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Discussion Paper No 124

Discussion Paper on Apportionment of Trust Receipts and Outgoings

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This Discussion Paper is published for comment and criticism and does not represent the final views of the Scottish Law Commission

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The Commission would be grateful if comments on this discussion paper were submitted by 31 December 2003. Comments may be made on all or any of the matters raised in the paper. All correspondence should be addressed to:

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NOTES

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[1] Amended by the Scotland Act 1998 (Consequential Modifications) (No 2) Order 1999 (SI 1999/1820).

Contents

Abbreviations

Barr *et al*, *Drafting Wills*

A R Barr, J M H Biggar, A M C Dalgleish & H J Stevens, *Drafting Wills in Scotland* (Edinburgh, 1994)

Collison and Tiley, *UK Tax Guide*

D Collison and J Tiley, *Simon's Tiley and Collison: UK Tax Guide 2002-03* (20th edn) (London, 2002)

Dobie, *Liferent and Fee*

W J Dobie, *Manual of the Law of Liferent and Fee in Scotland* (Edinburgh, 1941)

Erskine

J Erskine, *An Institute of the Law of Scotland* (Edinburgh, 1773)

Gordon, *Land Law*

W M Gordon, *Scottish Land Law* (2nd edn) (Edinburgh, 1999)

Lewin, *Trusts*

T Lewin, *Trusts* (17th edn, J Mowbray, L Tucker, N Le Poidevin & E Simpson) (London, 2000)

Capital and Income of Trusts

Trust Law Committee, Consultation Paper on *Capital and Income of Trusts* (1999)

Stair Memorial Encyclopaedia

The Laws of Scotland – Stair Memorial Encyclopaedia, 25 Vols (Edinburgh, 1986 – 1995)

Part 1 Introduction

Background to the project

1.1 Trust law has been one of the Commission's programme subjects for some time. In our *Fifth Programme of Law Reform*, published in 1997, we indicated that trust law was a long-term project meaning that work would be undertaken only as and when resources permitted. During the currency of that programme (1997-2000) we looked at trustees' powers of investment and the Trustee Investments Act 1961. We made recommendations on those areas in a joint report with the Law Commission, *Trustees' Powers and Duties*.[1] The Scottish recommendations were confined to the investment powers of trustees and their ability to purchase land whether for investment or otherwise. The remainder of the project contained recommendations by the Law Commission alone in relation to the powers and duties of trustees in England and Wales. The Trustee Act 2000 implemented the report's recommendations as far as England and Wales were concerned, but there has as yet been no legislation to implement our recommendations.

1.2 Trust law was promoted to a medium-term project in our *Sixth Programme of Law Reform* published in 2000. It was envisaged that a substantial amount of work would be done on the project during this programme which is due to end in December 2004. We have drawn up a list of topics for inclusion in the project with assistance from the Law Society of Scotland, members of the Society of Trust and Estate Practitioners, individual practitioners and academics. We also received further suggestions from our Advisory Group[2] and the speakers and participants at our Trust Law Review Seminar.[3]

1.3 The Trust Law Committee[4] and the Law Commission[5] have published several papers in the area of trust law. We have derived much benefit from reading them and at various points in this paper we make specific reference to the Trust Law Committee's Consultation Paper on *Capital and Income of Trusts*. We have also been in close contact with the Commissioners and staff of the Law Commission and have had useful and constructive discussions with them.

The trust law review

1.4 Our trust law project is mainly confined to express voluntary trusts, both public and private. Implied, resulting and constructive trusts are dealt with only in so far as they

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[1] Scot Law Com No 172, Law Com No 260 (1999).
[2] See para 1.8 below.
[3] See para 1.9 below.
[4] Consultation Paper on *Rights of Creditors Against Trustees and Trust Funds* (1997); Consultation Paper on *Equitable Interests in Pools of Investments* (1998); Consultation Paper on *Capital and Income of Trusts* (1999); Consultation Paper on *Draft Schedule A Powers for Trustees* (1999); Consultation Paper on *Trustee Exemption Clauses* (1999); Consultation Paper on *Proper Protection of Trustees by Liens, Indemnities etc* (2000); Report on *Rights of Creditors against Trustees and Trust Funds* (2000).
[5] Consultation Paper on *Trustees' Powers and Duties* (No 146, 1997); Report on *The Rules against Perpetuities and Excessive Accumulations* (Law Com No 251, 1998); Report on *Trustees' Powers and Duties* (Scot Law Com No 172, Law Com No 260, 1999); Consultation Paper on *Trustee Exemption Clauses* (No 171, 2003).

impinge on express trusts. We do not intend to examine pension trusts or unit trusts either, except in so far as the powers, duties and liabilities of trustees are concerned. We have decided to tackle the review of trust law in two phases. Phase 1 concentrates on trustees and their powers and duties, with the exception of powers of investment on which we have already made recommendations.[6] This discussion paper on allocation and apportionment of receipts and outgoings between income and capital is one of two discussion papers being published simultaneously as part of the first phase, the other being a discussion paper on breach of trust. A third paper, dealing with various administrative issues including the assumption, resignation and removal of trustees, trustees' management powers and the role of the courts in trust administration, will be the third and final discussion paper of Phase 1. We aim to publish this third paper early next year.

1.5 Phase 2 of the trust law review will deal with trusts, their constitution and termination, and the restraints on accumulation of income and long-term private trusts. It will also look at the liability of trustees to third parties and the ways in which beneficiaries may enforce their rights against the trustees and the property subject to the trust. However, before starting on the second phase we intend to issue a discussion paper on the question of whether a trust should have separate legal personality. Giving a trust legal personality would mean that the trust estate was owned by the trust with the trustees being its administrators or managers, rather than its owners as under the present law. Such a change would radically affect most of the topics in Phase 2 and therefore needs to be consulted upon in advance.

1.6 The definitions of "trust" and "trustee" in the Trusts (Scotland) Acts of 1921 and 1961 include judicial factories and judicial factors respectively.[7] A judicial factor is a person appointed by the court to administer and manage property where the existing machinery breaks down. For example, a judicial factor may be appointed to manage the property of a person who has disappeared and cannot be traced. A substantial majority of judicial factors used to be curators bonis who were appointed to manage the estates of incapable individuals. Curators have been replaced by guardians whose powers and duties are laid down in the Adults with Incapacity (Scotland) Act 2000 and who are no longer subject to the Trusts Acts. As a result, the number of judicial factors now subject to the Trusts Acts is fairly small. Even then, much of the trust legislation is either not applicable to judicial factors or there are alternative provisions in the judicial factors legislation.[8]

1.7 Judicial factors are mentioned as a long-term project in our *Sixth Programme of Law Reform*,[9] and some initial research has already been carried out on it. This is an area in need of a radical overhaul and it is very likely the end result will be new legislation dealing comprehensively with judicial factors and removing them from the Trusts Acts.

Advisory Group

1.8 In 2002 we set up an Advisory Group to assist us in this project. The group contains both practitioners and academics and its members have a good spread of interests. So far it has met once to consider preliminary drafts of the three Phase 1 discussion papers and

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[6] See para 1.1 above.
[7] 1921 Act, s 2 and 1961 Act, s 6(1).
[8] The Judicial Factors Act 1849, the Judicial Factors (Scotland) Act 1880 and the Judicial Factors (Scotland) Act 1889.
[9] Scot Law Com No 176 (2000), paras 2.9–2.10.

members have subsequently commented on revised drafts. We have received a great many helpful comments and much information about how the law works in current practice. We are very grateful to the group for this input. We wish, however, to make it clear that the members of the Advisory Group do not bear any responsibility for the proposals in this discussion paper or for any errors in it.

Trust Law Review Seminar

1.9 In November 2002 we held a seminar on trust law with an invited audience of practitioners, academics and officials from the Scottish Executive. One of our Commissioners, Professor Joseph Thomson, presented a paper on the remedies of beneficiaries where a breach of trust has occurred. Mr Simon Mackintosh of Turcan Connell, Solicitors, spoke about the problems currently faced by practitioners. Professor David Hayton outlined the recommendations made by the Trust Law Committee in England and Wales, of which he is the deputy chairman, in its various consultative papers[10] and commented on the provisions of the Trustee Act 2000. We found the papers and the discussion following them very helpful and are most grateful to the speakers and all the participants.

Our general approach and the plan of the discussion paper

1.10 Allocation and apportionment between income and capital are of importance where the trust deed creates a liferent with the liferenter being entitled to the income and the fiar the capital of the trust estate. Another aspect of apportionment arises at the start or termination of a liferent. Sums received which relate to a period that includes the start or termination date have to be apportioned on a time basis so that each interested person gets an appropriate fraction of the total. Time apportionment also has to be carried out on the purchase and sale of income producing investments. Distinguishing between income and capital is also of importance for taxation purposes, while trustees of continuing public trusts and trustees who run businesses have to ensure that income and expenditure do not get too far out of line with each other.

1.11 The law in this area is very largely common law. There is no general rule governing the question of whether particular receipts are to be treated as capital or income.[11] Attempts have been made to formulate such a rule,[12] but this endeavour has been doomed to failure by the breadth and complexity of the situations in which it would have to be applied. In proposing legislation in relation to apportionment and allocation we do not intend comprehensively to restate the existing common law rules, as has been done in the United States of America by the Uniform Principal and Income Act 1997.[13] Such an endeavour would be very time-consuming and would be of limited utility. Given the pace at which new types of receipts and outgoings arise, particularly receipts from companies, the usefulness of a comprehensive set of guidelines to govern all current practical difficulties and uncertainties in this area would rapidly diminish with time. Practitioners have long recognised that the rules governing apportionment and allocation are unwarrantably complex and can in many cases engender inequitable results for one class of beneficiary or

[10] See above, footnote 4.
[11] Gloag and Henderson, *The Law of Scotland* (11th edn, 2001), para 47.25.
[12] See, for example, Lord McLaren's sensible if somewhat simplistic formulation in *Ross's Trs v Nicoll* (1902) 5 F 146 at 149.
[13] See App A, paras 13-15 for further details.

another. Many trust deeds now contain specific provisions, ordinarily in the form of a discretionary power, aimed at circumventing the common law rules.[14] Our proposals build on such provisions.

1.12 In Part 2 we consider the complex matrix of common law rules which, in the absence of any satisfactory general rule, have developed to govern the multiplicity of situations where apportionment is required to hold a fair balance between different classes of beneficiary. In this connection we examine the difficult area of dividends and other company distributions in which the legal rules have constantly to adapt and develop apace with changing company practice. We also look at the rules regarding the apportionment of the fruits of liferented subjects such as minerals, timber and intellectual property rights. Finally, we examine the rules relating to wasting assets and unauthorised investments, reversionary or future property and outgoings. These rules are of English origin but have, to varying extents, been accepted into Scots law.

1.13 In Part 3 we consider the issue of time apportionment. The rules are set out in the Apportionment Act 1870 and govern the situation where a liferent begins or terminates between dates upon which a periodic payment falls due to the trustees. Time apportionment is also effected on the sale or purchase of income producing investments. Apportionment at the start of a liferent can lead to the liferenter having to go without income for a considerable period. Moreover, a balance of apportioned income may be due to the deceased liferenter's executors after his or her death. The apportionment rules on sale and purchase of investments usually have little effect on the extent of a liferenter's entitlements overall, but do give rise to a great deal of complex calculations. Accordingly, the rules are often expressly excluded by modern trust deeds.

1.14 In Part 4, we turn our attention to consider whether our proposals have any implications for the taxation of trusts. Part 5 lists the proposals and questions on which we invite comments. Appendix A contains an overview of the law relating on apportionment and allocation of receipts and disbursements in selected foreign jurisdictions. Appendix B sets out a list of the members of the Advisory Group.

Legislative competence

1.15 The proposals in this discussion paper relate to powers and duties of trustees which are not in general reserved matters in terms of the Scotland Act 1998. However, our proposals would affect the powers and duties of trustees of unit and investment trusts,[15] and also the obligations of trustees of occupational and personal pension trusts,[16] which are matters reserved to the UK Parliament. Our provisional view is that the Scottish Parliament would nevertheless have legislative competence to implement our proposals in these areas in terms of section 29(4). This provides:

> "A provision which –
>
> (a) would otherwise not relate to reserved matters, but

[14] Barr *et al*, *Drafting Wills*, Style 5, para 12(11); Journal of the Law Society of Scotland, Workshop, p lxxiv.
[15] Scotland Act 1998, Sch 5, s A3.
[16] Scotland Act 1998, Sch 5, s F3.

(b) makes modifications of Scots private law, or Scots criminal law, as it applies to reserved matters,

is to be treated as relating to reserved matters unless the purpose of the provision is to make the law in question apply consistently to reserved matters and otherwise."

Scots private law includes the law of trusts[17] and the purpose of our proposals is to make the law in question apply consistently to trusts that deal with reserved matters and those that do not. Although in Part 4 we examine taxation, another reserved matter,[18] we do not make any proposals for changes.

1.16 A further aspect of the legislative competence of the Scottish Parliament is that an Act of the Parliament must be compatible with the rights set out in the European Convention on Human Rights.[19] In our view enactment of the proposals made in this discussion paper would not breach Convention rights.

[17] Scotland Act 1998, s 126(4).
[18] Scotland Act 1998, Sch 5, s A1.
[19] Scotland Act 1998, s 29(2)(d); Human Rights Act 1998, s 1(1).

Part 2 Allocation and Apportionment between Income and Capital

Introduction

2.1 There is little difficulty with normal dividends on trust shares or interest payments on bonds. Such items are clearly income in nature. Likewise, the proceeds of sale of a trust asset are generally treated as capital. However, there is no general rule applicable to all the various other kinds of receipts. One of the most problematic areas in current practice is payments other than ordinary dividends from companies.

Receipts from companies

2.2 The truster may include special provisions in the trust deed as to how various distributions by a company whose shares form part of the trust estate are to be treated. In the absence of such provisions the question is decided by the nature of the payment as determined by the act of the company. This general principle was summarised by the House of Lords in *Bouch v Sproule*:[1]

> "When a testator or settlor directs or permits the subject of his disposition to remain as shares or stocks in a company which has the power either of distributing its profits as dividend or of converting them into capital, and the company validly exercises this power, such exercise of its power is binding on all persons interested under the testator or settlor in the shares, and consequently what is paid by the company as dividend goes to the tenant for life, and what is paid by the company to the shareholder as capital, or appropriated as an increase of the capital stock in the concern, enures to the benefit of all who are interested in the capital."

Payments made in pursuance of an authorised reduction of capital are clearly capital,[2] as are payments made by a company in liquidation.

2.3 Apart from the special case of a return of capital, distributions in cash by a company not in liquidation are regarded as income, even if they are paid out of the profits from a sale of the company's capital assets. In *Forgie's Trustees v Forgie*[3] the company made a substantial cash distribution from uncapitalised profits arising out of the sale of investments. This was held to be income in the trustees' hands.[4] Although the distribution was part of the scheme for voluntary liquidation of the company, the company was not in liquidation at the date of the distribution. A distribution in cash is still income even though the trustee shareholders

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[1] [1887] 12 AC 385, Lord Herschell at 397 quoting Lord Justice Fry in the Court of Appeal. This was accepted as being the law in Scotland by Lord President Normand in *Forgie's Trs v Forgie* 1941 SC 188 at 191.
[2] *Hill v Permanent Trustee Company of New South Wales* 1930 AC 720, Lord Russell at p 730, accepted as settled law by Lord President Normand in *Forgie's Trs v Forgie* 1941 SC 188 at 193.
[3] 1941 SC 188.
[4] See also *Inland Revenue v Reid's Trs* 1949 SC (HL) 71.

were, in the same communication from the company, invited to subscribe for new shares to the value of the distribution and actually did so.[5]

2.4 Where a company distributes new shares to shareholders as part of capitalising accumulated profits then these new shares will normally be treated as capital. The position is the same where the company capitalises by issuing debenture stock.[6] However, the nature of the shares as capital or income depends on whether the company intended to capitalise profits or merely distribute them. The company's intentions are to be ascertained from the form and substance of its acts and resolutions.[7] In *Cunliff v Cunliff's Trustees*[8] shares in a limited company formed part of the residue of the truster's estate, the liferent of which was left to his widow and the fee to his children. The company had power to capitalise its profits and the articles of association gave the directors power to issue a certain number of shares as they wished and to use them to create a reserve fund. In particular, the board was authorised to apply sums standing at the credit of any reserve fund by way of dividend distributed as cash or specific assets, "and in particular, of paid up shares of the company". A resolution was passed allowing them to apply £60,000 of the sum standing at the credit of the reserve fund and to distribute it by way of new shares to the existing shareholders. The trustees received an allotment of 352 £10 shares. Lord President Balfour considered that if the board had exercised its powers to apply the reserve funds in the distribution of shares as dividends then the liferenter would have had strong grounds for claiming the shares as income. However, the company had passed resolutions which empowered the board to pay the dividend by a distribution of shares, to convert a portion of the reserve funds into capital and issue it to the shareholders in that form. He considered this to be a resolution to capitalise the amount which would otherwise have been required to pay the dividends and to issue the shares "with all the qualities and incidents attaching to shares of capital"[9].

2.5 Companies sometimes offer shareholders the option of taking their dividends in the form of new shares - a scrip dividend. The shares representing scrip dividends are to be treated as income by trustee shareholders as the underlying intention of the company is to distribute the profits. The position is less clear with enhanced scrip dividends where the new shares are issued below market value. The trustees will be under a duty to take up the new shares as they are worth more than the cash alternative. It has been held that only the cash amount should be treated as income, with the balance of the value of the new shares going to capital.[10]

2.6 Demergers are another source of difficulty for trustee shareholders. The following example illustrates a direct demerger. Company X wants to spin off part of its business into a separate company. A subsidiary, company Y, is formed to which that part is transferred. Company X then issues to its own shareholders shares in company Y which later ceases to be a subsidiary of company X and becomes an independent entity. This was the situation in *Smith's Trustees v Graham*[11] where the transport undertakings of Thomas Tilling Limited were nationalised and compensation paid to the company in British Transport stock which it then

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[5] *Blyth's Trs v Milne* (1905) 7 F 799.
[6] *Inland Revenue v Fisher's Exs* [1926] AC 395.
[7] *Blyth's Trs v Milne* (1905) 7 F 799; *Howard's Trs v Howard* 1907 SC 1274.
[8] (1900) 3 F 202.
[9] *Ibid*, 207–208.
[10] *Re Malam, Malam v Hitchens* [1894] 3 Ch 578.
[11] 1952 SLT (Notes) 23.

distributed to its shareholders. It was held that the distribution was not a capital payment and therefore had to be treated as income.[12]

2.7 Another type of demerger is the indirect demerger which has been held to give rise to a different result. An example was the ICI/Zeneca demerger in 1993. ICI ended up transferring its bio-science and pharmaceutical business to a new company Zeneca. Zeneca issued to existing ICI shareholders one Zeneca share for every ICI share held by them, in return for a large payment from ICI to Zeneca. It was held in *Sinclair v Lee*[13] that the Zeneca shares were to be regarded as capital by trustee shareholders. The previous direct demerger cases were distinguished as the new shares were issued by the new company, not the original company.

Minerals

2.8 The removal of minerals on a trust estate might be thought of as the disposal of a capital asset. However, a liferenter of a landed estate is entitled to use minerals for domestic consumption and estate purposes and is also entitled to the royalties or other returns from minerals which were already being worked before the liferent commenced. The liferenter has no right to royalties from workings established after the opening of the liferent. These rules are of course subject to any contrary provisions in the trust deed.[14]

Timber

2.9 Timber on a trust estate belongs to the fiar. The liferenter may however take timber for the purposes of maintaining the estate and its buildings, and is entitled to ordinary windfalls and normal coppicing.[15]

Copyright and other intellectual property rights

2.10 If a literary work is published before the liferent commences, the royalties paid to the trust estate are treated as income and hence go to the liferenter. However, unpublished works which the trustees exploit are part of the capital of the trust estate and any lump sums or royalty payments go to the fiar.[16] Patents are considered to be in the same position.[17]

Wasting assets and unauthorised investments

2.11 In England, the position is governed by what is known as the rule in *Howe v Earl of Dartmouth*.[18] The first branch of the rule has been summed up as follows:

> "If a testator gives his residuary personal estate in trust for, or directly to, persons in succession without imposing a trust for sale and it comprises wasting assets or unauthorised investments then, unless the tenant for life can show that the testator

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[12] Applying *Hill v Permanent Trustee Co of New South Wales* [1930] AC 720 and following *Re Sechiari* [1950] 1 All ER 417.
[13] [1993] Ch 497.
[14] Gordon, *Land Law*, paras 17-40–17-41; *Campbell v Wardlaw* (1883) 10 R (HL) 65; *Naismith's Trs v Naismith* 1909 SC 1380.
[15] Gordon, *Land Law*, para 17-39; Stair Memorial Encyclopaedia, Vol 13, para 1639. A more detailed account is given in Dobie, *Liferent and Fee*, 98-102.
[16] *Davidson's Trs v Ogilvie* (1910) 1 SLT 45.
[17] Stair Memorial Encyclopaedia, Vol 13, para 1644.
[18] (1802) 7 Ves 137.

meant him to enjoy the income of those assets or investments in specie, they must be sold and the proceeds invested in authorised securities."[19]

This rule is founded on the need to balance the interests of income and capital beneficiaries. Wasting assets may not last out the liferent, while in the early 19th century, unauthorised investments, ie non-trustee investments, often produced a high income but risked the capital. The rule does not apply where the intention of the testator was that the trustees were to retain such assets permanently.[20]

2.12 The second branch of the rule deals with situations where the wasting assets, etc have not been sold in accordance with the first branch of the rule or any other rule or provision which makes sale compulsory. Where the trust estate consists of pure personal property which should have been sold, then as between the income beneficiaries and those who are to take it later (ie the capital beneficiaries) it is to be treated as if it had in fact been sold and the proceeds invested in proper investments. The income beneficiaries are then entitled to a "fair equivalent" of the sums such assets would have yielded on sale. The rate of interest to be applied to ensure that the income beneficiaries receive a "fair equivalent" of the income which would have accrued on actual sale is unclear. In 1961 the rate was set at 4%.[21]

2.13 It is unusual for the actual income of an estate to be precisely commensurate to the "fair equivalent" to which the income beneficiary is entitled. If there is a surplus, the excess of income should be invested in authorised securities and added to capital with the income beneficiary being entitled to the whole income of those securities. Conversely, if there is a shortage of income the income beneficiary does not have an automatic entitlement to have the "fair equivalent" made up immediately out of capital. However, when the sale of the wasting assets ultimately takes place the income beneficiary is entitled to any accumulated arrears.

2.14 The adjustment between capital and income in relation to wasting assets and unauthorised investments has received little consideration in the Scottish courts and the precise status of the English equitable rules is unclear.[22] In *Strain's Trs v Strain*[23] Lord M'Laren referred to *Howe* with approval, at least so far as it related to terminable interests declaring that in Scotland, as in England, equitable considerations require the sale of wasting assets to ensure the income beneficiary receives a proper benefit.[24] However, Lord M'Laren made no reference to how the income from such an asset should be treated before realisation. In *Stewart v Stewart's Trs*[25] the Lord Ordinary (Kincairney), in applying the rule in *Howe v Earl of Dartmouth*, declared that he was "not aware that there is either principle or practice with us which can be said to be opposed to the rules thus established in England."[26] On the other hand in *Ferguson v Ferguson's Trustees*[27] the testator's estate included two very profitable mineral leases that had only a few years left to run. The annual profits were held to be capital (in line with how the testator had regarded them while he was alive) on which

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[19] Lewin, *Trusts*, para 25-29.
[20] Lewin, *Trusts*, para 25-53.
[21] *Ibid*, para 25-57.
[22] See generally, Dobie, *Liferent and Fee*, 117-122.
[23] (1893) 20 R 1025.
[24] *Ibid*, 1031.
[25] (1898) 36 SLR 625.
[26] *Ibid*, 628.
[27] (1877) 4 R 532.

the widow got interest. Neither the Lord Ordinary (Rutherfurd Clark) in the Outer House nor Lord President Inglis was disposed to accept the English rules and the latter preferred to adopt a more general equitable approach.

2.15 In *M'Leod's Trustees v M'Leod*[28] the deceased left his widow the free income of the residue of his estate, a substantial part of which consisted of shipping investments. The investments in question comprised shares of ships as well as shares in single ship companies. While the testator was alive he had written off 10% of the value of each investment as depreciation, treating the balance of the trading profits as income. The profits from the companies were paid to the shareholders (including the testator) towards the extinction of their non-interest bearing debentures. The Inner House held that the widow was entitled to the profits from the ships, but not those from the single ship companies as they had been used to pay back the capital of loans. The English case of *Brown v Gellatly*[29] which followed *Howe v Earl of Dartmouth* was distinguished as Mr M'Leod's clear intention was for his trustees to continue to trade for as long as they thought fit.

2.16 In *Bain's Trs v Bain*[30] the deceased had a share in a leasehold colliery which the trustees retained but it was not intended to be a permanent trust asset. The House of Lords held that the liferenter was to get 4% on the capital value of the share (which was a wasting asset) rather than a share of the profits of the colliery, but *Howe v Earl of Dartmouth* is not mentioned in the speeches.

Reversionary or future property

2.17 The principle in *Howe v Earl of Dartmouth* demands a similar treatment of future or reversionary assets which yield no present income for the liferenters. This is known as the rule in *Re Earl of Chesterfield's Trusts*,[31] and its scope has been described as follows:

> "The rule 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 it until it falls into possession, or at any rate defer selling in the exercise of their discretion."[32]

2.18 The rule requires a series of complex calculations to be undertaken. The trustees are to ascertain the sum which, with accumulations of compound interest (with yearly rests and deducting income tax) would, on the day when the reversion falls in or is realised, amount to the sum actually received. The sum ascertained by this process is treated as capital and the balance of the amount actually received goes to income. The interest rate stands at 4%.[33]

2.19 In *Dempster's Trustees v Dempster*[34] the rule in *Re Earl of Chesterfield's Trusts* was quoted with general approval by the Lord Ordinary (Pearson) and applied with an amended starting date.[35] The marriage contract trust estate had a share in a testamentary trust estate which had already been divided with the exception of land in India. The testamentary

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[28] 1916 SC 604.
[29] [1867] 2 Ch 751.
[30] (1902) 40 SLR 66. In *Strain's Trs v Strain* (1893) 20R 1025 the liferenter got the whole profits of collieries.
[31] (1883) 24 Ch 643.
[32] Lewin, *Trusts*, para 25-67.
[33] *Ibid*, para 25-68.
[34] (1898) 35 SLR 657.
[35] He did say that it might have to be modified if it operated harshly, but it produced a fair result in that case (at 659).

trustees made certain payments to account to the marriage contract trustees out of rents and after the realisation of the property the latter received a final payment in respect of their share of the residue. The marriage contract trustees treated all payments as capital. The Lord Ordinary held that the marriage contract trustees should ascertain the respective sums which, put out at 4% interest at the date the residue of the testamentary trust became divisible, and accumulating at compound interest at that rate, with yearly rests, under deduction of income tax, would, with the accumulation of interest, have produced at the respective dates of receipt the amounts actually received by them.

2.20 It would seem that the Scottish courts have accepted the principles underlying the cases of *Howe v Earl of Dartmouth* and *Re Earl of Chesterfield's Trusts* and will apply them, if necessary with such modifications as are required, to produce a fair result.

Outgoings

2.21 Turning to the incident of outgoings and burdens as between income and capital beneficiaries, the general rule is that:

> "Liferenters as they are entitled to the profits, must also bear the burdens attending the subject liferented; as taxations, duties payable to the superior, ministers' stipends, and the other yearly payments chargeable on the lands, which may fall due during the liferent."[36]

The same rules applies to trust liferents as they do to proper liferents.[37]

2.22 A liferenter is not normally liable to pay the truster's debts out of the trust income, although there is liability for the interest arising after the commencement of the liferent on heritably secured debts.[38] The liferenter is entitled to the actual income of the gross trust estate while the debts are being paid and then after they have been paid to the income of the net estate,[39] ie the gross estate minus the sum paid out to satisfy the estate's debts. A different rule may apply if the debts are substantial and the estate is such that they cannot be paid immediately and have to be satisfied over a period of time out of income. Then there may be an apportionment between income and capital; the capital being charged with the sum that with simple interest at the rate earned by the trust estate over the period from the start of the liferent until payment would be sufficient to satisfy the debt.[40]

2.23 Inheritance tax is payable out of capital, but any interest on it during the course of the liferent is payable out of income.[41] Administration expenses fall to be allocated to capital or to income and a particular item of expenditure may be apportioned between these two heads.[42] Generally speaking, all expenses incurred on behalf of the estate in general and the beneficiaries as a whole (for example, the expenses of ingathering, realising and investing

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[36] Erskine, ii. ix, 61, approved in *Johnstone v Mackenzie's Trs* 1912 SC (HL) 106, Lord Shaw at 109.
[37] *Johnstone v Mackenzie's Trs* 1912 SC (HL) 106.
[38] *Glover's Trs v Glover* 1913 SC 115.
[39] Dobie, *Liferent and Fee*, 166.
[40] *Wilson Trs v Morton* 1938 SLT 215, applying the English rule in *Allhusen v Whittell* (1867) LR 4 Eq 295.
[41] *Robertson Petr* (1914) 1 SLT 492.
[42] *Smith v Bennie* (1890) 18 R 44, Lord Justice-Clerk Macdonald at 47.

the estate) are charged against capital,[43] while the expense of collecting the income is a deduction from income.[44]

2.24 Liferenters have a general duty to preserve the subjects liferented, but the precise extent of their duty is unclear.[45] A number of the institutional writers considered that a liferenter's obligation extended to maintaining the liferented subjects in the condition in which they were received. Thus the liferenter was bound "to attend…to all those articles of ordinary and annual repair, which, if made timefully, preserve the subject, and prevent it from going to waste."[46] The liferenter was not to be liable for inherent defects in the liferented subject or for the consequences of accidents or natural disasters or for any large outlays the benefits of which would accrue to the fiar.[47] This was in accordance with civil law tradition.[48] Later Scottish commentators have moved towards construing a liferenter's duty as including a general exemption from liability for fair wear and tear. For example, later editions of Erskine's *Principles*[49] concluded that "liferenters are not answerable for ordinary wear and tear".[50] Similarly, Dobie notes that:

> "The liferenter is bound to carry out all ordinary repairs, and generally to do what is necessary to preserve the subjects in a habitable and tenantable condition… Apart from neglect, a liferenter is not answerable for damage resulting from the 'waste of time', nor is he responsible for the result of natural wear and tear, or accidental destruction or damage by fire, water, *vis major* or other cause beyond his control, and to the occurrence or result of which he has not contributed."[51]

This reflects English law on the duty of temporary holders of property to maintain the subjects in which they hold a temporary interest[52] and would appear now to be the accepted position in Scots law.[53] Extraordinary repairs or the expense of rebuilding or improvements of trust property which benefit the fiars are chargeable against capital.[54]

Exclusion of normal rules

2.25 The trust deed may exclude the normal rules on allocation of receipts and disbursements and/or their apportionment as between income and capital. In *Low's Trustees*[55] a clause in a trust deed provided that the trustees "shall be the sole and only competent judges" of what was to constitute the free residue of the estate and within that residue what was to be considered to be income and thus payable to the liferenters. The

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[43] *Baxter & Mitchell v Wood* (1864) 2 M 915, Lord President McNeill at 917.
[44] *Casamaijor v Pearson* (1841) 2 Rob 217 at 229.
[45] R Caterina, "A Comparative Overview of the Fair Wear and Tear Exception: the Duty of Holders of Temporary Interests to Preserve Property" (2002) 6(1) Edin LR 85.
[46] Hume, *Lectures*, 4.355.
[47] *Ibid*.
[48] R Caterina, "A Comparative Overview of the Fair Wear and Tear Exception: the Duty of Holders of Temporary Interests to Preserve Property" (2002) 6(1) Edin LR 85.
[49] See, for example, 19th edn, 1895, by J Rankine.
[50] *Ibid*, ii. ix, 33.
[51] Dobie, *Liferent and Fee*, 205.
[52] *Warren v Keen* [1954] 1 QB 15, Denning LJ at 20.
[53] R Caterina, "A Comparative Overview of the Fair Wear and Tear Exception: the Duty of Holders of Temporary Interests to Preserve Property" (2002) 6(1) Edin LR 85 at 98. See *Stronach's Exs v Robertson* 2002 SLT 1044 for the fiar's remedies if the liferenter neglects the property.
[54] *Shaw's Trs v Bruce* 1917 SC 169.
[55] (1871) 8 SLR 638.

Inner House confirmed the validity of the clause giving the trustees the ultimate discretion in questions of allocation between income and capital. Lord President Inglis observed:[56]

> "If a testator were to lay down in his will that there was to be no litigation about his succession whatever, I should have great doubt about the validity of such a provision. But where a testator merely provides that there shall be no going to law upon certain special points, and arranges so clearly for their determination as here, the case is very different, and the provisions must receive effect."

2.26 We return to provisions in trust deeds when setting out our proposals for reform below.

Options for reform

2.27 The present rules for allocating receipts and outgoings between income and capital are arguably too rigid. They can lead to results that are widely regarded as unfair to one class of beneficiaries or another. Many of the problems occur in the field of distributions by companies to their shareholders. For example, the treatment of direct demerger shares as income led in *Re Sechiari*[57] to the capital of the trust being reduced by over 75% and the income beneficiaries receiving an unexpected and enormous windfall. The same result has occurred in a number of recent high profile demergers.[58]

2.28 At present the company law rules as to whether payments to shareholders are to be treated as income or capital bind trustees. The trustee shareholders are therefore obliged to apply them in the internal administration of the trust in allocating such receipts as between income and capital beneficiaries. These rules are simple to apply but do not necessarily produce a fair result. A testamentary liferent trust is set up with the intention of providing the liferenter with an adequate income yet securing the capital for the fiars. Yet this intention may be frustrated by the binding effect of the company law rules. This binding effect was criticised by Nicholls, V-C in *Sinclair v Lee*.[59] He pointed out that the purposes of the rules of allocation in the two situations are different and 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 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."[60]

In addition, he noted that the failure of company law to take account of the distinction between capital profits and trading profits rendered it unsuitable to govern the classification of receipts into trust estates. The distinction between capital and trading profits is of little practical significance to a company (save for tax considerations), but such a distinction is of fundamental significance to trustees and both the income and capital beneficiaries. In his view, the failure of company law principles to take cognisance of these concerns disqualified them from being rules of administration in a trust context.

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[56] At 638.
[57] [1950] 1 All ER 417.
[58] Lewin, *Trusts*, paras 25-12–25-13.
[59] [1993] Ch 497 at 511.
[60] *Ibid*.

2.29 However, the problems are not confined to payments from companies. Other areas where unfair results may occur are the exploitation of assets such as minerals, timber and intellectual property. It is not obvious why a liferenter should be entitled to the royalties if the assets were already being exploited before the liferent commenced, yet be entitled to none if the trustees begin to exploit the same assets after the liferent commenced.

2.30 One possible approach would be to change the existing rules by legislation containing new, hopefully fairer, rules. Such legislation could take the form of a restatement along the lines of the USA Uniform Principal and Income Act 1997. However, even such a comprehensive restatement would not cover all the situations where an allocation or an apportionment of receipts and outgoings between income and capital should be made. We are not convinced that the existing Scots law is so deficient that it must be replaced by a comprehensive new statute. In addition, the amount of work involved in preparing such legislation should not be underestimated.

2.31 Legislative intervention in the form of new fixed rules could take a more limited form. For example, it has been suggested[61] in relation to exceptional distributions by companies that income should be credited with that part which was a reasonable return on the capital value of the shareholding, with the balance going to capital. This was taken forward by the Trust Law Committee who considered two options: enacting a prescribed percentage (say 6%) as a reasonable return or leaving what constituted a reasonable return undefined. We think that having a prescribed percentage could give rise to new anomalies. For example, if a company had had a series of lean years and then a very profitable one with a large dividend, it seems fair that all of that dividend should go to the income beneficiaries. Moreover, the prescribed percentage would have to be altered from time to time in line with interest rates.[62] More generally, we do not think that the problems in this area are best solved by new fixed rules. The environment in which companies and other entities operate is constantly changing. Just as rules that evolved in an earlier era may no longer be appropriate today, so today's new rules may cease to produce fair results in the not too distant future. Taxation changes every year and may affect how transactions are structured. The new transactions may no longer be covered by the rules designed to cater for different transactions.

2.32 Another possible approach would be to give the courts a general power to alter an allocation or an apportionment produced by the existing rules if satisfied that an alteration was necessary to achieve a fair result. We do not think that this by itself would be a satisfactory solution. It could give rise to a considerable amount of litigation as decisions in earlier cases would have limited value in view of the varied nature of trusts and their provisions. The courts would have to be presented with detailed information about the trust estate, its past and present income and capital value and the beneficiaries in order to reach a decision. It would also lead to delays in trust administration since trustees would have to apply to the courts for allocation orders. As Lord President Inglis commented in the context of a dispute as to allocation between income and capital of a trust in *Low's Trustees*:[63]

> "Questions arising between liferenter and fiar are generally questions of detail, better solved by ordinary sound headed men of business than by courts of law".

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[61] Sir Donald Nicholls, V-C, in *Sinclair v Lee* [1993] Ch 497.
[62] The Trust Law Committee's figure of 6% would have been over-generous in 2003.
[63] (1871) 8 SLR 638 at 638.

2.33 Our preferred solution is to give trustees power to decide on the allocation of both receipts and outgoings as between income and capital. This would be a default power in that it would apply only to the extent that there were no contrary provisions in the trust deed or statute. Such a power would be in line with modern styles of trust deed creating liferents or accumulation and maintenance trusts. Thus in a style of testamentary trust providing for a liferent for the surviving spouse and the fee to the children, the trustees are given power "to decide what is capital and what is income and the proportion in which expenses are to be charged against income and capital respectively".[64] It is also in line with the general tenor of the Trust Law Committee's Consultation Paper, although views were also invited on other solutions. The Ontario Law Reform Commission made a somewhat similar recommendation except that trusters had to "opt in" by declaring the trust to be a discretionary allocation trust. We see little advantage in that over the slightly longer wording in the style quoted above.

2.34 The default power would be in line with one of the fundamental duties of trustees of a trust with various classes of beneficiaries (especially those entitled to income or to capital) which is to be even-handed and not seek to promote the interests of one class over the other. The existing rules set out in paragraphs 2.2 to 2.24, above, would continue to apply and would serve as a background against which the trustees could exercise their discretionary power in order to produce a fair result between the various classes of beneficiaries.[65] This power would be particularly useful for trustees who were running a business in that they could hold back profits in order to build up working capital or fund foreseeable major repairs. It would also enable investment decisions not to be dominated by the liferenter's need for income. The trustees could invest more in low-yielding growth stocks and allocate part of the annual growth in total capital value to the liferenter. Conversely, in an economic situation favouring bonds, part of the good income yield could be allocated to capital so that those beneficiaries would also get some benefit.

2.35 There is a danger that excessive use of the discretionary allocation power would radically alter the beneficiaries' entitlements under the trust deed and indeed render meaningless the incidents of liferent and fee. All trusts might in effect become discretionary trusts where a beneficiary's entitlement was only to what was allocated by the trustees. We think that this would be minimised by the default power being available only if the trustees considered that the allocation under the existing rules was uncertain or did not produce a fair result. The requirement to be even-handed would be another brake on an arbitrary exercise of the power.

2.36 The Ontario Law Reform Commission thought that trustees of a discretionary allocation trust would have to have greater financial acumen than normal to exercise the power properly. We do not share this concern. The decision seems no more difficult than many other financial decisions trustees are called on to make. A final disadvantage is that it might give rise to litigation by beneficiaries aggrieved by the trustees' exercise or failure to exercise the power. At present the very limited role the courts have in reviewing the exercise of a discretion by trustees would be a sufficient brake. We deal with this in more detail in paragraphs 2.38 to 2.40 below.

2.37 Should there be statutory guidelines to assist trustees in exercising the new discretionary allocation power? The USA Uniform Principal and Income Act 1997 sets out a

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[64] Barr *et al*, *Drafting Wills*, Style 5.12(11); Journal of the Law Society of Scotland, Workshop, p lxxiv.
[65] See para 2.41 below about abolition of rules of equitable apportionment.

list of factors which the trustees must consider in deciding whether and to what extent to exercise a discretionary power similar to that we are proposing. They include:

(1) the nature, purpose and expected duration of the trust;

(2) the intent of the settlor;

(3) the identity and circumstances of the beneficiaries;

(4) the needs for liquidity, regularity of income, and preservation and appreciation of capital;

(5) the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;

(6) the net amount allocated to income under the other sections of the Act and the increase or decrease in value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;

(7) whether and to what extent the terms of the trust give the trustee power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;

(8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and

(9) the anticipated tax consequences of an adjustment.

We are not convinced of the need for such a detailed list of factors. Most of them are considerations that trustees would naturally take into account or would receive advice on from their professional advisers. There is a danger that in focusing on the listed factors, the trustees would omit to take into account some other considerations that were relevant in the particular circumstances.

2.38 We turn now to consider the role of the courts in relation to the trustees' exercise of their new discretionary powers. In 1982 the Lord Chancellor's Law Reform Committee recommended that trustees should have a discretionary power to deal with both receipts and outgoings so as to maintain an even-handedness between income and capital beneficiaries. It went on to recommend that beneficiaries aggrieved by the trustees' exercise or failure to exercise their discretionary powers should be entitled to apply to the court. The court was to be given an overriding statutory power to apportion and trustees who in good faith had declined to exercise their discretionary powers would not be found personally liable for the expenses of a beneficiary's application.[66]

[66] These recommendations have been substantially enacted for the Bahamas by section 89 of the Trustee Act 1998, see Appendix A, paras 6 and 7.

2.39 The current common law position in Scotland is that trustees who are given a discretion are obliged to exercise it and the court can intervene when the trustees refuse to come to a decision.[67] The trustees are under a duty to ensure that they have all the necessary information required to exercise their discretion, including professional advice where that would be appropriate.[68] Where trustees make a decision in exercise of a discretionary power, the court may intervene and interfere with the trustees' decision in a number of circumstances, even if the trust deed expressly provides that the trustees are to be the sole judges on a particular issue. In the 19th century the courts would intervene when the trustees had failed to act reasonably.[69] The position now seems to be that the courts will intervene only if the trustees considered the wrong question, did not really apply their minds to the question, perversely ignored the facts or did not act honestly or in good faith.[70] Trustees are under no duty to give reasons for their decisions, although giving reasons will make it easier for the court to examine the merits of the trustees' decision.[71]

2.40 We are not in favour of altering the present powers of the court to intervene solely in relation to the allocation of income and capital by trustees. If the courts are to be given an enhanced role to intervene in the trustees' exercise of a discretionary power then it should apply in respect of all discretionary powers enjoyed by trustees. This wider issue will be examined in our third discussion paper which we intend to publish early in 2004.

2.41 Finally, should the various equitable apportionment rules, ie the rule in *Howe v Earl of Dartmouth*, the rule in *Re Earl of Chesterfield's Trusts* and the rule in *Allhusen v Whittell*, be abrogated? As the Trust Law Committee pointed out, they are of little use nowadays in that they require complex calculations to be made and generally affect the rights of the various beneficiaries to only a minor extent. There is also some doubt whether they are part of Scots law at all. If they are not expressly abrogated there is a danger that trustees would feel obliged to work out the results using these rules before exercising their discretion. We tend to think that giving the trustees a discretion unfettered by the equitable apportionment rules is a better solution to the problems faced by trustees when situations similar to those in the above cases arise.

2.42 In order to obtain views on the matters discussed above we put forward the following proposals and questions:

1. **Trustees should have a new statutory power to alter the allocation under the existing statutory or common law rules of a receipt or an outgoing to income or capital or to alter the apportionment of a receipt or an outgoing between income and capital in order to maintain a fair balance between the income and capital beneficiaries of the trust. This power should be subject to any contrary provisions in the trust deed.**

2. **Should there be a statutory list of factors that the trustees must take into account in exercising the discretionary power, and if so, what factors should be listed?**

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[67] *Train v Buchanan's Trs* 1907 SC (HL) 26.
[68] *Martin v City of Edinburgh District Council* 1988 SLT 329.
[69] *Baird v Baird's Trs* (1872) 10 M 482.
[70] *MacTavish v Reid's Trs* (1904) 12 SLT 404; *Dick v Audsley* 1908 SC (HL) 27, Lord Chancellor Loreburn at 28; *Board of Management for the Dundee General Hospitals v Bell's Trs* 1952 SC (HL) 78, Lord Reid at 92.
[71] *Board of Management for the Dundee General Hospitals v Bell's Trs* 1952 SC (HL) 78, Lord Normand at 85.

3. **Should the rules of equitable apportionment contained in the cases of *Howe v Earl of Dartmouth, Re Earl of Chesterfield's Trusts* and *Allhusen v Whittell* be expressly abrogated?**

Part 3 Time Apportionment

Introduction

3.1 Time apportionment is of practical importance where a liferent begins or terminates between dates upon which a periodic payment falls due. Such payments may have to be apportioned between the liferenter and those entitled to income before the liferent commenced or after it terminates. Take the example of trustees who let a shop subject to a liferent to a tenant for an annual rent of £20,000 payable half yearly on 28 May and 28 November.[1] If the liferenter dies in March the instalment of £10,000 may have to be apportioned, in terms of the Apportionment Act 1870, between the liferenter's estate and the fiar who becomes entitled to the rents on the liferenter's death. Another situation where apportionment is encountered in practice is in the purchase and sale of income-producing investments.

The current law

3.2 At common law, an instalment of an annuity, rent and interest on heritable bonds did not vest until the time for payment arrived.[2] The liferenter was therefore entitled to all such payments made during the currency of the liferent, but not to any made before the start of the liferent or after its end. However, interest on personal bonds and profits of enterprises such as fishings, collieries and salt works which arose from continual daily labour were regarded as accruing from day to day (*de die in diem*) and were apportionable.[3] The free income of the *universitas* of an estate was in the same position.[4]

3.3 The Apportionment Act 1870 changed the common law. It provides that all rents, annuities, dividends and other periodical payments in the nature of interest are to be considered as accruing from day to day and are hence apportionable timewise.[5] Thus in *Tennant's Executor v Lawson*[6] the liferenter let a house for five years with rent payable half yearly at Whitsunday and Martinmas. The liferenter died between Whitsunday and Martinmas and the Martinmas rent had to be apportioned in terms of the 1870 Act between the liferenter's estate and the purchaser from the fiar. The apportioned amount is recoverable when the whole amount of which it forms part is due.[7] So, for example, if rent is payable half yearly on 28 May and 28 November and the half year's rent for the period 28 May to 28 November falls to be apportioned between two persons, each will receive their portion when the half year's rent is due on 28 November.

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[1] These are the term days under the Term and Quarter Days (Scotland) Act 1990.
[2] Erskine, ii. ix, 64-66.
[3] *Ibid*.
[4] *Andrew's Trs v Hallett* 1926 SC 1087.
[5] S 2.
[6] (1897) 35 SLR 72.
[7] Apportionment Act 1870, s 3.

3.4 "Rents" are defined to include rent service as well as tithes and all periodical payments or renderings in lieu of or in the nature of rent or tithe.[8] However, it must be noted that, as the 1870 Act applies only to *accruing* income, rent payable in advance, which has already accrued, is not apportionable.[9] "Annuities" are defined to include salaries and pensions.[10] The Act attempts to obviate some of the difficulties encountered in the context of distributions made by companies by providing a very comprehensive definition of "dividends". These are held to include all payments made out of the revenue of public companies which are divisible between all or any of the members of such companies whether made in the name of dividend, bonus or otherwise. This applies regardless of whether such payments are usually made or declared at any fixed times. All such revenue is deemed to have accrued by equal daily increments during the period in respect of which the payment of the revenue is declared or expressed to be made. Payments in the nature of a return or reimbursement of capital are expressly excluded.[11] Income which accrued before the liferent commenced even though it is paid afterwards is treated as part of the capital of the estate.[12]

3.5 Scottish trust practice also time apportions on the sale or purchase of income producing investments. Where an investment is sold the income beneficiary is credited with a proportion of the expected dividend as the price will have included a payment for the dividend which the purchaser will receive.[13] The dividend is that expected at the date of sale and is usually taken to be the same as the last equivalent payment unless there is information publicly available suggesting a different figure.[14]

> **Example:** A trust sells on June 1 £10,000 nominal of 6% stock for £11,751 with the purchaser being entitled to the half yearly interest payment of £300 on 30 June. The income beneficiary is credited with £250.28 (ie £300 x 151/181[15]) and capital beneficiary with the balance of £11,500.72.

A similar apportionment on the purchase of an income bearing asset seems to be established Scottish practice,[16] although there is Outer House authority to the contrary.[17] In England and Wales there is no apportionment on the purchase and sale of trust investments except, perhaps, where to ignore apportionment would result in a glaring injustice.[18]

3.6 The Apportionment Act 1870 allows opting out. Section 7 provides that the provisions of the Act "shall not extend to any case in which it is or shall be expressly stipulated that no apportionment shall take place". Even where there is no express exclusion, an intention to exclude may be inferred. For example, in *Macpherson's Trustees v Macpherson*[19] where a testator directed that shares he held in a company "shall be retained by my trustees during the survivance of my wife, and the dividends from said shares shall, as

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[8] S 5.
[9] Lewin, *Trusts*, para 25-80.
[10] S 5.
[11] S 5.
[12] *Manclark v Thompson's Trs* 1958 SC 147.
[13] Unless the sale is *ex div*, when the seller retains the right to the dividend.
[14] *Donaldson v Donaldson's Trs* (1851) 14 D 165; *Cameron's Factor v Cameron* (1873) 1 R 21; Dobie, *Liferent and Fee*, 142-146; Barr *et al*, *Drafting Wills*, para 7.28.
[15] 151 is the number of days from 1 January to 31 May. 181 is the number of days from 1 January to 30 June.
[16] Dobie, *Liferent and Fee*, 147; Barr *et al*, *Drafting Wills*, para 7.28.
[17] *Gardiner Baird* (1907) 15 SLT 25.
[18] Lewin, *Trusts*, paras 35-153 to 35-144; *Re Maclaren's Settlement Trusts* [1951] 2 All ER 414 at 420, per Harman J.
[19] 1907 SC 1067.

received, be paid over to her", it was held that the use of the words "as received" amounted to a direction which excluded apportionment so that the whole dividend fell to be paid to the widow.[20]

Proposals for reform

3.7 Time apportionment at the beginning and end of a liferent can produce results that are far removed from what most trusters expect to happen. Dividends, interest and other periodical payments that accrued before the liferent commenced form part of the capital of the estate even if paid after the commencement of the liferent. Dividends, interest and other periodical payments which accrue and are paid after the start of the liferent have to be apportioned if part of the period in respect of which they are due falls before the commencement of the liferent. The result is that liferenters receive little or no income at the start of the liferent. This may be the very time when they are most in need of it, particularly widows who have lost husbands on whom they were financially dependent. Conversely, at the termination of the liferent on death, dividends and other payments due for a period in part of which the liferent was in existence are apportioned so that the liferenter's estate receives a proportion of these payments.

3.8 Time apportionment on the sale and purchase of income-bearing investments involves a lot of work for very little substantial benefit. As the authors of a recent book on will drafting including testamentary trusts state:[21]

> "Apportionment on purchase and sale is usually neutral overall, as between income due to capital and income due by capital. A very great deal of administrative work is necessary to carry out the calculations".

3.9 There is no apportionment on purchase and sale in England and Wales unless non-apportionment produces a glaring injustice. The Trust Law Committee considered in its Consultation Paper[22] that a general discretionary power to allocate or apportion receipts as between income and capital would address this problem as well.

3.10 There are also practical difficulties and problems with both types of time apportionment. The date when the dividend, etc is declared has to be ascertained since that is the time from which apportionment runs. It is not clear how interim dividends should be dealt with; are they due in respect of a half-year (or quarter) or are they on account of a full year's dividend? We understand that many modern trust deeds contain a provision declaring that there will be no apportionment as between capital and income on any occasion.

3.11 We do not propose the repeal of the Apportionment Act 1870 in this discussion paper. Its applicability is not limited to trusts. We consider that the options are to have legislation (applicable unless the contrary is expressed in the trust deed) providing either that there should be no apportionment on any occasion or that the trustees should have a discretionary power not to apportion in circumstances where they would otherwise be

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[20] However, it is unclear whether the provisions of the Act can be excluded by a stipulation contained elsewhere than in a will or trust deed, eg a company's articles of association – see *In Re Oppenheimer* [1907] 1 Ch 399 and Dobie, *Liferent and Fee*, 136.
[21] Barr *et al*, *Drafting Wills*, para 7-28.
[22] Para 6.7.

required[23] to do so. Our tentative preference is for the second - a discretionary power - approach. A no-apportionment provision seems too rigid a rule. Cases may arise, such as the sale of a company shareholding with a very large dividend entitlement, where fairness requires apportionment. Apportionment is also required for income tax purposes on the purchase and sale of certain fixed interest securities.[24] Where such apportionment has to be done, the trustees may wish to apply it for trust purposes as well. If trustees are to have a discretionary power then the issue of the need for a statutory list of factors which the trustees must take into account, already discussed[25] in connection with allocation between capital and income, also arises.

3.12 We put forward the following proposal and ask the following questions:

4. Trustees should have a new statutory power, exercisable on a discretionary basis, not to apportion dividends and other periodical payments on a time basis when they would otherwise be required to do so in terms of the Apportionment Act 1870 or any rule of law.

5. Should there be a statutory list of factors that the trustees must take into account in exercising this discretionary powers, and if so, what factors should be listed?

[23] On account of their duty to maintain a fair balance between all beneficiaries so far as this is possible.
[24] Income and Corporation Taxes Act 1988, ss 710-728. These were designed to prevent tax avoidance through "bond washing" whereby interest is converted into capital.
[25] See para 2.37 above.

Part 4 Taxation

Introduction

4.1 A trust is essentially a separate taxpayer under United Kingdom revenue law. Trusts may be subject to inheritance tax, capital gains tax and income tax and the taxation of income or capital received into the trust is a separate matter from the taxation of income or capital paid out of the trust.

The taxation implications of our proposals

4.2 It is common in current practice for apportionment between income and capital to be effected by trustees. This can happen in two main ways. First, apportionment may be necessary in accordance with legal rules developed by the courts to maintain a fair balance between income and capital beneficiaries. In such circumstances, the tax implications of apportionment are of limited significance and the Revenue has demonstrated an awareness of the degree of leeway which may properly be conceded to trustees. For example it has published a Statement of Practice on "Enhanced Stock Dividends Received by Trustees of Interest in Possession Trusts" which allows trustees some discretion in that area.[1] Apportionment may also be carried out by trustees under a discretionary power to apportion granted by the trust deed itself. Such an express power is common in modern practice. Our proposals to make this the default position should not alter the present taxation implications of its exercise, although more frequent use might give rise to concern on the part of the Revenue.

4.3 Capital apportioned to income will simply be treated as income in the hands of the beneficiary. For example, in *Cunard's Trustees v Inland Revenue Commissioners*[2] a beneficiary was entitled to a certain income from the income of the testator's residuary estate. The testator's will provided that if during any year the income of the residuary estate was not sufficient to bear this minimum payment, the trustees were to exercise a discretionary power to supplement the beneficiary's income from the capital of the residuary estate. The trustees exercised this power on two occasions and the Revenue claimed that these payments from capital were taxable income. The trustees disputed this, arguing that the payments were of a capital nature. Lord Greene, MR, held that capital paid as augmentation of an income interest, as occurred in this case, is income in the hands of the beneficiaries.[3] A discretionary power to appoint a capital receipt to income beneficiaries should therefore be unproblematic as far as the Revenue is concerned. Such payments would be taxed as income in the hands of the beneficiary, regardless of the fact that their source was a sum of capital. The important consideration is the nature of the distribution itself, rather than where it came

[1] SP 4/94.
[2] [1946] 1 All ER 159.
[3] See also, *Brodie's Trs v IRC* (1933) 17 TC 432; *Lindus and Hortin v IRC* (1933) 17 TC 442; *Milne's Exrs v IRC* (1956) 37 TC 10.

from.[4] So, for example, where trustees satisfied a capital expenditure using the trust's income they were not entitled to claim the expenditure as a deduction from income for tax purposes. The expenditure was a capital expense and the source of the funds used to pay it was irrelevant.[5]

4.4 There is no authority on the legitimacy of appointing income to capital, but the Trust Law Committee has suggested that, in England and Wales at least, this too should be unproblematic. It contended that such income would simply not be treated as taxable income of the beneficiary.[6] Unfortunately, the position in Scotland may be complicated somewhat by section 118(1) of the Finance Act 1993, which provides:

> "Where –
>
> (a) any of the income of a trust having effect under the law of Scotland is income to which a beneficiary of the trust would have an equitable right in possession if that trust had effect under the law of England and Wales, and
>
> (b) the trustees of that trust are resident in the United Kingdom,
>
> the rights of that beneficiary shall be deemed for the purposes of the Income Tax Acts to include such a right to income notwithstanding that no such right is conferred according to the law of Scotland."

The precise effect of this provision is not clear. One commentator suggests that section 118(1):

> "…ensures that trusts which, if they were a trust under the law of England and Wales, would confer an interest in possession on a beneficiary but which, because they are governed by Scottish law, do not do so, shall be treated as if they did confer an interest in possession provided that the trustees of that trust are resident in the United Kingdom."[7]

However, it is also possible that it could mean that income deemed to be capital by the trustees will nonetheless be treated as income of the income beneficiary for income tax purposes. On balance, we consider this latter interpretation to be rather strained in view of the provision's legislative history.[8]

4.5 Section 118(1) of the Finance Act 1993 was inserted into the Finance Bill fairly late in its Parliamentary stages to address a divergence between the treatment of Scottish and English beneficiaries in Scottish liferent trusts and English interest in possession trusts as far as income from bank and building society accounts was concerned. This discrepancy arose when a new lower rate of tax was introduced for savings income. Such income is taxed at a rate of 20% rather than the basic "ordinary" income tax rate of 22%.[9] In English interest in possession trusts the nature of the beneficiaries' right to the trust property gives them an

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[4] The nature of the distribution is to be determined by the "reality" of the situation in which it is made – *Stevenson v Wishart* [1987] 1 WLR 1204. A discretionary advancement to the liferenter of capital from the trust estate would not normally be assessed to income tax.
[5] *Carver v Duncan* [1985] AC 1082.
[6] *Capital and Income of Trusts*, para 6.12.
[7] P G Whiteman, *Whiteman on Income Tax* (11th cumulative supplement to the 3rd edn, 2000), para 20-138.
[8] The information in the following paragraph was kindly provided by Mr R Willoughby of the Inland Revenue's Edinburgh Trust office.
[9] Collison and Tiley, *UK Tax Guide* para 5:22.

entitlement to specific trust property, eg "savings income" as opposed simply to "income".[10] The right of a Scottish beneficiary in a liferent trust is different. Scottish trust beneficiaries are not entitled to specific items of trust property unless that is expressly provided for in the trust deed. Accordingly, a Scottish liferent beneficiary is entitled simply to "income" rather than "savings income" in particular. Without section 118(1), Scottish liferent beneficiaries would have been taxed at the higher basic rate of 22% on interest from banks and building societies, whereas English interest in possession beneficiaries would be taxed at the lower rate of 20% on identical income. Section 118(1) avoids this unfortunate result by providing that, for the purposes of the Income Tax Acts, Scottish beneficiaries are to have the rights to income enjoyed by English beneficiaries. In our view section 118(1) does not have any bearing on our allocation and apportionment proposals and we do not put forward any amendments to it.[11]

4.6 However, there is legislation providing that particular receipts should be chargeable to tax as income in the hands of the trustees. Examples are section 249 of the Income and Corporation Taxes Act 1988 dealing with taxation of stock dividends (scrip issues and bonus shares) and section 421(2) of that Act which treats the writing off by a close company of a loan to the company by a participator as income of the participator equal to the grossed-up amount written off. Similarly, section 686(2AA) provides that in working out trust income chargeable at "the rate applicable to trusts",[12] the trustees may deduct expenses properly chargeable to income under the general trust law, ignoring any express provisions in the trust deed. If the general discretionary powers for trustees in relation to apportionment of receipts and outgoings between income and capital that we propose were to be used by them primarily to avoid or mitigate tax, then further anti-avoidance provisions might have to be introduced. Having said this, the default powers of apportionment suggested above are aimed at allowing trustees to maintain a fair balance between the beneficiaries. The purpose is not to allow trustees to engage in tax avoidance and any attempt by trustees to use the power to this end or for any other illegitimate purpose will be invalid.

4.7 One possible problem we have identified regarding our proposals is in relation to the income and inheritance tax regimes applicable to particular types of trust. Implications may arise in relation to both taxes if a discretion to apportion between capital and income were to be regarded as a dispositive discretion (ie a discretion over "such matters as who is actually to benefit from the trust, in what proportions and when they are to benefit, or in some other way concerning the nature and extent of the interests in the trust."[13]) rather than a purely ministerial or administrative discretion. This would make the trust a "discretionary trust". In relation to income tax, such a conclusion would subject trustees not only to basic or savings rate income tax, but also "the rate applicable to trusts" under section 686(1A) of the Income and Corporation Taxes Act 1988. The general rate charged on discretionary trusts is 34%, with a special rate of 25% (the Schedule F trust rate) being charged on dividends.[14] In relation to inheritance tax, a different tax regime applies to discretionary trusts. Where property held in such a trust is "relevant property" within the meaning of the Inheritance

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[10] The beneficiaries have a proprietary right to the trust property, Lewin, *Trusts*, para 1-20.
[11] S 118(1) uses the formula "having effect under the law of Scotland" rather than the more normal "having Scots law as the applicable law".
[12] See next paragraph.
[13] K McK Norrie and E M Scobbie, *Trusts* (1991), 25.
[14] Collison and Tiley, *UK Tax Guide*, para 12:06.

Tax Act 1984[15] the trust may be subject to a charge to inheritance tax every ten years with an "exit charge" being levied when funds are paid out of the trust. The ten year charge is levied on relevant property immediately before a ten year anniversary of the trust.[16] "Ten year anniversary" generally means the tenth anniversary of the date on which the trust commenced and subsequent ten year anniversaries.[17] Tax is charged at 30% of the "effective rate".[18]

4.8 The Trust Law Committee argued that a discretion to apportion between capital and income is in the nature of an administrative discretion.[19] The Committee's reasoning was based on the fact that, rather than shifting income from the income beneficiaries to the capital beneficiaries, the trustees would simply be determining what is capital and what is income of the trust: thereafter the trustees have no discretion as to which beneficiaries should receive which funds. This already seems to be the accepted position in Scots law. Thus in *Robertson's Trustees v Inland Revenue Commissioners*[20] it was held that a power to apportion income to capital funds was an administrative rather than a dispositive function exercised by the trustees. Similarly, in *Miller v Inland Revenue Commissioners*[21] it was decided that in exercising a power to appropriate income to meet a depreciation of capital the trustees were merely exercising an administrative function. In the light of these cases we do not think that any change of the law is needed.

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[15] The term "relevant property" is used for all settled property where there is no qualifying interest in possession, other than property specifically excluded by: Inheritance Tax Act 1984, s 58; Finance Act 1990, s 126(5); Finance Act 1991, s 121(4); Finance Act 1994, s 248(1).
[16] Inheritance Tax Act 1984, s 64.
[17] Inheritance Tax Act 1984, s 61. However, see the qualifications in s 61(2), (3) and (4).
[18] The "effective rate" is "the tax chargeable, using lifetime rates , expressed as a percentage of the amount on which it is charged. The tax chargeable depends on a calculation of a hypothetical value to be taxed and a hypothetical point from which that value is to start." – Collison and Tiley, *UK Tax Guide*, para 42:08. As to the "hypotheticals" see Collison and Tiley, paras 42:09 and 42:10 and Inheritance Tax Act 1984, s 66(4) and (5).
[19] *Capital and Income of Trusts*, para 6.12.
[20] 1987 SLT 534.
[21] [1987] STC 108.

Part 5 List of proposals and questions

1. Trustees should have a new statutory power to alter the allocation under the existing statutory or common law rules of a receipt or an outgoing to income or capital or to alter the apportionment of a receipt or an outgoing between income and capital in order to maintain a fair balance between the income and capital beneficiaries of the trust. This power should be subject to any contrary provisions in the trust deed.

(Paragraph 2.42)

2. Should there be a statutory list of factors that the trustees must take into account in exercising the discretionary power, and if so what factors should be listed?

(Paragraph 2.42)

3. Should the rules of equitable apportionment contained in the cases of *Howe v Earl of Dartmouth, Re Earl of Chesterfield's Trusts* and *Allhusen v Whittell* be expressly abrogated?

(Paragraph 2.42)

4. Trustees should have a new statutory power, exercisable on a discretionary basis, not to apportion dividends and other periodical payments on a time basis when they would otherwise be required to do so in terms of the Apportionment Act 1870 or any rule of law.

(Paragraph 3.12)

5. Should there be a statutory list of factors that the trustees must take into account in exercising this discretionary power, and if so what factors should be listed?

(Paragraph 3.12)

Appendix A

Comparative Law

Australia and New Zealand

1. The rules for time apportionment of periodical payments are much the same as in the United Kingdom. The Apportionment Act 1870 has been adopted in most Australian jurisdictions and in New Zealand.

2. The rule in *Allhusen v Whittell* is generally followed, but it has been abolished by statute in New South Wales, Victoria, Queensland, Western Australia and in New Zealand.[1]

3. The rule in *Howe v Earl of Dartmouth*[2] requires trustees of a residuary personal estate to sell wasting assets or assets of a future or reversionary nature and invest in solid income-bearing assets in the interests of fairness between the income and capital beneficiaries. If such a sale is not carried out the trustees are to account as if such a sale had occurred. Western Australia[3] and New Zealand[4] have abrogated the duty to account as if a notional sale had taken place.

4. The Queensland Trusts Act 1973 empowers trustees to apportion outgoings between capital and income and pay disbursements that should be borne by income out of capital recouping it later from future income.[5]

5. There is generally no apportionment between income and capital on the sale or purchase of trust investments. Nevertheless in certain circumstances, such as the sale of shares *cum* dividend where the dividend is substantial, an apportionment will be made or can be ordered by the court.[6] In New Zealand trustees have a statutory discretion to apportion.[7] The rules as to company distributions are much the same as in the UK, but the New Zealand Trustee Act empowers the court to give directions to trustees as to the allocation of any "capital dividend" received.[8]

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[1] Queensland: Trusts Act 1973, s 78; New South Wales: Wills, Probate and Administration Act 1898, s 46D; Victoria: Trustee Act 1958, s 74; Western Australia: Trustees Act 1962, s 84; New Zealand: Trustee Act 1956, s 84.
[2] (1802) 7 Ves 137.
[3] Trustees Act 1962, s 105.
[4] Trustee Act 1956, s 85.
[5] S 33(1)(g).
[6] H A J Ford and W A Lee, *Principles of The Law of Trusts* (September 2002 update), 11330-11390.
[7] Trustee Act 1956, s 88.
[8] *Ibid*, s 64B; see *Manukau City Council v Lawson* [2001] 1 NZLR 599.

Bahamas

6. Section 89 of the Trustee Act 1998 provides:

> "(1) The rules of equitable apportionment known as the Rule in Howe v. Earl of Dartmouth, the Rule in Re Earl of Chesterfield's Trust 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 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 a contrary intention is not expressed in the trust instrument and shall have effect subject to that instrument."

7. It legislates the recommendations made by the Lord Chancellor's Law Reform Committee in England and Wales in 1982.

Canada: Ontario

8. Payments expressed to be due in respect of a period of time accrue from day to day and hence are apportionable.[9] There is no apportionment on purchase or sale of trust investments unless non-apportionment produces a glaring injustice, in which case the court may apportion. The equitable apportionment rules in *Howe v Earl of Dartmouth* and *Re Earl of Chesterfield's Trusts* apply. The Ontario Law Reform Commission recommended widening the scope of these rules by introducing a general principle of even-handedness between income and capital beneficiaries whatever the nature of the assets and the type of the trust.[10] The rule in *Allhusen v Whittell* has been abolished by section 49(1) of the Trustee Act.

9. The law as to allocation of receipts as between income and capital follows that of the United Kingdom. The Ontario Law Reform Commission recommended that trustees should be given a discretionary power to allocate subject to the overriding duty of care and even-handedness. The truster would have to "opt-in" to this statutory regime by specifying that the trust was a discretionary allocation trust. The discretionary allocation power would also

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[9] Apportionment Act, RSO 1990, Ch A23.
[10] Report on *The Law of Trusts* (1984), Vol I, 286.

extend to outgoings.[11] The sections of the draft Bill annexed to the Commission's report which deal with these recommendations are set out below.

> "**39.**-(1). Trustees shall act impartially as between income and capital beneficiaries, having regard to each item of trust property, whatever the nature of the property, and whether it is an original asset or an asset acquired subsequently, further to an authorisation in the trust instrument or conferred by statute.
>
> (2) Notwithstanding section 2 and except where the trust instrument expressly provides otherwise, this section applies to every trust.
>
> **40.**-(1). Trustees may apportion any payment or expenditure for any outgoing between the income and capital accounts, or they may charge the payment or expenditure exclusively to either income or capital as they consider just and equitable in all the circumstances.
>
> (2) Trustees may pay for any outgoing from income or capital, or wholly or partly from each, as appears to them to be in accord with sound business practice and in the best interests of the trust beneficiaries as a whole, and, where the whole or part of the payment or expenditure is made out of or charged to capital, they may recoup capital from subsequent income, or where whole or part of the payment or expenditure is made out of or charged to income, they may recoup income from capital, if, in either case, they consider that course to be just and equitable in all the circumstances.
>
> (3) Trustees may, and if ordered by the court on application shall, deduct from the income derived from trust property that is subject to depreciation or obsolescence such amounts as are fair and reasonable having regard to sound business practice in order to protect the capital of the trust from loss, and any sums so deducted shall be set aside and added to the capital of the trust so as to become capital for all purposes.
>
> (4) …….
>
> (5) This section is subject to section 39 and applies only to trusts that take effect after this Act comes into force.
>
> **41.**-(1). Subject to section 39, where trustees are expressly directed by the trust instrument to hold trust assets on discretionary allocation trusts, they shall allocate receipts to and charges for outgoings against the income and capital accounts as they consider just and equitable in all the circumstances.
>
> (2) Where the trustees are expressly directed by the trust instrument to hold trust assets on discretionary allocation trusts, subsections 40(2) and (3) apply.
>
> (3) For the purposes of this section and for determining the relative proportionate interests of beneficiaries of the trust, but not so as to limit in any way the powers conferred by subsection (1),
>
> > (a) income may be understood to be the return in money or property derived from the use of capital; and

[11] *Ibid*, 298-300.

(b) capital may be understood to be the property set aside by the trust instrument to be delivered eventually to a remainderman, while the return or use of the capital is in the meantime taken or received by or held for accumulation for an income beneficiary."

South Africa

10. An income beneficiary is analogous to a usufructuary and as such is liable for rates and moderate repairs. Extraordinary repairs and improvements are a charge on capital, although an income beneficiary who carries out improvements is not entitled to compensation from the capital beneficiary.[12] When a usufruct terminates there is an apportionment of payments that are in consideration of continuous use such as rent or interest, between owner and usufructuary. Payments of uncertain occurrence such as fines or penalties are due to the usufructuary if they fall due within the period of the usufruct.[13]

11. Trustees must not favour one beneficiary or class of beneficiaries against another but must treat all impartially. As Honoré puts it in relation to capital and interest beneficiaries: "Apportionment of assets between capital and income are therefore to be made on equitable grounds rather than by a mechanical application of certain items to capital and others to income".[14] Trustees who held a heritable security over land foreclosed when the land failed to sell for sufficient to pay off the debt. The court ratified an agreement between the trustees and the beneficiaries that if the land was later sold at a profit the income beneficiaries would be credited with the interest payments they would have received had the security remained in existence.[15] Equitable apportionment along the lines of *Re Earl of Chesterfield's Trusts* was carried out where the trust held a life policy. The capital beneficiaries got the sum that at 4% compound interest would have produced the amount paid under the policy, with the income beneficiaries getting the rest plus interest on the annual premiums paid.[16]

United States of America

12. Section 803 of the Uniform Trust Code provides that if a trust has two or more beneficiaries the trustees shall act impartially in investing, managing and distributing the trust property. The comment on this section states that the trustees should be particularly sensitive to allocation of receipts and disbursements between income and capital and should consider, in an appropriate case, reallocation if allowed under the law of the State in question.

13. The Uniform Principal and Income Act 1997[17] replaced the Uniform Principal and Income Act 1962.[18] The 1997 Act contains detailed rules for the allocation of certain receipts to principal or income. Section 401 provides that cash payments from a company not in

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[12] *Honoré's South African Law of Trusts* (5th edn, 2002, by E Cameron, M de Waal, B Wunsh, P Solomon and E Kahn), 609.
[13] C G Hall, *Maasdorp's Institute of South African Law* (9th edn, 1971), Vol II, 169.
[14] *Honoré's South African Law of Trusts* (5th edn, 2002, by E Cameron, M de Waal, B Wunsh, P Solomon and E Kahn), 316-7.
[15] *Ex parte Estate Atwell* 1938 CPD 543.
[16] *Ex parte Administrator Estate Heaton* 1941 (1) PH G14 (C).
[17] The Act has been adopted in its entirety by 24 States so far (Arkansas, Alabama, Arizona, California, Colorado, Connecticut, District of Columbia, Hawaii, Idaho, Iowa, Kansas, Maryland, Missouri, Nebraska, New Jersey, New Mexico, New York, North Dakota, Oklahoma, South Carolina, Tennessee, Virginia, West Virginia and Wyoming) and is pending before the legislature in six others.
[18] Adopted by 31 States.

liquidation are to be allocated to income, while receipts of property other than cash (eg shares) are principal. Scrip dividends are a case where the trustees would be expected to exercise the discretionary power of adjustment in section 104 described below. For wasting assets such as patents, 10% of a payment is income, the rest principal.[19] There is a similar rule for minerals and other natural resources such as oil, whether or not extraction commenced before the income interest arose.[20]

14. Section 103 requires a trustee to allocate receipts and disbursements as between income and principal in accordance with the trust deed and the Act's rules. A trustee is to administer the estate impartially, based on what is fair and reasonable to all the beneficiaries, unless the trust deed clearly shows an intention to favour certain beneficiaries. As part of this duty of impartial action a trustee who is following the prudent investor regime is given power under section 104 to adjust between income and principal. Various factors are to be taken into account in deciding whether and to what extent to exercise this power. They are:-

(1) the nature, purpose and expected duration of the trust;

(2) the intent of the settlor;

(3) the identity and circumstances of the beneficiaries;

(4) the needs for liquidity, regularity of income, and preservation and appreciation of capital;

(5) the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;

(6) the net amount allocated to income under the other sections of the Act and the increase or decrease in value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;

(7) whether and to what extent the terms of the trust give the trustee power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;

(8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and

(9) the anticipated tax consequences of an adjustment.

Thus if the trust estate is mainly invested in growth stocks the trustees may allocate part of the annual capital growth to income in line with the "total return portfolio theory". There are certain circumstances in which the adjustment power cannot be exercised. These

[19] S 410.
[20] S 411.

include: altering the amount of a fixed annuity and where the trustee is a beneficiary or would benefit from the allocation indirectly.

15. The 1997 Act also contains rules as to apportionment at the beginning and end of an income interest. For periodical payments (such as rent, interest or dividends) a payment whose due date occurs on or after the beginning of the income interest is wholly allocated to income. Non-periodical receipts are treated as accruing from day to day and are apportionable. All income received before the termination of the income interest generally goes to that beneficiary or his or her estate.[21] The same rules apply to disbursements (such as rent due by the trust estate[22]).

[21] S 303.
[22] S 302.

Appendix B

Advisory Group on Trust Law

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