Singapore Academy of Law
Law Reform Committee

Report on Total Return Investment and Classification and Apportionment for Capital and Income Trustees

February 2020

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An electronic copy of this report may be accessed from the Singapore Academy of Law website at *https://www.sal.org.sg/Resources-Tools/Law-Reform/Law-Reform-e-Archive-By-Date*.

National Library Board, Singapore Cataloguing in Publication Data

Name: Singapore Academy of Law. Law Reform Committee. | Lee, Jack Tsen-Ta, editor. | Tan, Yock Lin. | Lim, Charles Aeng Cheng. | Tang, Hang Wu. | Yeo, Tiong Min.
Title: Report on total return investment and classification and apportionment for capital and income trustees.
Description: Singapore: Singapore Academy of Law, 2020
Identifier(s): OCN 1129113858 | ISBN 978-981-14-4302-2 (softcover) | 978-981-14-4303-9 (e-book)
Subject(s): LCSH: Legal investments–Singapore. | Trusts and trustees–Singapore.
Classification: DDC 346.5957092–dc23

ISBN 978-981-14-4302-2 (softcover)
978-981-14-4303-9 (e-book)

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The Law Reform Committee ("LRC") of the Singapore Academy of Law makes recommendations to the authorities on the need for legislation in any particular area or subject of the law. In addition, the Committee reviews any legislation before Parliament and makes recommendations for amendments to legislation (if any) and for carrying out law reform.

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EXECUTIVE SUMMARY

1 This Report considers the merits of reforming the legal rules dealing with the classification and apportionment of trust capital and income. It proposes reforms which will fill a gap created by the 2004 amendments to the Trustees Act (Cap 337, 2005 Rev Ed) which introduced the prudent investor norm, but did not consider if the legal categorisation of capital and income is aligned with that norm.

2 The Report is divided into four parts. Part I (Chapters 2–6) addresses the case for and against implementing total return investment as fulfilment of the prudent investor norm. Part II (Chapters 7 and 8) considers apportionment rules and the need to update them in light of or align them with the prudent investor norm. Part III (Chapters 9 and 10) focuses on the rule which classifies corporate distributions in the hands of trustees, which is in serious need of reform. Part IV (Chapters 11–13) contains a summary of the recommendations and deals with certain ancillary issues.

PART I

3 Under the present rules, capital and income trustees are under a duty to pay income beneficiaries the income earned on trust assets, and to hold the capital gains for capital beneficiaries. Unless expressly provided for in the trust instrument, trustees have no power to divert income earned to capital beneficiaries, nor to sell trust assets to pay capital gains as income to income beneficiaries. In addition, trustees must determine what expenses are incurred by income and by capital, and ensure that such expenses are properly charged to income and capital respectively.

4 The traditional rules work well where investment markets are characterised by high and stable interest rates, steady capital appreciation, and significant distributions of dividends by corporate issuers. However, since the onset of low current yields in 2002, some capital and income trustees have struggled to maintain sufficient levels of income while maintaining a conservative asset portfolio.

5 To address this situation, the Committee considered two principal reform options:

(1) To empower trustees to invest on a total return basis without regard to the distinction between capital and income by giving trustees full discretion to determine what is income and capital for the purposes of distribution to the income and capital beneficiaries.

A weaker version of this option is to retain the classification rules as a starting position but to empower trustees to adjust accounts for the purposes of distribution.

(2) To empower trustees to convert the trust to a unitrust or percentage trust, that is, to enable them to determine in advance of any course of investment what percentage of the total return will be distributed to income and capital respectively.

6 The Committee does not recommend that either of the above reform options be adopted, for the following reasons:

(1) Option 1 may lead to trustees incurring moral hazards. Some trustees may decline to exercise the new power for fear of exposing themselves to unnecessary criticism of their investment policies. Others, concerned about being faulted for not taking advantage of the power, yet lacking the experience to make capital appreciation forecasts, may have to seek expert advice and thus incur high costs. At any rate, once total return investment is permitted, trustees will have to consider whether the power should be exercised from time to time. This may be inconvenient and costly for trustees of small trusts.

(2) Although permitting trustees to convert trusts into unitrusts or percentage trusts (Option 2) is simpler to administer, it has the disadvantages of Option 1 without the advantage of flexibility because trustees would have to commit themselves to fixed and perhaps arbitrary percentages of the total investment return that must be distributed to income and capital.

In the Committee's view, for the time being the law should leave it to settlors to decide whether to confer on capital and income trustees the power to pursue total return investment. For the avoidance of doubts as to the extent to which the settlor should declare his intention to implement the policy of total return investment, the Committee recommends legislation to clarify among other things the terms and conditions in which the settlor may direct, in a trust instrument, the trustee to adopt total return investment with respect to all or part of trust property.

PART II

7 The Committee recommends that the following rules that provide capital and income trustees with limited powers of adjustment as between capital and income receipts be disapplied as they have become too rigid for the present investment environment:

(1) The rule that where the residuary personal estate is held on trust, trustees must dispose of unauthorised investments of a wasting or non-productive nature and re-invest the proceeds in authorised investments.

(2) The rule that wasting assets held on trust for sale must be converted into productive assets, and that the income beneficiary is entitled to interest on the estimated value of these assets pending conversion.

(3) The rule which requires the proceeds of conversion of non-productive assets such as future property to be apportioned between capital and income where the trustee defers conversion of the assets in the interests of the trust as a whole.

(4) The rule that where the residue is held on trust, earnings on the estate during the year of administration must be apportioned between income and capital.

(5) The rule in the Apportionment Act (Cap 8, 1998 Rev Ed) that periodic payments in the nature of income are to be considered as accruing from day to day, and thus apportionable between successive income beneficiaries (insofar as it applies to trusts).

The Committee favours disapplication over abrogation to remind capital and income trustees that their duty to treat capital and income beneficiaries impartially is not superseded. It also recommends that disapplication should apply retrospectively to trusts created before the law is amended, where trustees have failed to make adjustments at material times.

8 The Committee recommends retention of the rule that trustees who have invested in loan stock as an authorised investment are under a duty, when the realisation of the security is insufficient to redeem the debt in full, to apportion the net proceeds of realisation between income and capital in the proportion that the interest due bears to the principal sum. This rule of apportionment is consistent with total return investment and ensures that trustees deal fairly as between income and capital.

PART III

9 When trust property is invested in shares of companies, whether dividends received from these companies are to be allocated by trustees to capital or income depends on the source of the dividends. Thus, dividends paid out of a company's profits must be allocated to income, and those paid out of a company's capital (for example, by way of a share reduction) as capital. This rule produces inconsistent results. For example, if a company elects to pay no dividends even though it makes profits, the income beneficiaries of a trust holding shares of the company receive no income. If the stock is later sold, the income beneficiaries gain nothing from the accrued undistributed profits. Furthermore, it may be necessary for trustees to examine the company records to determine whether dividends have been paid from a company's profits or capital, which is inconvenient.

10 The Committee recommends that the rule be replaced by a simpler statutory rule that all receipts and distributions from a company to a trustee shareholder shall be regarded as income if they are cash receipts, and capital if they are non-cash (for example, in the form of a share distribution). In addition, trustees should have a power to make adjustments between income and capital.

PART IV

11 The Committee recommends that where a trust is governed by foreign law which provides for total return investment on a mandatory basis, and the trustee is amenable to the jurisdiction of the Singapore courts, the law should clarify that any exercise by the trustee of a power of adjustment between capital and income should be deemed valid if adjusted in a manner in accordance with, and not prohibited under, the applicable foreign law. In addition, where a trust is not stated to be governed by foreign law, but is subject to foreign law providing for total return investment, the question of adjustment between capital and income should not be governed by Singapore law but be presumptively governed by the foreign law unless this is rebutted.

12 The Committee has not considered whether trustees of permanently endowed charitable trusts and other permanently endowed public trusts should be permitted to adopt total return investment. This raises complex issues of whether and the extent to which risk-taking by charities is compatible with the conduct of charitable functions, including the questions of whether special safeguards are needed to minimise the risk of destruction of permanently endowed funds, and the optimal relationship between the Commissioner of Charities and charitable investment policies. These issues are deserving of special investigation, but not suitably considered alongside the reforms examined in this Report.

CHAPTER 1

INTRODUCTION

1.1 This Report considers the merits of reforming the rules concerning classification and apportionment of capital and income in trusts. These rules are applicable to capital and income trustees (ie trustees of trusts for successive beneficiaries).[1]

1.2 The proposed reform to modify these rules matches an English initiative which began in 2000 when the UK Trustees Bill 2000 introducing the prudent investor norm was first proposed. In order then not to delay passage of the bill in the UK, concerns which were expressed as to whether the rules relating to capital and income were at odds with the prudent investor norm were reserved for future consideration. After some protraction, the English Law Commission completed this outstanding task and its report containing the Trusts (Capital and Income) Bill was published in 2009.[2] The bill finally received royal assent as the Trusts (Capital and Income) Act 2013[3] on 31 January 2013.

1.3 Following passage of the UK Trustee Act 2000,[4] this Law Reform Committee in a published report also made similar recommendations for adopting various reforms contained in the Act introducing the prudent investor norm.[5] In due course, the Government announced that it would implement those recommendations and in 2004, the Trustees (Amendment) Act was enacted.[6] Like the UK Trusts (Capital and Income) Act 2013, the proposed reform is intended to fill the gap created by the 2004

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1 For convenience, trustees who hold property in trust for successive interests or persons in succession are called capital and income trustees. *Cf* trusts not for successive beneficiaries but for a single beneficiary. The latter may involve payment of income until the single beneficiary attain a specified age thereafter the principal to be paid to him. To be distinguished also from trusts for simultaneous beneficiaries where although there are seemingly income and capital beneficiaries, these are the same people.

2 *Capital and Income in Trusts: Classification and Apportionment* (Law Com No 315) (London: The Stationery Office, 2009).

3 2013 c 1 (UK); after the Bill was introduced in the House of Lords in 2012 leapfrogging the House of Commons as it was regarded as a matter of uncontroversial technical law. Sections 1 to 3 came into force in October 2013. Provisions of section 4 which insert a new section 104B in the Charities Act 2011 (c 25) (UK) came into force in April 2013 while the remaining provisions which insert a new section 104A came into force on 1 January 2014 after the Charity Commission had completed its work on the regulations which would govern permanently endowed charities undertaking total return investment.

4 2000 c 29 (UK).

5 *Reform of Certain Aspects of the Trustees Act: A Report of the Law Reform Committee of the Singapore Academy of Law* (Singapore: Singapore Academy of Law, 2003).

6 No 45 of 2004.

amendments to the Trustees Act[7] by modifying and modernising the rules relating to capital and income and capital in alignment with the prudent investor norm.

1.4 The proposed reform will have an impact on the development of Singapore as a centre of wealth management. It will bring the capital and income rules which are applicable to trusts of property held for successive interests into alignment with the changes in the investment market. It will strengthen the 2004 trust law reforms to implement the prudent investor norm and encourage the professionalisation of trust practice and custodian trusteeship where appropriate. At the same time, it will not impede settlors of small trusts from continuing to place "greater reliance on passive [usually non-professional] rather than active [usually professional] management, which has increased costs" (words in parentheses added by way of adapting the speech of Deputy Prime Minister Tharman Shanmugaratnam).[8]

1.5 There are four parts to this Report. Part I addresses the case for and against implementing total return investment as fulfilment of the prudent investor norm. Part II considers apportionment rules and the need to update them in light of or align them with the prudent investor norm. Part III focuses on a classification rule which is in serious need of reform, namely the rule which classifies corporate distributions in the hands of trustees. Part IV contains a summary of our recommendations as well as certain ancillary issues.

1.6 In the preparation of this Report, the Law Reform Committee sought views from trust practitioners and is grateful to those who took time to read the report in draft but who for reasons of time were unable to provide the Committee with specific comments.

7 Cap 337, 2005 Rev Ed.

8 "Big Opportunity in Asia for Insurers, Says Tharman", *The Straits Times* (14 June 2016).

PART I

CHAPTER 2

TRUSTEES' DUTY TO INVEST TRUST FUNDS

2.1 As a result of the 2004 reforms, all investments are now by default 'authorised' trust investments if they are such as a prudent investor considering the trust investment portfolio as a whole would make. The introduction of this prudent investor norm was necessary in order to reflect and adapt trustee investment to changes in the investment and capital markets. A particularly significant change was the development of portfolio investment management which stresses the importance of diversification of risks among different investment types or classes for the sake of yield maximisation at any given or desired level of risk. Another change was already evident prior to the 2004 amendments. It has since 2004 become a serious alternative investment strategy as investment markets began to offer asset-based securities, and other investment options such as derivatives and options, which produce low income but high capital gains. The new strategy of total return investment responds to these market developments by calling for investments to be made not according, or by reference, to the traditional distinction between capital and income (earning income from maintaining or preserving capital) but with a view to maximising returns in terms of both income and capital appreciation. Total return investment thus assumes that capital gains are as much income as income yields or complete exchangeability between capital and income.

2.2 The investment duties of capital and income trustees can be stated simply. These trustees have a duty to invest or exercise their powers to invest "so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question; and the prospects of the yield of income and capital appreciation both to have to be considered in judging the return from the investment".[9] In line with modern portfolio theory, the prudent trustee will first construct a portfolio of assets to purchase and determine also where or in which account to purchase these assets. After determining the target asset class allocations for the portfolio according to the desired or acceptable level of risk (for example, the respective percentages of bond investments, equity investments and so on), he or she will adopt a total income or income-only investment strategy in seeking to achieve the required minimum distribution or desired return for distribution to income beneficiaries. In the next section, we discuss whether the present classification and apportionment rules preclude capital and income trustees from adopting total return investment as an alternative to total income investment.

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9 *Cowan v Scargill* [1985] 1 Ch 270 at 287, HC (England & Wales). Megarry VC regarded the above as a duty to act in the best interests of present and future beneficiaries of a pension trust fund.

CHAPTER 3

CAPITAL AND INCOME TRUSTEES' DUTY OF IMPARTIALITY

3.1 Capital and income trustees owe a duty of impartiality. Four major aspects or components of the duty of impartiality are typically identified. We discuss the first two aspects which bear directly on the question of total return investment.

3.2 The first is the duty to pay income beneficiaries income earned on trust assets and to hold capital gains for capital beneficiaries. Capital and income trustees have no power to divert income earned to capital beneficiaries in the absence of express provisions in the trust instrument otherwise such as powers to accumulate income. Nor can they sell trust assets to pay the capital gains as income to income beneficiaries in the absence of powers to invade the capital. To this end, capital and income trustees must separate income receipts from capital receipts and maintain distinct accounts.

3.3 The second is the duty to allocate disbursements and expenses as costs of earning the receipt in question. This duty must be discharged fairly as between income and capital. Capital and income trustees must determine what expenses are incurred by capital and by income, as the case may be, and ensure that expenses thus incurred are properly charged to capital and income respectively. In other words, they must maintain income and capital accounts, carrying receipts and charging expenses according to that distinction.

3.4 In a word, capital and income trustees are obligated to keep separate capital and income accounts of receipts, corresponding expenses (in accordance with the classification rules, also known as trust accounting rules) and income and capital distributions.

CHAPTER 4

THE NEED AND REASONS FOR REFORM

4.1 A foremost reason for reform is that capital and income trustees cannot under the present rules adopt total return investment without violating their duty of impartiality. Their duty of impartiality requires that they must invest by reference to the distinction between capital and income; and that they distribute trust property according to that distinction – income to income and capital to capital beneficiaries.

4.2 On the one hand, the fact that capital and income trustees must invest trust funds by reference to capital and income means that they must pursue a balance of income generation and capital preservation.[10] In the previous environment of stable interest rates, capital and income trustees could discharge their duty by investing in reliable high quality bonds and blue chips. In the current environment of low yields, adoption of income-only investment strategies would arguably not be ruled out entirely provided the desired risk level can be achieved by spreading the income paying instruments across industries and economic sectors or regions. The problem is that the desired conservative risk level is difficult to achieve in the present environment of low current yields where managing a portfolio at this risk level frequently means coming short of the required minimum or reasonable income distribution. There are strong views that a total return investment strategy is more likely to satisfy the needs of capital and income trustees in these circumstances.

4.3 The classification rules, however, require separate and distinct treatment of income and capital and the distribution rules will not permit trustees to pay the income beneficiaries out of selling capital stock since capital gains cannot be re-distributed as income and vice versa. There is no general power to adjust as between different capital and income beneficiaries. The primary question for reform is whether these rules seriously impede capital and income trustees from reaping the advantages of total return investment strategies.

10 While they have to aim for the best financial benefits and "to consider total return on assets as the yardstick of their investment performance", this must not prejudice the position of a life tenant (income beneficiary) or a remainderman (capital beneficiary). See *JW v Morgan Trust Co of the Bahamas Ltd* (2001–2002) ITELR 541 at 544, SC (Bahamas).

CHAPTER 5

REFORM OPTIONS

5.1 We considered two principal options of reform:

(1) Allow trustees to invest on a total return basis without regard to the distinction between capital and income and give trustees who do so power to determine income and capital for the purposes of distribution to income and capital beneficiaries and recover disbursements from income or capital in their discretion. A weaker version of this option would be to retain the classification rules as a starting position for the purposes of the duty to maintain capital and income accounts but give trustees power to adjust accounts for purposes of distribution.

(2) Allow trustees to convert to a unitrust or percentage trust. A percentage trust will allow trustees to determine in advance of any course of investment what percentage of total return will be distributed to income and capital respectively. Trustees who have done this will be permitted to invest on a total return basis.

A. ALLOW TRUSTEES HOLDING TRUSTS TO INVEST ON A TOTAL RETURN BASIS AND TO DETERMINE CAPITAL AND INCOME FOR THE PURPOSES OF DISTRIBUTION

5.2 The theoretical merits of this reform seem to be obvious if tax law complications are absent. Under the strong version, capital and income trustees will invest without regard to capital and income rules. All receipts will be regarded as trust income. Trustees will not need to apply the classification of income and capital rules when making investments but will charge expenses or disbursements as well as make distributions in their discretion out of the total return on investments to income and capital.[11] It is possible for trustees to determine the maximal return to be achieved and to make such distributions as are commensurate with achievement of the intended return. The weaker version maintains the classification rules for the purposes of maintaining the capital and income accounts. Trustees who adopt a total return investment strategy will have power make equitable adjustments at appropriate intervals to ensure that the realised income does not entirely accrue to income beneficiaries so that income in excess of the desired return will be allocated to capital beneficiaries. Conversely,

11 Trusts which empower trustees with discretion to determine capital and income for the purposes of making disbursements and distributions are known as discretionary allocation trusts.

where the realised income is lower than the desired total return, trustees will realise and allocate some of the capital gains to make up the deficiency.

5.3 The weaker version is adopted in some 44 United States jurisdictions. Under the Uniform Principal and Income Act approved in 1997, revised in 2004, and amended in 2018,[12] trustees are given discretion to make equitable adjustments between income and capital relating to investments, to be exercised in accordance with enumerated standards and limited or prescribed conditions. An important standard ensures that the discretion to adjust between capital and income is to be exercised only if the income generated under a total return investment strategy is insufficient to meet the required minimum distribution or if as a result of pursuing total return investment the trustee determines that he is unable to allocate income in a fair and impartial manner; for example, where the trust realises significant asset appreciation or capital gain but generates little or no income in the form of dividends or interest. The discretion is further limited to enumerated situations or withdrawn from enumerated situations. Section 104(c), for example, lists a number in situations in which a trustee may not make an adjustment.

5.4 The pros and cons of Option 1 may be summarised as follows. The stronger version giving trustees discretion to determine income and capital (in effect to re-classify) has not seriously been attempted. It gives too wide a discretion and is thought to open up serious possibilities of abuse of discretion. The weaker version has been adopted in many US jurisdictions in the form of the Uniform Principal and Income Act 1997. While it produces a better match, and adapts trust investment functions effectively, to changes in the financial and capital markets, it cannot easily be implemented by lay trustees or by small trusts. It requires trustees to predict capital appreciation, a task daunting to lay trustees and unaffordable by small trusts. Such trustees will also be apprehensive about the higher risks of litigation the exercise of discretion is apt to provoke while beneficiaries may be concerned about risks of abuse of discretion. The US experience does not indicate that the 1997 Act has achieved widespread success. Trustees have been slow to embrace the flexibility afforded to them under the Act. In no small part, this lack of enthusiasm is attributable to the need to match the power of adjustment to tax law and Internal Revenue Service guidelines while increasingly favourable to total return investment continue to leave the tax treatment of adjustments between capital and income unclear.

1. Whether Option 1 is precluded by adverse taxation consequences

5.5 The principal concern about adopting Option 1 in those jurisdictions which have done so is that Option 1 may lead to tax distortions. In those

12 The Uniform Fiduciary, Income and Principal Act approved by the Uniform Law Commissioners in July 2018 is intended to supersede UPAIA 1997.

jurisdictions, therefore, the power to make equitable adjustment may be withdrawn for the avoidance of adverse tax consequences or as a check on its significant potential for abuse. For instance, where the power if exercised would have the effect of a beneficiary being regarded as owner of the asset for income tax purposes which he would not be if the power was not exercised, the trustees may not so exercise the power.

5.6 We note that concerns about taxation distortions either will not arise or are negligible in Singapore. The rule of taxation is that "where a beneficiary is entitled to the trust income or a share of it, the beneficiary may be taxed on the entitlement, and allowed a credit for tax already imposed at the trustee level".[13] However, the Comptroller may also agree to allow a transparent tax treatment so that the beneficiary will be taxed exclusively and directly at his personal level on the distribution received.[14] We understand that the transparent tax treatment is preferred so that income beneficiaries are in most cases taxed at their personal level on the basis of actual receipt of trust income. On the other hand, capital gains are not taxable. If the tax authorities do not regard a statutory power of adjustment as between income and capital as affecting the normal position of tax transparency treatment, which is likely, the result will be tax neutrality as between income and capital beneficiaries. Any distribution from realised capital gains as income will be taxed to the income beneficiary at the personal level as income while capital gains that are eventually distributed as capital will be non-taxable. There will be no question of realised capital gains being distributed as tax free income. Abuse of discretion is possible where trustees notionally shift high income payouts to capital in any tax year in order to minimise an income beneficiary's income tax liability who is also a capital beneficiary. This can be controlled by impugning the exercise of discretion as being improper if it is not directed to meeting the duty of impartiality. In the exceptional event that total return investing results in excess income to be attributed to capital, it will be taxed to the trustee as income before being added to capital. There is again tax neutrality in that the power to adjust between capital and income will not alter the bases on which tax is exigible or not exigible.

B. PERMIT CONVERSION TO UNITRUST OR PERCENTAGE TRUST

5.7 Option 2 involves allowing trustees to determine at stipulated intervals and at least annually trust income as a percentage of trust assets, without regard to the actual source of the income. In the technical jargon, trustees can convert to a unitrust or percentage trust. Trustees who do so

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13 "Background" in *Income Tax Treatment of Trusts* (Singapore: Inland Revenue Authority of Singapore, 2014) <*https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/Other_Taxes/etaxguide_income%20tax%20treatment%20of%20trustsOct2014.pdf*> at 4, [4.2]. See the Income Tax Act (Cap 134, 2014 Rev Ed) ('ITA'), ss 35(11) and 50B(1)(b).

14 ITA, *id*, s 43(2).

can adopt total return investment strategies without breaching their duties of impartiality. This follows because the conversion liberates them from the constraints of the classification rules and consequentially the distribution requirements.

5.8 Option 2 achieves the effect of adjusting between income and capital without the complications and complexities of adjustments. It lessens the administrative burden on trustees but has the drawback of being a blunt *a priori* mechanism to achieve fairness between income and capital beneficiaries. This may explain why only a smaller number of jurisdictions in the US, about 25, have adopted it. Among them, some implement a "Delaware model" statute (allowing trustees to choose between a 3% to 5% unitrust rate) while others following the New York statute specify an inflexible 4% rate. In theory, conversion legislation could allow trustees discretion in wide terms provided only that they choose reasonable and consistent rates. But this is rare in practice.

5.9 Tax considerations again explain why specified percentages of unitrust rates have been imposed. Too low a rate will favour high-income beneficiaries and if unrestrained could be chosen by trustees for the ulterior purpose of minimising the tax burden of high-income beneficiaries. If these are also capital beneficiaries, the accumulations could later be distributed to them as capital gains which meanwhile are taxed at the trust level at lower rates. If unrestrained, too high a rate could be chosen by trustees so as to evade gift tax leviable on gifts from remainder to income beneficiaries. These tax complications, however, are generally of little or no relevance in Singapore where gift tax is unknown and where income receipts not paid to income beneficiaries will be taxed to the trustee at the corporate rate.

CHAPTER 6

CONCLUSIONS AND RECOMMENDATION ON TOTAL RETURN INVESTMENT

6.1 The traditional capital and income distinction worked well for capital and income trustees when investment markets were characterised by high and stable interest rates, steady capital appreciation, and significant distributions of dividends by corporate issuers. They could simply invest in reliable bonds and blue chips, thereby earning a reasonable income whilst preserving capital. It is well known that since the onset of low current yields in 2002, not a few capital and income trustees have struggled to maintain sufficient levels of income while maintaining a conservative asset portfolio. This situation is unlikely to change in the medium to long term. "Higher savings (because people are living longer and need to save) will [...] mean a continuing surplus of savings over investment globally [...] and it also means that interest rates over the medium to long term, even after the normalisation of monetary policy, will remain low."[15]

6.2 Both total income and total return investment strategies have emerged as measures to maximise returns. Income-only investment strategies seek higher income by, *inter alia*, extending the duration of the bond portfolio, and increasing exposure to high-yield bonds and high dividend-paying corporate stock. The problem is that income-only investment strategies may involve high risks of capital loss and not be prudent for capital and income trustees to pursue. Total return strategies in contrast generate the desired higher income by spending capital gains made from capital growth stocks when income return is insufficient. The diversification effects are said to be stronger when total returns are emphasised because the overall risks of all instruments failing will be smaller when they are spread across both income paying and capital growth instruments. Moreover, it is claimed that investment on a total return basis is more likely to provide a successful hedge against inflation in the long term than income-only investment strategies. However, unlike total income investment which predicates predictable income returns, the total return strategy calls for predictions of capital appreciation. The higher uncertainty in predicting capital appreciation gives rise to significant risks of misprediction. This implies that not all trustees will take to it or be willing to incur the costs of seeking expert advice in forecasting future price returns. There are thus divided views over the comparative merits of both strategies. This explains why few jurisdictions have legislated that capital and income trustees be required to adopt total return investment strategies.

15 Shanmugaratnam, above, n 8.

6.3 We acknowledge that capital and income trustees have been seriously challenged in achieving a reasonable income for income beneficiaries in an investment climate of low yields. We also acknowledge that conferring a general statutory power to adjust between capital and income receipts for the purposes of distribution will not be fraught with tax complications. To an extent, such a power can be construed in appropriate circumstances as contained in the trust instrument. For example. a settlor who stipulates a fixed return for distribution in his or her trust instrument executed in a low return environment could be construed as evincing an intention to approve a total return investment strategy. In other cases, his or her reference to providing a reasonable income could be understood to mean a reasonable total return. The possibility of implementing total return however is not a given. Courts must uphold the settlor's intention. They must respect the intention of a settlor who has stated that an income beneficiary shall receive only whatever income can be earned from capital. Where this is the case, to give capital and income trustees a general power of adjustment as between capital and income will be tantamount to altering the intentions of settlors. Unless the case for total return investment is compelling, it would be hard to justify this.

6.4 For us, the critical consideration is that the merits of total return investment are not conclusive across all combinations of risk tolerance, investment experience or level of sophistication as investor, and the specific goals imposed on different trustees. It would therefore also be difficult to justify setting total return investment as a default option at the risk of incurring moral hazards. That risk is significant. Adoption of Option 1 will be seen as a sea change by trustees used to the rigid classification and apportionment rules with their appearance of certainty of application. Some trustees may shy away from relying on equitable adjustment powers, afraid to expose themselves to unnecessary complaint and criticism of their investment policies. Others will unduly incur the costs of implementing total return investment strategies out of abundant caution, fearful of being criticised for ignoring the additional flexibility which they have to adjust between capital and income. In many cases, trustees who lack investment experience and are thus unable to make capital appreciation forecasts would need to incur high costs of seeking expert advice if adoption of such strategies was mandated. In these circumstances, making total return investment available without mandating it could put trustees in an embarrassing position of being criticised if they avail themselves of the facility as well as if they do not. At any rate, once total return investment is permitted, trustees can no longer ignore it but must consider whether to exercise the power from time to time. Trustees of small trusts may find this a difficult, costly and inconvenient imposition. For these reasons, we do not recommend Option 1.

6.5 We also do not recommend Option 2. Although Option 2 is simpler to administer, it would require trustees to select a return based on percentage of total assets. It has the disadvantages of Option 1 without the advantage

of flexibility because it requires trustees to commit themselves to a fixed and perhaps arbitrary percentage.

6.6 Until the economic case for total return investment has become compelling, our view is that the decision to pursue total return investment should be taken not by capital and income trustees but by the settlor conferring the power to do so as part of his or her initial trust design. However, doubts could easily arise as to the extent to, as well as the manner in, which a settlor should direct, in a trust instrument, the trustee to implement the policy of total return investment. For the avoidance of doubts, we recommend that the Trustee Act be amended to clarify that a settlor may so direct the trustee to implement total return investment along the lines of sections 39 and 40 of the Canadian Uniform Trustee Act. In the absence of conferment of the power in the trust instrument, trustees who are unable to meet income requirements in the face of declining income yields can apply to the court under section 56 of the Trustees Act to be permitted to pursue total return investment strategies. In another report where we recommend enacting a statutory variation of trust statute,[16] an application to include a power to adopt total return investment will be even more straightforward if the beneficiaries all consent or where there are beneficiaries incapable of giving consent the court consents on their behalf.

16 *Report on Introducing a Statutory Variation of Trusts Jurisdiction* (Singapore: Law Reform Committee, Singapore Academy of Law, 2019).

PART II

CHAPTER 7

MODIFYING THE APPORTIONMENT RULES TO ALIGN WITH PRUDENT INVESTOR NORM

7.1 In this Part of the Report, we discuss the limited powers of adjustment as between capital and income which are presently available to capital and income trustees and consider whether they should be brought into alignment with investment market changes and the prudent investor norm. Our conclusion is that the limited powers of adjustment have ossified into rigid rules which are no longer sensible under the new investment normal. We therefore make recommendations to disapply them. Such powers of adjustment are confined to limited categories and we do not recommend any changes in the way they are presently identified. In Part III, we do however recommend conferring a new power of adjustment in respect of receipts of corporate distributions to reflect the increasing dissonance between the needs of trust law and the goals of company law.

7.2 Aside from the two duties already considered in paras 4.1 and following, capital and income trustees owe a third and fourth duty for the discharge of which they are vested with limited and restricted powers of adjustment. The third is a duty to make trust assets productive. Capital and income trustees holding property on a trust for sale must convert wasting (or hazardous or over-productive) assets for the sake of fairness to capital beneficiaries as well as non-productive assets so as to earn income for the sake of fairness to income beneficiaries.

7.3 The fourth is a duty to apportion the burdens of trust administration among capital and income, among which is the duty to allocate payments of debts, legacies and administration expenses fairly to both income and capital beneficiaries of residuary property under a will.

A. APPORTIONING ON CONVERTING WASTING OR OVER-PRODUCTIVE ASSETS AND NON-PRODUCTIVE ASSETS

7.4 Where the trust corpus held under a trust for sale includes wasting and non-productive assets, trustees must convert and/or apportion the actual income received or proceeds of sale between income and capital beneficiaries. Wasting or over-productive assets are assets which depreciate in time or decline in value or are otherwise subject to depletion. These are likely to favour income beneficiaries since they yield high levels of income and trustees do not have any duty to create a reserve out of income for depletion, depreciation or amortisation. Non-productive assets are those which do not yield income. These are obviously prejudicial to income beneficiaries.

7.5 Both kinds of assets are dealt with in the rule in *Howe v Earl of Dartmouth*[17] and the rule in *Re Earl of Chesterfield's Trusts*[18] which complements it. The former stipulates in its first limb that trustees holding unauthorised investments comprised in a residuary personal estate (such as wasting and non-productive assets) have a duty (implied) to sell the assets. This rule can be said to have been superseded by the introduction of the principle of prudent investment in 2004. Since trustees are now in substance and effect authorised to invest in any prudent investment, they may continue to retain any unauthorised investments held under a trust of the residue provided it is prudent to retain them as part of the trust investment portfolio.

7.6 The second limb of the rule in *Howe v Earl of Dartmouth* stipulates that trustees holding wasting or over-productive assets on a trust for sale have a duty to sell them within a reasonable period of time, and reinvest the proceeds in productive assets. Pending actual realisation, income beneficiaries are entitled only to interest on an estimated value of the assets and not the actual income which is yielded.

7.7 Under the complementary rule in *Re Earl of Chesterfield's Trusts*, trustees holding non-productive assets such as future property have a duty to sell them and reinvest the proceeds in productive assets. Where however they exercise the power to defer sale of the assets until the assets fall into possession, the proceeds of conversion must be apportioned between income and capital. Upon actual conversion of non-productive assets, income beneficiaries are to be compensated with payment of interest, also known as the delayed income, by way of the formula set out in the case.

7.8 In our view, the rules which have been outlined have become rigid. Trustees must convert wasting assets even though by investment of the portfolio as a whole and making depreciation allowances, they could balance out the effect of individual reduction in capital created by wasting assets taken in isolation. Conversely, they must convert non-productive assets even though they could consistently with the prudent investor norm retain non-productive assets that have high growth potential while adding on more income-producing investments to the trust investment portfolio. The same may be said about retaining wasting assets as part of the trust's investment portfolio. The fact that these rules are routinely disapplied in professionally drafted trust deeds is clear evidence that they have outlived their purposes. The simple reason for this is that the development of portfolio investment management means that these are no longer regarded as second class or inferior assets.

17 (1802) 7 Ves Jr 137, 32 ER 56, and 2 Ves Jr Supp 14, 34 ER 976, HC (England & Wales).

18 (1883) LR 24 Ch D 643, HC (England & Wales).

B. APPORTIONING BURDENS OF LEGACIES AND DEBTS BETWEEN CAPITAL AND INCOME BENEFICIARIES OF THE RESIDUARY ESTATE

7.9 We discuss next a miscellany of rules of adjustment which require trustees to apportion the burdens of trust administration as between capital and income beneficiaries. All but one is statutory. The statutory rule is the burden of apportioning income accruing and hence vesting at differential times among income beneficiaries. Each rule responds to a specific and identified category of impartiality. Each rule has been devised in the interests of impartiality when the settlor has not stipulated his desired method of apportionment. It is well settled that the settlor's intention is governing but where that is undiscernible the court presumes the intention from the nature or type of property.

7.10 One such rule is the rule in *Allhusen v Whittell*,[19] which predicates (a) that the residue bears the burden of payments of legacies, debts and administration expenses, and (b) that where the residue is held on trust, earnings earned on the estate during the year of administration accrues to the income beneficiary. This income will be inflated because part of it will be generated from assets which would later be sold to pay legacies, debts and administration expenses. The rule strives to be fair to the capital beneficiary by requiring the income beneficiary to refund some of the inflated income to the capital beneficiary.[20]

7.11 Criticisms of the rule typically point out that its application is complex because decisions to pay estate burdens are not made at the same time but from time to time during the year of administration. The apportionment in practice must be done on an asset by asset basis. The necessary calculations will be asset-specific and complicated since an estate will usually consist of many different kinds of assets with different yields or returns and executors are free to pay legacies, debts and administration expenses out of any part or portion of the estate. Furthermore, although the payments to be made may be small amounts, relatively costly calculations must be made to achieve the apportionment called for by the rule. We observe that these shortcomings of the rule in modern applications weighed heavily with the English Law Commission which recommended disapplication of the rule.

7.12 An important predicate of the rule which is often glossed over is that the same distinction between income and capital must also be maintained

19 (1867) LR 4 Eq 295, HC (England & Wales).

20 Trustees of the residuary estate must calculate what portion of the asset which together with the income earned from it prior to payment would be required to make the payment in question. Income beneficiaries will not be entitled to the full income earned on the asset during the year of administration but only such income less the income earned on the portion actually used to make the payment in question. The rest will go to the capital beneficiary.

with respect to pre-trust assets which are specifically designated and ultimately destined to be held on residuary trust. With conversion to the prudent investor norm, this underlying predicate is sensible if the pre-trust assets already make up such a trust investment portfolio as would in the view of a prudent investor befit the residuary trust. Where they do not (a likely event), what is needed is to ensure that adjustments are made when implementing the prudent investor norm so as to minimise differences in income and capital allocation in the interval between commencement of administration of the estate and commencement of the residuary trust. The rule in *Allhusen v Whittell* is too rigid, somewhat arbitrary, and fails to do this.

C. APPORTIONMENT ACT 1870

7.13 There are also rules of time apportionment which apportion receipts and disbursements at the beginning of and preceding the creation of the trust or commencement of an income interest. Apportionment of receipts and disbursements between income and capital beneficiaries is necessary if they accrue or are attributable to a period that precedes the creation of the trust. In the case of testamentary trusts, periodic receipts and recurring disbursements must be apportioned by reference to the time of death of the testator. Thus, receipts accrued before death will accrue to capital and income beneficiaries will be entitled to those accrued after death.

7.14 As between successive income beneficiaries, periodic receipts are not apportioned but accrue to the income beneficiary who is the beneficiary on the date at which they arise. In 1870, the Apportionment Act[21] was introduced in England to require periodic receipts to be treated as accruing from day to day, thereby legislating for apportionment of periodic receipts among all income beneficiaries.

7.15 The 1870 Act did not become part of the law in Singapore until 1928. In *Re Alkaff's Settlements*,[22] it was held by the Straits Settlements Supreme Court that this Act was not part of the law in the Straits Settlements.[23] In 1928, however, the Apportionment Ordinance[24] was passed in exactly the same terms as the 1870 Act, presumably to overrule the above decision.[25]

7.16 The English Law Commission noted that the 1870 Act often had to be applied to small sums of money and as a result called for disproportionate

21 33 & 34 Vict, c 35 (UK).
22 [1928] SSLR 188, SC (Straits Settlements).
23 *Cf Re Fleury* [1928] SSLR 113, SC (Straits Settlements), where Murison CJ applied it on the basis that the testator (a British subject) had adopted the rule in clause 1 of his will whereby he declared his desire for his will to take effect according to English law.
24 No 25 of 1928 (Straits Settlements).
25 The Ordinance was modelled exactly on the 1870 Act and was left unaltered as Chapter 8 of the 1998 Revised Edition of the Statutes.

expenditure of trust administration expenses. In the Commission's opinion, the statutory time apportionment rule is unfair to life tenants in certain circumstances and inconvenient and expensive to implement when the sums involved are relatively small. Disapplication of the statutory rule means that the original rule that income accrues to the income beneficiary for the time being of an *inter vivos* trust will no longer be qualified by time apportionment. It was felt that a settlor who does not wish to avoid the disproportionately expensive application of the statutory rule should be the one to write the rule expressly into his or her intended trust. We note that in the case of investments in corporate stock the Act exacerbates the fact that the timing of payment, and receipt, of dividends is not something trustees can foresee but depends on external considerations over which trustees have no control and known only to the corporate issuer whose stock is held in trust. The Act therefore has the effect of impeding investment decisions in corporate stock.

7.17 In our view, the statutory apportionment of time sensitive payments has outlived its rationale. It is no longer consistent with the adoption of the prudent investor norm. As we have said before, the norm leaves considerable discretion to trustees to time investments as well as review them. The rule has in relation to corporate stock investment become inconvenient and arbitrary. It purports to require trustees to do justice as between income beneficiaries when it is not open to them to predict or foresee the timing of payments of corporate dividends. We note that if the rule is disapplied, and not abrogated, its applicability to contractual claims to a portion of a lump sum salary will not be affected.[26]

D. EQUITABLE ADJUSTMENTS RELATING TO TAX IMPLICATIONS OF TRUST AND ADMINISTRATION EXPENSES

7.18 The duty of impartiality in relation to tax and administration expenses is only implicated in very circumscribed contexts. The first context in which difficulties of unfairness of tax burdens may arise is where in administrations of estates, executors have discretion to elect to deduct administration expenses for income tax purposes rather than for estate duty purposes. In the event they elect the former course, the capital beneficiaries will benefit at the expense of income beneficiaries and vice versa. This context is irrelevant in Singapore following the abolition of estate duties in February 2008. The second context is where both income and capital gains are taxable at differential rates. In the event that trustees have discretion to deduct trust expenses from capital, rather than income, capital beneficiaries may benefit more than income beneficiaries and vice versa. This context is also irrelevant since there is no capital gains tax and

26 See *Item Software (UK) Ltd v Fassihi* [2004] EWCA 1244, [2004] IRLR 928, CA (England & Wales). See also Paul Matthews, "Salaries in the Apportionment Act 1870" (1982) 2 Legal Studies 302.

deductible expenses under the classification rules are entirely those which are incurred for the purposes of generating income.

E. APPORTIONMENT OF LOSS OF PRINCIPAL FOLLOWING A LOAN SECURITY DEFAULT

7.19 Mention should be made of the rule in *Re Atkinson*[27] which requires trustees who have invested in a mortgage security or debenture stock in a company or other loan security, as an authorised investment, to apportion the loss of trust funds, where the realisation of the security is insufficient to redeem the debt in full. Trustees are to allocate the net proceeds of realisation between income and capital in the proportion that the interest due bears to the principal sum.

7.20 This rule is a specialised rule apportioning capital and income loss between income and capital beneficiaries rateably. It does not appear to have caused serious difficulties in practice and is consistent with the prudent investor norm, if by authorised mortgage investment is meant a prudent mortgage investment. It is to be opposed to the rule in *Cox v Cox*,[28] which apportions loss when trustees have invested in an unauthorised mortgage security the realisation of which is deficient. Where realisation of the unauthorised mortgage security is insufficient to repay principal and interest outstanding, the income and capital beneficiaries will bear the loss rateably in proportion to the total income and capital that would have been received in the same period from an authorised loan security. Put another way, the capital beneficiaries will receive the amount from the net proceeds which with interest thereon would equal the net proceeds and income beneficiaries the rest. The difference between the two rules of apportionment is that the rule in *Re Atkinson* apportions the loss in accordance with the mortgage interest rate. The rule in *Cox v Cox* employs the interest rate that would have been earned on an authorised loan security.

7.21 We note that the rule of apportionment of loss of capital is fully consistent with total return investment and remains essential to deal fairly as between income and capital where trustees make loan security investments. Such investments are typically made by considering the joint benefit of income and capital beneficiaries after computing and factoring in the predictable value of the security in the event of default weighted against the likelihood of default. Trustees are very likely to consider whether such investments would be prudent as part of the trust investment portfolio on the basis that any loss will be apportioned between income and capital in the proportion that income bears to capital. The rule in *Cox v Cox*, however, is substantially superseded by the prudent investor norm. If

27 *Re Atkinson, Barbers' Company v Grose-Smith* (1904) 2 Ch 160, CA (England & Wales).

28 (1869) LR 8 Eq 343, HC (England & Wales).

a risky mortgage cannot be justified on the prudent investor norm, it will be an imprudent investment and any loss will have to be made good by the defaulting trustees with interest.

CHAPTER 8

REFORM – DISAPPLYING EQUITABLE APPORTIONMENT RULES WHICH IMPEDE PRUDENT INVESTMENT

8.1 With the exception of the rule in *Re Atkinson*, the rules of adjustment no longer sit well with the prudent investor norm. The English Law Commission recommended prospective disapplication of the rules of apportionment with an opting out option. We should emphasise that the Trusts (Capital and Income) Act 2013 Act which implements that recommendation does not abrogate the duty of impartiality embodied in the equitable apportionment rules. By disapplying the equitable rules, the duty of impartiality is technically restored to its pristine character. This duty trustees can choose to satisfy by for example retaining wasting assets and creating a reserve for depreciation or amortisation. In similar fashion, trustees who are subject to the disapplication of the rules and desire to purchase reversionary interests can adopt at the pre-investment stage a portfolio which will include high-income but more risky investments to compensate income beneficiaries for income foregone on the reversionary interests. Again, consistent with the prudent investor norm, trustees can satisfy their duty of fairness as between different classes of income beneficiaries by making pre-investment adjustments which factor in the differential time receipts flowing from intended investments.

8.2 Similarly, in relation to the rule in *Allhusen v Whittell*, the effect of its disapplication is that trustees who receive the residuary estate can now discharge their duty of impartiality by broadly taking into account, when making initial portfolio investments, the preceding uneven allocation between income and capital in relation to payments of debts, legacies and administration expenses.

8.3 We agree that disapplication instead of abrogation is appropriate in reminding capital and income trustees that the duty of impartiality is not superseded. However, we would go further than the English Law Commission in recommending retroactive application to trusts created before the coming into force of the reform. This does not mean that previous applications of the rules would have to be unwound. Such applications will remain intact and cannot be called into question or revisited. We appreciate that prospective disapplication of the rules of adjustment has the advantage that it will not engender doubts about the construction of trust instruments which may or have been drafted on the basis of pre-existing apportionment rules. However, the retroactive application we recommend will be limited to instances where trustees have failed to make adjustments at the material time. As between income and capital beneficiaries, disapplication of the rules of adjustment will lead to a fairer outcome consistent with the prudent investor norm.

8.4 In its report, the English Law Commission also recommended disapplication of the rule in *Re Atkinson* which relates to the allocating of loss among income and capital beneficiaries when there is a shortfall in principal and income from realising a deficient loan security. The Law Commission acknowledged that without apportionment the realisation of the security would only compensate the capital beneficiaries. However, the Commission ultimately recommended its disapplication for reasons of convenience and expedience; the retention of the rule it was thought would be more onerous than beneficial. This recommendation to abolish the rule was not accepted in the course of passage of the eventual Act where the opposite view prevailed. We recommend retention of the rule in *Re Atkinson* for the reasons given in paragraph 7.21 above.

PART III

CHAPTER 9

ATTRIBUTION OF RECEIPTS AND EXPENSES WITH RESPECT TO NON-CORPORATE DISTRIBUTIONS ARE GENERALLY UNPROBLEMATIC

9.1 In this Part we set out the classification rules in outline and then proceed to consider the merits of reforming one of these rules, namely the rule in *Bouch v Sproule*.[29] Classification of receipts and expenses into income and capital is a duty incumbent on such trustees. Generally speaking, receipts are classified according to source. Income receipts are a current return on principal which does not impair it. Capital receipts are accretions to capital, such as capital appreciation, proceeds of sale of principal and insurance proceeds payable on destruction or loss of trust assets.

9.2 A similar classification is necessary for allocating expenditures incurred in trust administration in general and in making investments in particular.[30] Generally speaking, ordinary current and recurring expenses are chargeable to income whether or not they are necessary to preserve trust property or its value. Extraordinary expenses such as the costs of capital improvements or purchase of trust assets are chargeable to capital. This classification of expenses may not always coincide with the classification of receipts. For instance, expenditures incurred in preserving capital are nevertheless payable out of income whereas expenditures which are extraordinary such as extraordinary repairs or improvements are payable out of capital though they will also benefit income beneficiaries.

9.3 Despite their complexities, the classification rules which are in the nature of default rules do not appear to have given significant difficulties in practice insofar as non-corporate receipts and expenses are concerned. The need for flexibility is easily foreseen at the outset when the trust is created and trust deeds often in practice inject needed flexibility to the classification of receipts and expenses by making express provisions for trustees to defray stipulated expenses regardless of whether they would otherwise be chargeable to income or capital.

A. CLASSIFYING CORPORATE DISTRIBUTIONS TO TRUSTEE SHAREHOLDERS

9.4 The same, however, cannot be said of corporate receipts paid to trustee shareholders of shares in company stock. The pertinent allocation

29 As stated by Fry LJ in (1885) 29 Ch D 635 at 658–659, CA (England & Wales), and affirmed by the House of Lords in (1887) LR 12 App Cas 385, although reversing the Court of Appeal on the result of application of the rule.

30 See *Carver v Duncan* [1985] AC 1082, HL (UK).

rules were singled out for special attention by the English Law Commission in its report. Difficulties of allocating receipts derived from trustee investments in shares of company stock have also been litigated in Singapore when dividends are paid in cash, shares or other property or when receipts are made following the liquidation in whole or in part of the company concerned.[31] These difficulties stem from applying to trust property the classification of income and capital according to company law which is entailed because trust law obligates trustees to classify receipts according to source. As a result, the rule in *Bouch v Sproule*[32] regards dividends paid out of a declaring company's profits as being income and those paid out of capital as capital. The form in which the distribution is made, whether in cash or declaring company's own stock or other property of the company, is not the basis of classification. The source of the distribution is. If, for instance, instead of declaring dividends out of profits, the directors of the company concerned intended to capitalise the profits and use company reserves to issue paid-up shares to shareholders, the stock issue will be regarded in the hands of trustee shareholders as being a capital receipt.

9.5 The rule under examination has been criticised for ignoring the realities of investment in modern corporate stock. Investors in modern corporate stock do so both for the sake of gaining value (and hedging against inflation) as well as earning returns by way of distribution of dividends. Modern corporations satisfy their investors by both retaining profits so as to build up reserves, enhancing the value of their shares, as well as making dividend distributions or by a return of capital. Whichever mode of satisfying investors is adopted, it is clear that both capital and income considerations are implicated. The choice between them is a matter of capital budgeting and depends on whether the issuer considers it more expedient to reinvest profits for the sake of higher net present value. Yet the rule rigidly constrains trustees to regard payments of dividends as income and payments by way of authorised share reduction as capital. This has led to a much-criticised result, namely that shares received from a demerger by way of dividends are regarded as accruing to income. In *Sinclair v Lee*,[33] it was, however, held that such shares would be capital in a case of indirect demerger. That decision by no means suggests that the courts now accept that there is flexibility in classifying capital and income by reference to matters other than the machinery by which the assets are distributed. In *First Nationwide v Revenue and Customs Commissioners*[34] the English Court of Appeal held that *Sinclair v Lee* was a decision on its facts.[35]

31 In *Re Fleury*, above n 23, Murison CJ held that a right to subscribe for further shares at a discounted price and bonus shares representing capitalisations of profits accrued to capital although the income therefrom would belong to income.

32 Above, n 29.

33 [1993] Ch 497, HC (England & Wales).

34 [2012] STC 1261, CA (England & Wales).

35 *Id* at [26].

The mechanisms of payment whether by payment of dividends or by authorised share reduction alone determines the capital or income classification of corporate shares.

9.6 The rule in *Bouch v Sproule* has also produced inconsistent results, not all of which can be eliminated or mitigated by exercise of a judicial discretion to moderate the rigidity of the classification. A glaring example arises when no dividends are paid although profits are made by the company whose stock is held in trust. The rule produces no income for income beneficiaries in the 'years of drought' and no recovery from the proceeds of sale of the stock for undistributed earnings accrued in those years. Another major criticism of the rule is that judicial development cannot eradicate the practical difficulty arising from classification by the company law distinction between income and capital, namely that examination of company records is required for a successful classification of capital and income of receipts by the trustees. Trustees will understandably feel unsafe in relying on statements made by the company about the source of the distribution as conclusive. While the rule can in theory be circumvented by the settlor making express provision as to allocation of corporate dividends and other kinds of corporate distributions, in practice, settlors have seldom manifested any such intention. This could be because the technical rule was not well known under the previous investment regime with its limited avenues of investing in corporate stock. In any case, settlors would not easily have foreseen the circumstances under which companies might decide on one or another form of distributions to shareholders.

9.7 In summary, we consider that despite its complexities, the classification rules have worked relatively well with the exception of the rule in *Bouch v Sproule*. We note that consideration of the last-mentioned rule is particularly important as trustees of a larger trust for successive interests in today's investment climate cannot forego investing a high proportion of trust funds in corporate stock in order to seek higher income at a reasonable and acceptable risk of capital loss.

CHAPTER 10

REFORM OPTION – CORPORATE STOCK

10.1 In relation to the rule in *Bouch v Sproule*,[36] the English Law Commission would have preferred to replace it with a simpler rule whereby cash distributions are treated as income while non-cash receipts are treated as capital, coupled with a power to make adjustments. However, without a guarantee of tax neutrality from Revenue, the Commission had to forego their preferred option for a narrower version for the sake of tax neutrality. The result is a very narrow recommendation: "all distributions falling within sections 213(2) or 213A of the Income and Corporation Taxes Act 1988[37] (defined as exempt distributions in section 218) should be classified as capital for trust law purposes".

10.2 Similar tax complications do not exist in this country where corporate dividends are non-taxable at both trustee and beneficiary levels.

10.3 We agree that the rule that the English Law Commission would have recommended but for tax complications has strong merits. The rule in *Bouch v Sproule* should be replaced by a statutory rule that all distributions from a company to a trustee shareholder shall be regarded as income if they are cash receipts and capital if they are non-cash. Trustees will have a power to make adjustments between income and capital. This power will clearly be tax neutral since corporate distributions are taxed at source once only.

36 Above, n 29.
37 1988 c 1 (UK).

PART IV

CHAPTER 11

RECOMMENDATIONS IN SUMMARY

11.1 Trustees need to have flexibility to respond and adapt to changes in the financial, capital and property markets. The evolution of these markets continues to obliterate or eviscerate the traditional dichotomous distinction between capital and income. As a result, the risk and yield profiles of investments which lie on a spectrum can no longer be neatly compartmentalised according to these traditional dichotomous categories. At the same time, the investment market can no longer be neatly categorised by types and singular characteristics. Hybrid investment products are continually introduced consistent with prevailing portfolio investment practices. The result is that trustees can no longer avoid exercising more pronounced discretion in choice of investments. Moreover, investment market dynamics exhibit significant negative correlations between types of investment resulting in a changing spectrum of investments ranging from high income and high risk investments to low or no income and high capital growth investments. These values do not necessarily stay constant over the period of investment. Trustees must also exercise discretion in reviewing the trust investment portfolio. The more particular problem we have sought to address in this Report is the problem of low income yields which has characterised the investment market since 2002. The problem looks to be enduring in the light of demographic changes as well as slowing technological productivity.

11.2 Option 1 which involves conferring a power to determine capital and income will facilitate adoption by capital and income trustees of total return investment strategies. Although tax complications or adverse tax consequences are generally absent and the risks of tax distortion negligible, we recommend that Option 1 should not be adopted for the reasons given at paragraph 6.4 of this Report.

11.3 Option 2 is also not supported for the reasons given at paragraph 6.5 of this Report.

11.4 Instead, we recommend that the decision to adopt a policy of total return investment should be left to the settlor of a capital and income trust who may direct in the terms of his or her trust that the trustee pursue such a policy in respect of all or any part of trust property.

11.5 On the other hand, although a general power of adjustment does not exist, the case law recognises that capital and income trustees have limited powers to adjust between capital and income in accordance with a number of equitable apportionment rules. These rules by and large were judicially created formulas attempting to crystallise more precisely the duty of impartiality in specific instances. Since the basis for these formulas has disappeared with the introduction of the prudent investor norm, we

recommend that they should with one exception be disapplied with retroactive effect. The exception is the rule in *Re Atkinson*[38] which is consistent with the prudent investor norm.

11.5 With respect to the rule in *Bouch v Sproule*,[39] our recommendations are twofold. First, the rule should be replaced by a simple rule which treats cash payments as income and non-cash distributions as capital in the hands of trustee shareholders. Second, such capital and income trustees will be given a limited statutory power to adjust between capital and income. This means that trustees minded to invest in corporate stock can adopt a limited total return investment strategy by holding a portfolio of high income and capital growth stocks. To a limited extent, these recommendations pave the way for capital and income trustees to deepen investments in corporate stock and shares in order to alleviate such problems of low income yields as they may face.

38 Above, n 27.
39 Above, n 29.

CHAPTER 12

WHERE TOTAL RETURN INVESTMENT OR UNITRUST CONVERSION IS MANDATED OR PERMISSIBLE BY FOREIGN GOVERNING LAW

12.1 As we have pointed out, we do not find any fundamental objection to settlor-imposed mandatory total return investment obligations on capital and income trustees. Nor do we see that there is any such objection to mandatory total return investment obligations imposed by foreign governing law. Where the trust is governed by foreign law which permits total return investment, and the trustees are amenable to the jurisdiction of the courts in Singapore, it should be clarified that any exercise of the power of adjustment between capital and income shall be deemed valid if adjusted in a manner not prohibited under applicable law and in accordance with it. Although we do not recommend Option 1 or 2, there is nothing contrary to Singapore policy about total return investment by capital and income trustees and it is right that trustees of a trust which has relocated or migrated to Singapore should continue to have recourse to the power of adjustment between capital and income in accordance with the foreign law. Where the trust is not stated to be governed by foreign applicable law, but was subject to foreign trust law providing for total return investment, the question of income and capital should not be governed by the law of the country of present trust administration but should presumptively be governed by the previous law unless rebutted.

CHAPTER 13

WHETHER PERMANENTLY ENDOWED CHARITABLE TRUSTS TO BE EMPOWERED TO ADOPT TOTAL RETURN INVESTMENT

13.1 Unlike the English Law Commission, we have not considered whether trustees of permanently endowed charitable trusts and other permanently endowed public trusts should be permitted to adopt total return investment. On the one hand, tax considerations are of no concern and not a barrier to such reform. Since charitable and other recognised public trusts are not required to pay tax on income expended on charitable or public purposes, difficulties of non-tax neutrality when making adjustments between income and capital are virtually non-existent. On the other, the promise of higher income available to promote the charitable mission seems to offer an attractive argument for supporting the reform.

13.2 In our view, the question of charities and investment is not a straightforward question of technical law. It raises complex issues of whether and the extent to which risk taking by charities is compatible with the conduct of charitable functions, including the question of special safeguards to minimise risks of destruction of the permanent endowment funds. Moreover, the question of availability of total return investment is only one of a number of controversial questions of investment by charities including social investment by charities. Still further, there are also difficult questions of policies and charity administration such as the optimal relationship between the Commissioner of Charities and charitable investment policies.

13.3 Our conclusion therefore is that reforms similar to those which have been conducted in the UK are deserving of special study and investigation but are not suitably considered alongside the reforms discussed and examined in this report.

ISBN 978-981-14-4302-2 (softcover)
978-981-14-4303-9 (e-book)