

SHOULD THE TRUST DRAFTSMAN EXCLUDE THE APPORTIONMENT ACT 1870?

James Kessler¹

This is the first of two articles discussing points of difficulty in trust drafting. This article asks whether the trust draftsman should exclude the provisions of the Apportionment Act 1870. The second will consider provisions authorising capital expenditure to be paid out of trust income.

The Statutory Apportionment Rule

Trustees receive income periodically. Under the Apportionment Act 1870 income is treated as accruing from day to day. This means that when there is a change in the beneficiary entitled to income, the income may need to be apportioned.

The matter is best illustrated by example.

Example 1

Trustees hold a trust fund on trust for A for life, remainder to B. A dies on 31st January 1992. Then:

- (1) At the end of March 1992 the trustees may receive rent for the quarter January to March 1992. A's estate will be entitled to one third of the rent.
- (2) In 1993 trustees may receive dividends for the calendar year 1992. A's estate will be entitled to one twelfth of the dividends.

¹ James Kessler, Tax Counsel, 24 Old Buildings, Lincoln's Inn,
London WC2A 3UJ Tel: (071) 242 2744 Fax: (071) 831 8095

The apportionment rule is intended to operate fairly between the different beneficiaries (or their estates). The rule produces fairness, but an expensive fairness: the operation of the rules is cumbersome.

The sums involved are usually small, and the calculations tedious. Like motorists with the urban speed limit, trustees ignore the apportionment rule if they feel they can do so safely. So common is this practice that some trustees are not even aware of the rule.

The effect of the apportionment rule - if it is applied strictly - will often be unfortunate in relation to settlements which fail to give trustees wide powers.

There are two classic examples:

(a) *Apportionment on death may deprive a widow of income*

Suppose H by his will leaves his estate to his widow for life with remainder to his children. After the death of H the trustees will receive income. They must apportion the income so that:

- (a) Income attributable to the period before the death of H will be apportioned to H's estate (and treated as trust capital).
- (b) Only income attributable to the period after the death of H will be payable to the widow.

In this way the apportionment rule prevents the widow from enjoying the full income from her husband's estate at a time when she may most need it: during the year after the husband's death.²

(b) *Apportionment on attaining majority may deprive the child of income*

Consider a trust for X if he attains the age of 25; assume the standard provisions of section 31 Trustee Act 1925 apply to trust income. After X attains the age of 18 the trustees must apportion income so that:-

- (a) Income attributable to the period before X reaches 18 must be accumulated.

² If the trustees have the power to apply capital for the benefit of the wife the problem is easily solved.

- (b) Only income attributable to the period after X reaches 18 is payable to him.

In this way the apportionment rule prevents the child from enjoying the full income from the trust during the year after he attains 18.³

In view of these difficulties, it is plainly desirable if possible to direct that these apportionment rules should not apply. This is also the view of a very distinguished Law Reform Committee who recommended effective abolition of the rule.⁴

Can the apportionment rule be reversed? As a matter of trust law there is no difficulty.⁵

A tax problem?

The tax position is more controversial. It has been suggested that the exclusion of the rule would prevent a beneficiary from enjoying an interest in possession in the trust fund.⁶ If this view were correct, then a settlement which excludes the usual apportionment rule would not qualify as an interest in possession or an accumulation and maintenance settlement; in short, disaster and catastrophe. Some draftsmen therefore prefer not to exclude the usual rule, however inconvenient that might be.

The purpose of this article is to set out the arguments against that view.

³ The trustees have no statutory power to apply that income for the benefit of the child as that power arises only during infancy. The case of *Re Joel* [1967] Ch 14 is sometimes cited as authority for this proposition, but the terms of s. 31 are so clear that authority is hardly needed. The problem does not arise if the trustees have adequate powers, such as the power conferred by STEP Standard Provisions clause 3(5).

⁴ Reform Committee 23rd Report (the powers and duties of trustees), para. 3.39.

⁵ Apportionment Act 1870 s.7 directs that the provisions of the section do not apply in any case where it is expressly stipulated that no apportionment shall take place.

⁶ The same fear is expressed in Venables, Thornhill and Jepson, *Tax Planning Through Wills* (2nd ed., 1984) p. 181.

Two Arguments from Principle

Since the decision of the House of Lords in *Pearson v IRC* [1980] STC 318 the basic law is plain: an interest in possession must confer the present right to the present enjoyment of the settlement. In Lord Keith's words in that case, there must be an *absolute right to any income as it accrues*. Does the exclusion of the apportionment rule affect that?

Let us begin with first principles. The starting point is to realise that the word "income" is not one with a single or precise meaning.⁷ Likewise the word "accrues". In example 1 above, trustees received rental income shortly after A, the life tenant, had died. Let us consider the income which may be said to have accrued during A's life, though it was only paid to the trustees after his death. Is this the income of A, the life tenant, or is it the income of B, the remainderman? In principle, there is something to be said for each view:

- (1) A can claim it should be his income, since he was alive while the right to the rent was accruing.
- (2) B can claim it as his income, since he was entitled to the property when the day for payment of the rent came.

The lawyer (unlike the economist) cannot admit the ambiguity. There must be a rule, and of course the statutory rule gives effect to A's claim and not B's. But after altering the rule, A still has the right to the "income of the settlement as it accrues". The draftsman has merely selected a slightly different definition of "income" (or "accrue") *which in principle is as legitimate as the statutory trust law definition*. After all, the draftsman has basically selected the definition of "income" or "accrue" which applies for income tax purposes. Tax is charged when income is payable or paid, not as it accrues from day to day.

The reader might object that when Lord Keith referred to "the right to income as it accrued" he must have been referring to "income" and "accrue" in the trust law sense, not the tax law sense; and the trust law sense must incorporate the Apportionment Act rules. The answer is that the Apportionment Act rules are not an essential part of the trust law concept of "income" or "accrue". They simply represent a *prima facie* assumption which the draftsman may modify if he thinks fit.

⁷ Some economists would deny that the word had any meaning. Thus Hicks (cited in J A Kay, *Is Complexity in Taxation Inevitable?* IFS Working Paper 57): "We should eschew the concepts of income and capital in economic analysis. They are bad tools, which break in our hands." Unfortunately, this option is not open to the trust or tax practitioner.

There is one further argument of principle. The exclusion of the apportionment rule is not in fact a matter of very great import. Its effect is transient: a year after the death of A, there will in practice be no more apportionment. The whole issue can be described as a mere administrative matter, and may be ignored just as any administrative provision may be ignored in recognising an interest in possession.

Three Anomalies

These arguments from principle alone will not satisfy the sceptics. Let us therefore consider the consequences of what I shall call the strict view, that an exclusion of the apportionment rule may prevent the existence of an interest in possession.

(1) Protected interests are not interests in possession

The Apportionment Act 1870 does not apply to protected interests: *Re Gourju* [1943] Ch 24. On what I have called the strict view, it must follow that every settlement which directs income to be held on protective trusts (governed by s.33 Trustee Act 1925) is in fact a discretionary settlement. That is quite untenable: see s.88 Inheritance Tax Act 1984.

(2) No interest in possession in policies of assurance

The 1870 Act does not apply to annual payments made payable in policies of assurance.⁸ So on the strict view there can be no interest in possession in such policies (unless the settlement makes express provision to extend the 1870 Act). That seems very unlikely.

(3) No interests in possession existed at common law

The Apportionment Act rule is a statutory modification of the case law rules and dates from the Apportionment Act 1834. Before the statutory enactments, interest was apportioned but other income payments were not. This is plainly stated in the recital to the 1870 Act: *Whereas rents and some other periodical payments are not at common law apportionable (like interest on money lent) in respect of time...*

Yet the phrase "interest in possession" was taken in *Pearson* to be equivalent to the 19th century conveyancing term "estate in possession" and the idea that such estates were not "in possession" until the enactment of the 1834 Act is absurd.

⁸ S.6 Apportionment Act 1870.

In view of these anomalies, it is submitted that no Court would possibly contemplate the strict view that the apportionment rules are essential to an interest in possession. The way is therefore clear for the draftsman to exclude them.

Drafting Notes

STEP Standard Provisions take the following form:

Income and expenditure shall be treated as arising when payable, and not from day to day, so that no apportionment shall take place.

The drafting echoes the terms of the statute.⁹

In my book *Drafting Trusts & Will Trusts*, the exclusion of the apportionment rule was made subject to an Interest in Possession Protection Clause. That is, the provision did not operate if (contrary to the view of the law set out here) the clause was incompatible with an interest in possession. STEP Standard Provisions takes the same form. The precaution is strictly unnecessary, but no harm is done: the apportionment rule is still excluded.

Conclusion

The draftsman can and should exclude the rules of the Apportionment Act 1870 in drafting lifetime settlements and will trusts.

There remains the question of capital and income clauses which I hope to address in another article.

⁹ Apportionment Act 1870 s.7.