These notes refer to the Trusts (Capital and Income) Act 2013 (c.1) which received Royal Assent on 31 January 2013

TRUSTS (CAPITAL AND INCOME) ACT 2013

EXPLANATORY NOTES

BACKGROUND AND SUMMARY

Capital and income in trusts

5. The Act gives effect, subject to minor modifications, to the recommendations made in the Law Commission's Report *Capital and Income in Trusts: Classification and Apportionment* (Law Com No. 315). It makes changes to technical rules of trust law which apply to trustees who have to distinguish between capital and income in managing the property of a private trust or a charity.

6. In this context, capital is trust property that constitutes a pool or fund of assets, and is to be distinguished from the income earned on those assets. The metaphor of a tree and its fruit is illustrative: the "tree" is the capital (such as an office block), and the "fruit" is the income (such as the rent received from renting out the offices). Trustees who manage capital assets and receive income are likely to have to invest to preserve the value of the capital and to produce the required income. In dealing with returns on investment, they may have to distinguish between beneficiaries entitled to receive income and beneficiaries entitled to receive capital. Trustees' powers and duties in relation to investment are governed not only by the terms of the trust itself, but also by the general law: in particular, by the Trustee Act 2000. Under the 2000 Act, trustees are given a general power of investment, but this is subject to duties such as the requirement to exercise reasonable care and skill, and to have regard to standard investment criteria.

7. Under the trust, one class of beneficiaries may be entitled to capital, and another to income. For example, a private trust (the AB Trust) may be established by a person making a gift of investments on trust "for A for life, with remainder to B". The trustees will pay the income arising on the investments to A until A dies, and then transfer the investments to B. A is termed the "life tenant", and B the "remainderman"; such a trust, which shares property and income over time, is termed a trust "for interests in succession".

8. Because of the different entitlements to income and capital, the trustees must distinguish between investment receipts according to their legal classification as income receipts due to A, or capital receipts which must be held for B and can be invested to produce income. They may also need to apply rules of apportionment between capital and income, which can affect the beneficiaries' entitlements; for example, by requiring the trustees to apply some of a capital receipt as though it were income (see paragraphs 11 and 12 below).

9. Similar issues arise in relation to charities with a permanent endowment. A permanent endowment is a protected fund which is subject to restrictions on what may be spent on the charity's purposes. This means that in order to achieve a balance between the charity's current and future purposes, the trustees must select their investments according to the likely form of the return as income or capital; capital receipts must generally be added to and held as part of the permanent endowment fund, and only income receipts can be spent. If that balance is not actually reflected in the returns received, the trustees cannot take a view over the whole return and reallocate capital and

income returns – they are constrained by the form the returns actually take. Therefore, they cannot follow the approach to investment taken by many other trustees, who are able to invest with a view to the overall return; selecting investments on the basis of achieving an appropriate balance between risk and return in accordance with the general law governing trustees' investment duties.

10. The Act makes three changes to the current law.

- It disapplies, for new trusts:
  - — the statutory rule requiring the apportionment of income over time imposed by the Apportionment Act 1870, insofar as it relates to trusts; and
  - — three of the rules of apportionment originating in case law, which require adjustments to be made to the entitlement to income and capital receipts in certain instances.
- It alters the classification of shares received by trustees by way of investment receipts when the company in which they hold shares undergoes a demerger. Where such shares are currently classified as income, they will be classified as capital.
- It facilitates total return investment for charities with a permanent endowment; trustees will be able to make a resolution opting for new Charity Commission regulations to apply in place of the investment restrictions that currently prevent total return investment.

The rules of apportionment

11. As a general principle, trustees must not favour one beneficiary or class of beneficiaries over another in exercising their powers and fulfilling their duties. They have a duty to keep a fair balance between beneficiaries who are entitled to capital, and those who are entitled to income.

12. In the past, that general duty has been considered to require certain returns and outgoings of a trust to be shared in a particular way between capital and income, and in some cases as imposing a duty to sell certain investments, in specific circumstances. These have become known as rules of apportionment. One derives from statute, and the others from case law (and are often known as the "equitable rules of apportionment"). The four rules affected by the Act can be summarised as follows.

- Section 2 of the Apportionment Act 1870 is the statutory rule of time apportionment. The effect of the section is that income beneficiaries are entitled only to the proportion of income that is deemed to have accrued during their period of entitlement. The trustees must work out how much income is attributable to each beneficiary, on the assumption that the income accrued at a constant rate over the period.

  For example, shares are held by the trustees of the AB Trust (see paragraph 7 above); a dividend is declared on 1st February on shares that last yielded a dividend on 1st December. A died on 1st January. Under section 2 of the Apportionment Act 1870, half the dividend is payable to B and half accrues to A's estate.

- The rule known as the rule in *Howe v Earl of Dartmouth* is divided into two parts.
  - — The first part of the rule creates an implied trust for sale, putting the trustees under an obligation to sell particular investments and reinvest the proceeds (known as a "duty to convert"). Broadly speaking, it applies to trusts for interests in succession created by will or codicil over the testator's residuary estate – that is, so much of the estate as remains after payment of debts, liabilities, legacies and other charges. The rule applies where the trust fund includes personalty (assets other than land) constituting investments which fulfil the following criteria. First, they must be unauthorised investments: the

trustees would have no power to invest in them, either under the general law (by which, following the Trustee Act 2000, only a few investments are unauthorised) or by express restrictions in the trust instrument (for example, establishing ethical investment criteria). Secondly, they must be "of a wasting or hazardous nature"; that is, having the potential to prejudice the capital beneficiary over time through a dramatic diminution in value, and to produce an augmented level of return for the income beneficiary.

— The second part of the rule applies to trusts for interests in succession where a trust for sale applies (this could be implied under the first part of the rule, or express). It applies more widely than the first part of the rule, as it is not limited to trusts created over residuary estates of testators, and applies to unauthorised investments of a wasting or hazardous nature in leasehold (though not freehold) interests, as well as in personalty (see above). Until the investments are actually sold in accordance with the trustees' obligation under the trust for sale, the life tenant receives a sum calculated by applying a specified rate of interest (traditionally 4 per cent) to the estimated value of the property. This operates to compensate the capital beneficiary for loss pending conversion of trust investments.

- The rule known as the rule in *Re Earl of Chesterfield's Trusts* applies where there is a trust for interests in succession and compensates the income beneficiary for loss of present income from future property held by the trust, where trustees have exercised a power to defer sale. For example, the trust fund of the AB Trust includes property held in reversion, where X is entitled to the income for life. Until X dies, the property will not produce any income for the AB Trust, but the trustees decide to hold onto it until that time. This rule requires that, when the property eventually comes into the trustees' hands, it is treated as though it represents partly arrears of income due to A; therefore, it is apportioned between capital and income.

- The rule known as the rule in *Allhusen v Whittell* applies where a testator's residuary estate is left on trust for interests in succession. It apportions debts, liabilities, legacies and other charges payable out of the residuary estate between capital and income beneficiaries so that broadly the beneficiaries are put in the same position as if payments had been made at the time of death. This requires the trustees to calculate the net average income of the estate from the date of death to the date of the relevant payment and from this to work out how much of each debt paid is attributable to capital and how much to income. The income beneficiary is then charged with interest at the rate of the net average income on the amount of the payment so that the payment is regarded as being made partly from income and partly from capital.

13. The rules apply to private trusts for interests in succession; the extent to which they apply to charitable trusts is unclear. Professionally drafted trust instruments generally exclude them. In most trusts where they have not been excluded they are either ignored or cause considerable inconvenience by requiring complex calculations generally in relation to very small sums of money.

14. The Act abolishes the rules for trusts coming into existence after commencement. But settlors and testators who wish any or all of the rules to apply to the trust can make express provision to that effect in the trust instrument.

The classification of shares received in the course of a demerger

15. The Act addresses an aspect of the trust law classification of investment receipts from companies as income or capital: the classification of dividends received by trustee shareholders which are distributions made in the course of a corporate demerger.

16. Such demergers can be of two kinds: direct and indirect. In each case Company A transfers part of its business to a new subsidiary company, Company B, and then

declares a dividend to its shareholders. In a direct demerger the dividend is satisfied by Company A distributing the share capital of Company B to its own shareholders. In an indirect demerger the shares in Company B are transferred to a separate holding company, Company C. In consideration for this transfer, Company C satisfies Company A's dividend by issuing its own shares to the shareholders of Company A.

17. Pursuant to a decision of the House of Lords,[1] shares distributed in the course of a direct demerger have to be classified as income. The result of this is that following a company reorganisation by way of a direct demerger, the trust fund's former capital asset – the original shareholding in Company A – will be effectively split between capital and income to the extent that the value is now represented by shares in Company B. The Company B shares passing to the income beneficiary could represent a substantial percentage of the original shareholding in Company A – far in excess of normal expectations for an income return.

18. However, exceptionally, it was later decided in the High Court that shares distributed in the course of an indirect demerger should be classified as capital.[2] Therefore, in such a case the shares in Company C retain the classification of the original Company A shareholding; the income beneficiary does not receive a portion of that asset merely by virtue of the corporate reorganisation.

19. The Act provides that the shares distributed in defined direct and indirect demergers will for the future in both cases be treated as capital for the purposes of the trust. This reform affects both private and charitable trusts, whenever created.

20. The new classification of such receipts may, in some circumstances, prejudice the income beneficiary. The Act provides a power to compensate the income beneficiary by way of a payment from trust capital in these circumstances.

Total return investment for charities

21. As explained at paragraph 9 above, charities with permanent endowment are ordinarily restricted in their investment decisions, since they must keep separate income available for current use and capital held to produce future income. Because investment returns that trust law classifies as capital cannot be spent on current charitable purposes, trustees of charities with permanent endowment have to pursue an investment strategy which produces sufficient income yet maintains a balance between capital and income returns. A strategy that produced too little income would limit the funds available to provide public benefit (even if a healthy overall profit had been made taking into account capital returns). A strategy that produced too much income would reduce the level of permanent endowment available to produce future income. Trustees must therefore invest with a view to the likely form of the receipt – as income or capital – in an endeavour to ensure that future investment receipts do not favour income or capital disproportionately.

22. By contrast, under a total return investment scheme, trustees invest with a view to optimising the overall investment return, no matter whether that takes the form of capital or income. The trustees then decide how much of that overall return should be allocated to be expended on current charitable purposes and how much should be retained to produce future returns; even if that means spending funds which would be classified as capital, and accumulating (adding to capital) returns classified as income. While in taking those decisions trustees have to balance the need for current expenditure and the need to maintain the long term capital value of the fund, decisions on investment are not influenced by the requirement to generate returns that take the form of income or capital, as the case may be. The usual considerations when trustees invest – in particular, the need to balance risk and return – still apply.

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1 *Bouch v Sproule* (1887) LR 12 App Cas 385.
2 *Sinclair v Lee* [1993] Ch 497.

23. At present, trustees of charities with permanent endowment can only operate total return investment if they apply to the Charity Commission for an order enabling them to do so, in accordance with the Charity Commission's scheme for total return investment set out in its Operational Guidance.[3] The Act gives the Charity Commission power to make regulations enabling total return investment, and enables trustees of charities with permanent endowment by resolution to operate total return investment in accordance with those regulations, without having to make an application to the Charity Commission for an order.

3 Charity Commission, *Operational Guidance 83 Endowed Charities: A Total Return Approach to Investment* (available at http://www.charity-commission.gov.uk/About_us/OGs/index 083.aspx).