Trustees' powers over income and capital

Synopsis: The usual key dispositive powers of trustees: power to accumulate income and advance capital.

Date published: 15.02.2024

Relevant statutory provisions dealing with trust income and capital

Trustees have responsibility to administer the trust for the benefit of the beneficiaries. This includes investment of the trust property to make it productive.

In addition to investment powers, the key powers of trustees are those with regard to advancing income and capital to the beneficiaries particularly where this is done at the trustees' discretion (i.e. except for interest in possession trusts in respect of income).

In most cases the trust deed itself will grant the trustees specific power to deal with the trust income and capital, obviously depending on the type of trust and the degree of discretion that the settlor wishes to grant the trustees. In the absence of express powers, statutory provisions will apply.

Where no specific contrary provisions exist in the trust then, under the law of England, sections 31 and 32 of the Trustee Act 1925 apply.

The Inheritance and Trustees´ Powers Act 2014 which applies in England and Wales came into effect from 1 October 2014.

The 2014 Act amends sections 31 and 32 of the Trustee Act 1925 for trusts created after 1 October 2014. The original provisions continue to apply to trusts created before that date. Therefore, an adviser must be familiar with both sets of rules.

Under the original s 31 trustees can apply income for the maintenance, education and benefit of a beneficiary at their discretion in circumstances in which they consider to be reasonable after due consideration of certain circumstances – including the beneficiary's age and requirements.

The 2014 Act reforms the trustees' power to apply income by removing the proviso that they have to take account of certain circumstances and instead leaves trustees free to pay out as much of the income as they think fit.

Under the original s 32, trustees can advance up to one half of a beneficiary's presumptive share for their benefit. This includes beneficiaries who may or will eventually become entitled to it under the terms of the trust, such as remaindermen.

If there is a life tenant under the trust, their agreement will be necessary before advancement to another beneficiary can be made. It should be noted that unless the trust specifically permits it, no advancement of trust capital to a life tenant (i.e. a beneficiary entitled only to income during their lifetime) will be possible.

The 2014 Act modifies section 32. First, it is now made clear that the advancement can also be made by a transfer of assets (i.e. not cash alone) and this change applies to all trusts whenever created.

The other modification, which only applies to trusts established after 1 October 2014, enables trustees to advance up to the whole of a beneficiary's presumptive share to them rather than just one half.

Obviously, the trust deed must always be checked to establish whether the statutory or express provisions apply and to ensure that the trustees are acting within their powers.

Most current trust deeds modify s 31 and s 32 to give the trustees wider powers of application of income and advancement of capital.

The rule against perpetuities and accumulations

In the context of trustees' powers to deal with the trust income it is important to understand the rules against perpetuities and accumulations. These apply regardless of the trust provisions (i.e. a trust must not include any provision that would contravene these rules).

It has long been considered to be against public interest for settlements to be created on consecutive interests in perpetuity. The relevant legislation is now in the Perpetuities and Accumulations Act 2009 (previously the Perpetuities and Accumulations Act 1964) which came into force on 6 April 2010 and which creates a fixed statutory perpetuity period of 125 years which applies to all trusts created from that date.

Prior to the commencement of the Act, the rules were more complex and were contained in the 1964 Act which defined the allowable perpetuity periods as either a term of years not exceeding 80 or the lives of those living at the date when the trust is made ('lives in being'), plus 21 years. Lives could be expressly selected and in older documents it was common to see a perpetuity period of Royal lives (for example 'the last survivor of the lineal descendants now living of Queen Victoria plus 21 years').

Clearly, without considerable expensive research it is almost impossible to establish a Royal lives period, so an 80-year period was most commonly found. Just as it was considered against public policy to hold trust property in perpetuity, it was also considered to be objectionable to allow income of a trust to be accumulated for prolonged periods. As a result, the 1964 Act prohibited excessive accumulations.

The permitted accumulation periods under the Law of Property Act 1925 (section 164) and section 13 of the Perpetuities and Accumulations Act 1964 were...

1. The life of the settlor, or

2. 21 years from the death of the settlor, or

3. 21 years from the date of the settlement, or

4. During the minority of any person living at the settlor's death, or

5. During the minority of any person living at the date of the settlement, or

6. The minority of any person who would, if of full age, be entitled to income.

Normally, the 21-year period from the date of the settlement would be chosen. While these rules still apply to trusts that came into force prior to 6 April 2010 (when the 2009 Act came into force), the rules have, for trusts created after that date, been abolished - except in relation to charitable trusts - with the effect that income can now be accumulated for the entire perpetuity period.

The changes have been welcomed by the Law Commission and other professional bodies as not only do they considerably simplify the position, they also make planning over successive generations much easier.

The following is a summary of the key provisions of the 2009 Act...

- Introduction of the single statutory perpetuity period of 125 years.
- Abolition of the rule against excessive accumulations except in relation to charitable trusts.
- Charitable trusts will generally be subject to a single 21-year limit on accumulations.
- The new rules generally apply only to instruments taking effect after commencement of the Act (although the Act granted the power to trustees of existing trusts to opt into the new 125-year period by deed where there are difficulties in establishing the perpetuity period applicable to trust under the old law).
- For wills, the new provisions apply where a will was executed after commencement of the Act.
- All pension schemes are exempt from the rule (currently some pension trusts are not exempt and must periodically reformulate the scheme so as to avoid breaching the rule).
- The legislation extends to only England and Wales. The rules on perpetuities and accumulations are different in Scotland and in Northern Ireland.

Classification and apportionment of income and capital

It is well known that trustees of trusts with competing interests (such as life interest trusts) have a duty to balance the competing capital and income interests of the beneficiaries. This is fairly straightforward where the trust property is invested in unit trusts or shares, but a trust fund can be invested in a wide range of investments, including, for example, works of art where the distinction is less straightforward.

Over time, the Courts have developed rules that determine whether various different forms of investment return are to be classified as capital or income of the trust. These are known as rules of apportionment.

There are several equitable rules of apportionment. For example...

- The rule in Howe v Dartmouth [1802] which requires trustees to sell 'wasting, hazardous and unauthorised assets' where residuary estate is left to persons in succession. This rule also provides that pending sale, the life tenant is unable to receive the income from those assets. This rule exists to protect the remaindermen who would otherwise be unfairly disadvantaged by any delay;

- The rule in Re Earl of Chesterfield's Trusts [1883] which compensates an income beneficiary for loss of income from future property where there is a delay in the sale of a capital asset by apportioning the proceeds of sale between capital and income; and

- The rule in Allhusen v Whittell [1867] which apportions debts, liabilities, legacies and other charges payable out of a residuary estate between capital and income beneficiaries.

There are also statutory rules of apportionment. Section 2 of the Apportionment Act 1870 is a rule of time apportionment which provides that income beneficiaries are entitled only to the proportion of income that is deemed to have accrued during their period of entitlement.

The Trusts (Capital and Income) Act 2013, which received Royal Assent on 31 January 2013 and came into force on 1st October 2013, reforms the outdated laws of apportionment – many of which have limited relevance today and are in most cases excluded as a matter of course by the trust instrument. The Act provides that none of the equitable or statutory rules of apportionment will apply to trusts created after implementation of the act unless the settlor has included a contrary provision in the trust instrument.

The Act is a direct response to the Law Commission's recommendations in its 2004 Consultation Document: Capital and Income in Trusts – Classification and Apportionment and although it will not solve all trustee problems or give trustees a choice of how certain receipts should be taxed, it should go some way to make it easier for trustees to make decisions.

The Act also allows trustees of charities with permanent endowment to adopt a 'total return' approach to investment giving them greater flexibility in achieving their investment objectives.

Improper or mistaken exercise of trustee's powers

It has been settled law since the decision in Re: Hastings-Bass, deceased [1975] Ch25 that any disposition by trustees may be declared to be void if the trustees have taken into account something that they should not have taken into account when entering into that disposition, or when they have failed to take into account something they should have taken into account (the so-called 'Hastings-Bass 'principle). That 'something' these days is usually the tax consequences of the intended disposition.

In recent years a number of cases have come up in English Courts where the Court was asked to void – or reverse – the trustees' decision, invariably because the trustees have failed to take into account the potential tax liability resulting from their disposition. Some of these – including the most recent Pitt and Futter cases (which appear to go against the established grain) - are considered below.

Abacus Trust Co (Isle of Man) Ltd and another v NSPCC

In Abacus Trust Co (Isle of Man) Ltd and another v. National Society for the Prevention of Cruelty to Children (NSPCC) 2001 STC 1344, the claimants (the trustee and protector of a settlement made by deed) successfully argued in the High Court that a deed of appointment executed in favour of the defendant (the NSPCC) was void from the beginning. Through an oversight, the claimants failed to have regard to the advice of leading counsel that the appointment should not be made before 6 April 1998.

The consequence of ignoring advice and making the appointment before that date gave rise to a deemed disposal by the trustee of the entire trust fund and a liability to capital gains tax on the settlor. The Court held that the trustee was obliged to consider if the effect of the intended appointment was likely to expose the trust fund or its beneficiaries to a significant charge to tax. A failure to take taxation consequences into account invalidated the exercise of the power of appointment.

Consequently, under the tax-planning scheme, the settlor of the trust escaped a capital gains tax liability of £1.2 million and the default beneficiary, the NSPCC, ended up with nothing. This case does appear to offer an escape route in limited cases where things have gone wrong.

In a similar case, the High Court declared that a deed appointing trust funds was an invalid exercise of a trustee's power of appointment and void where, again, this resulted in adverse UK capital gains tax consequences (when the trust inadvertently became UK resident).

Green and others -v- Cobham and others

In Green and others -v- Cobham and others [2000] WTLR 1101 the testator (A) died in 1973, domiciled, resident and ordinarily resident in the British Virgin Islands for the purposes of UK capital gains tax.

The trustees of A´s will ("the will trustees") sought a declaration that an appointment made by deed made in 1990 ("the 1990 deed") by which the will trustees appointed certain funds to be held on trust for the benefit of "C" (a granddaughter), then a minor, was invalid and void. The trustees of the 1990 deed and C supported the application.

At a meeting of the trustees of the will trust in 1990 it was resolved that certain funds of the will trust should be distributed to the testator´s grandchildren, three of whom were under the age of 18. In the case of the minors, the trustees executed deeds of appointment by which the distribution was settled on accumulation and maintenance ("A & M") trusts for C and her two cousins. The trustees were not aware that the will trust and the A & M trusts constituted a single composite trust for capital gains tax purposes with a single body of trustees consisting of the trustees of all the trusts.

Section 52 of the Taxation of Chargeable Gains Act 1992 contained the relevant CGT provisions. Section 52(1) provided, inter alia, that trustees of a settlement should be treated as resident and ordinarily resident in the UK, unless the general administration of the trust was ordinarily carried on outside the UK and a majority of them were not ordinarily resident in the UK. Section 52(2) provided, inter alia, that a person carrying on a business which included the management of trusts who acted as a trustee in the course of that business was to be treated as non-resident if the whole of the settled property had been provided by a non-resident.

On that footing, following the execution of the deeds of appointment, there were ten trustees of the composite settlement, of whom six were (or were to be treated as) non-resident trustees, and the remaining four of whom were resident trustees, with the consequence that the will trust remained a non-resident settlement for capital gains tax purposes.

In October 1990, however, a solicitor trustee had made known to the trustees of the will trust his intention to retire from practice at the end of 1990, with the consequence that he would not thereafter fall to be treated as a non-resident trustee for capital gains tax purposes. He duly retired from practice on 31 December 1990, but continued as a trustee of the 1990 deed. Following his retirement, therefore, there were only five trustees of the composite settlement who were (or who were to be treated as) non-resident trustees, and five resident trustees. The retired solicitor now ranked as a UK resident trustee.

The consequence, if the grandchild's appointment was valid, would be that the will trust would cease to be non-resident and would have become, as it were, an onshore settlement instead of an offshore one. The capital gains tax consequences of that would be catastrophic, in that the resident trustees would be liable for capital gains tax on disposals made not only by the will trust but also by the private company, in which the trustees held shares.

The High Court granted the declaration sought. It held that if the then trustees of the will trust had considered the possible adverse capital gains tax consequences of the proposed appointment in favour of C, they would not have gone ahead with it under any circumstances. It followed that this was a clear case for the application of the principle that required the Court to interfere by declaring the 1990 deed to be an invalid exercise of a trustee's power of appointment, and consequently void in its entirety. Accordingly, the 1990 deed was declared to be void.

Sieff & others v Fox & others

In Sieff & others v Fox & others [2005] WTLR 891 the trustees made an appointment of certain assets to a beneficiary and a subsequent assignment into another settlement with the consent of the beneficiary and his father. It was subsequently discovered that if the appointment and the assignment were valid, there would be a substantial immediate charge to capital gains tax.

The trustees applied to the Court to have the appointment set aside. The beneficiary supported the application. The Court decided to set aside the appointment under the rule in Hastings-Bass because of the trustees' mistake as to the tax consequences of the appointment.

Lloyd LJ said he was 'in no doubt' that, as a general proposition, the tax consequences of the trustees' decision are among the matters which may be relevant for the purposes of the Hastings-Bass principle. It did not follow, however, that the trustees need know 'every detail' of the tax consequences of their acting or not acting, so that being unaware of 'some subtle and perhaps unforeseeable detail of the tax consequences" may not be sufficient to bring the Hastings-Bass rule into play. What is required is a 'material difference' between the intended and the actual fiscal consequences of any action.

Burrell v Burrell

In the second case, Burrell v Burrell [2005] EWHC245, the tax in question was inheritance tax (IHT). Here the trustees were well aware of the importance of the tax considerations but nevertheless got it wrong.

The trust in question was an accumulation and maintenance trust for the benefit of the settlor's son, with the son becoming entitled to a life interest at age 18. The trustees had the power to terminate the life interest after the life tenant had attained the age of 19. The trust held a large number of shares in a private trading company which was about to pay a substantial dividend shortly after the son's 19th birthday. The settlor felt that in view of the son's age it would be more appropriate for the dividend to be retained in the trust. The trustees therefore agreed to exercise their power to terminate the son's life interest and impose a discretionary trust.

The parties appreciated that this was a chargeable transfer for IHT purposes but assumed that the unquoted shares would qualify for business property relief (BPR – now business relief). Indeed, there were other, quoted shares, in the trust and these were not appointed on to discretionary trusts.

What the parties overlooked was that as the beneficiary only became entitled to an interest in possession at age 18, he had been treated as the beneficial owner of the shares (section 49 IHTA 1984) for less than two years at the time the purported appointment took place. Therefore BPR did not apply at the relevant time (section 106 IHTA 1984).

An application to set the appointment aside as far as it related to the unquoted shares was granted, the Court yet again coming to the rescue of the trustees, and, in this case, their adviser. Interestingly the BPR issue was indeed raised in correspondence with the trustees' solicitors, but nevertheless the point was not properly followed up.

Pitt v Holt and Futter v Futter

In the more recent cases of Pitt v Holt [2010] EWHC 45(Ch) and Futter v Futter [2010] EWHC 449 the Courts have taken a somewhat different approach. While in the High Court, certain transactions which resulted in unintended tax implications were set aside under the rule in Hastings-Bass on the grounds that the trustees' mistakes had put them in breach of trust, on appeal the Court of Appeal reversed the High Court's decisions.

The trustees in both cases appealed to the Supreme Court, which unanimously backed the Court of Appeal's opinion and dismissed the appeals insofar as they rely on the Hastings-Bass rule - thereby severely restricting the application of the principle which has to date been substantially relied upon by trustees to undo actions that brought about unforeseen and undesirable consequences.

The Supreme Court held that, for the rule in Hastings-Bass to apply, there must be an inadequate deliberation on the part of the trustee which was sufficiently serious to amount to a breach of fiduciary duty. In other words, it is generally only a breach of duty on the part of the trustees that entitles the Court to intervene (contrast the situation where the trustee fulfils their fiduciary duty by obtaining and acting on advice which turns out to be wrong).

In Pitt - where a personal injury award was settled on discretionary trusts which attracted an IHT liability (which neither the claimant nor her advisers had appreciated, and which could have been avoided if the trust deeds had been drafted as a trust for disabled persons within the meaning s89 IHTA) - there was an alternative claim for setting aside the disposition on the grounds of mistake.

The Court of Appeal had found against Mrs Pitt on this ground, but the Supreme Court found in her favour, determining that the test for setting aside a voluntary disposition for mistake is that there must be a causative mistake of sufficient gravity which is related to either the legal character or nature of the transaction, or to some other matter of fact or law which is basic to the transaction.

Recognising that each case must be considered with an intense focus on the facts to enable the Court to 'make an evaluative judgment whether it would be unconscionable, or unjust, to leave the mistake uncorrected', the Supreme Court determined that there was nothing artificial or abusive about establishing a trust under Section 89 of the Inheritance Tax Act 1984 so as to obtain protection from IHT and, as such, the trust that had been established for Mr Pitt's benefit (which did not meet the requirements of Section 89) would be set aside on the ground of mistake.

This outcome confirms that while strict limits are now set on the use of Hastings-Bass, if the rule in Hastings-Bass does not apply, rescission on the grounds of mistake offers a possible alternative means of correcting a decision which has had unforeseen results. However, given that the mistake must usually be a mistake at law, the proper recourse in the majority of cases where the mistake results in unwanted tax effects will be against professional advisers in negligence rather than an application to Court for the transaction to be avoided.

Whilst these cases can offer some comfort that, if trustees make a mistake, all is not necessarily lost, trustees should not assume that they will always be protected by the Court from any adverse tax consequences of their actions. It is imperative these days to seek proper advice on, and to consider, the tax consequences of any appointment.

Even if the Court declares an appointment void as in the cases mentioned above, the legal costs of any Court action are likely to be substantial. Furthermore, the Court can only declare any disposition to be void, it will not make alternative arrangements. This may be particularly important if, for example, an appointment needs to take place at a particular time, say before a beneficiary reaches a certain age or before certain trust provisions become operative automatically, as any Court action will inevitably result in a delay.

020 7183 3931
www.riskassured.co.uk