recast the general provision.

6.14 The law on what outgoings are of a capital nature and what are of a revenue nature is nebulous, as has been seen, but in view of the great variety of types of outgoings, and of the circumstances in which they are payable, it would be difficult to formulate any statutory guidance of a firmer kind. Trustee charging clauses and schedules of charges can usefully indicate whether particular charges are payable out of income or capital, but legislation requiring this to be done could be considered unduly obtrusive. The most that could be done would be to give trustees a statutory discretion to pay administrative expenses out of capital or income, on the lines discussed in the two previous paragraphs for receipts.

6.15 It will have been observed that no substitute has been suggested above for the Rule in *Allhusen v. Whittell*, assuming that it is abolished. The antipodean legislation abolishing it⁹⁷ enacts no alternative apportionment. It will be recalled that the Rule requires the income of the income beneficiary of a residuary estate to be reduced during the period of administration to allow for the fact that during that period it is swollen by income from assets that are sold during the period to pay the deceased's debts. Abolishing the rule increases the income slightly during the administration period. Against that, however, it reduces the income very

⁹³ Income and Corporation Taxes Act 1988, s.686. These issues do not arise for charitable trusts.

⁹⁴ Though perhaps not a mere power unless exercised, see *Pearson v. I.R.C.* [1981] A.C. 753. at p. 774B to D per Viscount Dilhorne.

⁹⁵ See Inheritance Tax Act 1984, Part III and *Pearson v. I.R.C.* [1981] A.C. 753.

⁹⁶ See *Miller v. I.R.C.* [1987] S.T.C. 108 Ct. of Sess.

⁹⁷ See para. 4.5 above.

slightly after that period, by the amount that would have been earned by the small sums that under the Rule would have been added to capital during the administration period, and in the usual case this reduction will be suffered by the income beneficiary during the rest of his, or more likely her, life.

7.0 Time Apportionment

7.1 Two types of time apportionment call for consideration. Both are required by section 2 of the Apportionment Act 1870, which provides that,

“All... periodical payments in the nature of income... shall, like interest on money lent, be considered as accruing from day to day, and shall be apportionable in respect of time accordingly.”

That applies to trust income. The first result of this to be considered is that whenever a new beneficiary becomes entitled to the income it has to be apportioned between the period before the change of beneficiary and the period after the change. As the Law Reform Committee commented,⁹⁸ this can be both inconvenient and unfair.

7.2 An example of such unfairness arises where a testator creates a life tenancy in favour of his widow. As a result of the Act she will not be entitled to dividends which accrued during her husband's lifetime but are paid after his death, because section 2 requires these to be added to the capital of the estate. This means that the widow is prevented from enjoying the full income from her husband's estate at the time when she most needs it, during the year after his death. Such an apportionment of income to capital rarely reflects the testator's intention.

7.3 Time apportionments can also be inconvenient in creating disparities between the income of a fund for trust purposes and its income for tax purposes. They are often inconvenient in other ways, for instance under the rule that on the death of a life tenant of income his estate takes as income all dividends and bonuses in the nature of dividends declared before his death, or declared afterwards in respect of the period covered by his life.⁹⁹ It is often not easy for trustee shareholders to discover without laborious investigation whether a dividend is one that has been declared before or after the death, or whether it was paid in respect of a period then already complete or not yet commenced. Equally, it is not easy for the trustees' advisers to perceive what rules should be applied to an interim dividend, compared with a final dividend, given that the one is paid on account of a period that is running and the other in respect of the same period but after it is all in the past. This last is yet another example of the uncertainties that afflict questions of apportionment in the trust context.

7.4 Not surprisingly in view of the two previous paragraphs, the provisions of the Act are commonly excluded in wills and on the creation of settlements. They are sometimes not excluded, but left to apply, on the death of the life tenant. This is because when a life tenant

⁹⁸ 23rd Report The Powers and Duties of Trustees, Cmnd 8733, para.3.40, adopting the observations in a paper submitted to it by The Institute.

⁹⁹ See for instance *Re Muirhead* [1916] 2 Ch. 181.

dies there is little injustice in making an apportionment between his interest and that of the next life tenant or others interested in remainder.

7.5 The Law Reform Committee concluded that there was a strong case for providing that section 2 of the Act should only apply where expressly included, even on the death of a life tenant under a settlement, the number of cases where failure to apportion in such circumstances would cause significant hardship being relatively small. For those reasons, the Law Reform Committee considered that the best solution would be for the Act to be amended so that in its application to wills and settlements the income would be treated as belonging exclusively to the persons entitled to the income of the trusts on the date when that income becomes due, but subject in all cases to any contrary provision in the will or settlement.

7.6 The other type of time apportionment to be considered takes place under the rule in *Re Joel*.¹⁰⁰ This requires trustees, who apply money for the maintenance of a class of minors contingently entitled on attaining a specified age, to maintain a member of the class only out of the income attributable to the period when that member was alive. That means that complicated time apportionments have to be made to calculate the entitlement of each beneficiary. This application of the Apportionment Act can also produce odd results where income is received after a beneficiary has attained the age of 18. In so far as such income is apportioned to the period before the beneficiary was 18, it cannot be applied for that beneficiary under section 31 of the Trustee Act 1925 because the minority has ceased. There is still a number of private trusts where the Rule in *Re Joel* applies and requires such apportionments and, though it causes little real difficulty in practice, where it is left to apply it does require separate funds to be kept in respect of each member of the class of minor beneficiaries. The Law Reform Committee expressed the view that fairness could equally well be achieved if the income of the trust fund were to be apportioned among the class of beneficiaries as constituted on the date when it was received by the trustees.

¹⁰⁰ [1967] Ch. 14.

8.0 The questions on which views are sought

Consultees' views are therefore sought on the following questions:-

- (1) Is the principle in *Hill's Case* satisfactory in treating shares received by trustees in a direct demerger as income of the trust? (Paragraphs 2.4, 2.5)
- (2) If not, is the cure to give trustees a general discretion to allocate receipts between capital and income as necessary to produce a fair balance? Or is there a better method? (Paragraphs 6.5 to 6.11)
- (3) Should there be a statutory presumption that shares received in a demerger are capital of the trust, subject to the trustees' discretion? (Paragraphs 6.12, 6.13)
- (4) Should doubts over the treatment of enhanced scrip dividends be covered by a similar discretion? (Paragraph 2.3)
- (5) Should the Rule in *Howe v. Lord Dartmouth* be abrogated by statute? (Paragraphs 3.4 to 3.8 and 6.1)
- (6) If so, should it be replaced by a discretion for trustees to reallocate income? (Paragraphs 6.2 to 6.5) Or is there a better solution?
- (7) Should the rule in *Re Chesterfield's Trusts* be abrogated by statute? (Paragraphs 3.4 to 3.10 and 6.1)
- (8) If so, should it be replaced by a discretion for trustees to reallocate capital? (Paragraphs 6.2 to 6.5) Or is there a better solution?
- (9) Should trustees be given a general power to reallocate income and capital where no apportionment rule applies at present? (Section 5.0 and paragraph 6.6)
- (10) Should the Rule in *Allhusen v. Whittell*, including the Rule in *Re Perkins*, be abrogated by statute? (Section 4.0)
- (11) If so, is any replacement called for? (Paragraph 6.15)
- (12) Should any general statutory guidance be given as to the incidence of outgoings of trusts other than that a fair balance should be held between income and capital? Should trustees be given a statutory discretion to bring this about? (Paragraph 6.14)
- (13) Should the Apportionment Act 1870 be disapplied to trust income on changes in the beneficiaries entitled to it? (Paragraphs 7.1 to 7.5)
- (14) Should the Rule in *Re Joel* be replaced by a rule that, when it is to be spent on maintaining minors, the income of a trust fund must be apportioned among the class of beneficiaries as constituted on the date when it is received by the trustees? (Paragraph 7.6)