Total Return Investing by Trustees

A Report prepared for the British Columbia Law Institute by its Committee on the Modernization of the *Trustee Act*

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BCLI Report No. 16
August 2001

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(a) promote the clarification and simplification of the law and its adaptation to modern social needs,
(b) promote improvement of the administration of justice and respect for the rule of law, and
(c) promote and carry out scholarly legal research.

The Institute is the effective successor to the Law Reform Commission of British Columbia which ceased operations in 1997.

The British Columbia Law Institute gratefully acknowledges the financial support of the Law Foundation of British Columbia in carrying out its work

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National Library of Canada Cataloguing in Publication Data

British Columbia Law Institute. Committee on the Modernization of the Trustee Act.

Total return investing by trustees

ISBN 1-894278-11-9

1. British Columbia. Trustee Act. 2. Trusts and trustees--British Columbia. 3. Charitable uses, trusts, and foundations--British Columbia.
I. British Columbia Law Institute. II. Title.
KEB242.M3B75 2001 346.71105'9 C2001-911182-7
KF740.B75 2001

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I. Investment Strategy and the Distinction Between Capital and Income

Trustees invest the trust property in order to bring about an increase in value to the trust estate and protect the trust capital. When there is one class of beneficiaries with identical rights, whether their interests be fixed or discretionary, the source of the gains flowing from investment of the trust property is generally immaterial. Where there are successive beneficial interests, such as the fairly common situation in which one beneficiary has a life interest that is followed by a gift of the trust capital to another beneficiary, the character of the different sources of revenue becomes significant. The governing principle is that the life tenant is entitled only to income and the capital beneficiary is entitled only to capital, unless the settlor has indicated a different intention in the terms of the trust.

"Capital" is the original trust property, enlarged by growth in its purchasing power over the course of time. "Income," in the trust sense, is made up of the periodic revenues from the use of the trust property. Into the category of income fall interest, rents, and cash dividends. In addition to these obvious cases, there are many kinds of receipts which are not so readily characterized. The many forms of corporate distributions to shareholders are classified according to whether they represent distributions out of current profits, or reflect the capitalization of profits.[(1)] Thus stock dividends, distributions to existing shareholders of rights to purchase shares, and payments made to redeem preferred shares, are treated as capital.

A. Trustee's Duty of Evenhandedness

Unless the terms of the trust show that the settlor had a different intention, trustees are obliged to administer the trust so as not to favour one class of beneficiaries over another. This duty of evenhandedness requires the trustee to invest so as to maintain a careful balance between income and capital growth, a very difficult task. Trustees must consider the nature of returns that existing and proposed investments will bring in light of the conventional rules for allocating the returns to either the capital or income accounts. They must estimate the degree to which a proposed investment will enhance each account.

For example, common shares with excellent growth potential may bring little or no dividend income. When held for a substantial period, the entire gain in value would accrue to the beneficiary who gets the capital of the trust after the end of the life estate. Fixed rate bonds may provide a good rate of income, but their market value may be static or decline, and thus provide no prospect for any increase on the capital side. If the investment strategy pursued by a trustee results in gains to the value of the trust estate being skewed one way or the other in terms of capital and income, the trustee may be in breach of trust even though the overall return to the trust estate, in terms of absolute gain within an accounting period, is excellent.[(2)]

B. Incompatibility of Traditional Capital and Income-Based Investment with Modern Investment Practice

While the duty of evenhandedness retains its validity as a general principle, the way that present trust law requires it to be applied has been seriously out of keeping with the nature of the investment market for the last three decades, at the very least. The long-term rate of return from equity investments has consistently been shown to outstrip that on bonds and other debt instruments. In other words, most of the opportunity to obtain a good level of return on investment lies with growth in the market values of shares and mutual funds, rather than the interest rates obtainable on high quality bonds. If trustees must invest with a view to balancing the capital and income returns, both categories of beneficiaries are likely to be dissatisfied. Neither will benefit from an optimal rate of return.

In Canada, most trusts in which there are successive interests are created to take advantage of the spousal rollover under the *Income Tax Act*,(3) under which capital gains tax arising on the death of the testator are deferred for the life of the testator's spouse as long as no distribution can take place to any other beneficiary while the spouse remains alive. The primary purpose of these trusts is clearly to benefit the life tenant, and the duty of evenhandedness will usually be expressly overridden in some manner. This is often made clear by conferral of a power to encroach on capital in favour of the life tenant. The settlor's purpose in creating such a trust might be best achieved by removing altogether the need to distinguish between income and capital returns from investment.

The truth is that capital and income accounting is closely linked to the classic model of trusteeship in which the first duty of the trustee is to preserve the value of capital through legally authorized "safe" investments paying a standard rate of return which is deemed by the court to be acceptable for all income beneficiaries. This essentially 19th century model began to break down once the statutory list of authorized investments(4) or "legal list" ceased to provide adequate protection against erosion of purchasing power, and the concept of a normative rate of return for the income beneficiary became untenable with rising inflation. For decades, increasing numbers of settlors have avoided the straitjacket that the "legal list" created for trustees by giving wide powers of investment so that the trustees could take advantage of better investment opportunities.

The almost universal trend of reform throughout the common law world is to abolish the "legal list" of authorized investments and permit trustees to employ the same techniques used by successful investors in the marketplace, always subject to the overriding duty of prudence. In a previous report, *Trustee Investment Powers*, this Committee recommended the repeal of the legal list in section 15 of the *Trustee Act* and introduction of other changes to the Act to facilitate the application of the principles of modern portfolio theory in trustee investment.(5) We turn briefly to discuss these principles.

II. Portfolio Theory and Total Return Investment

A. Portfolio Theory: Risk and Return Analysis

Modern portfolio theory recognizes that investment decisions involve the assessment of two factors: the probable return and the level of risk. The investor strives to maximize return within an acceptable level of risk, regardless of whether it stems from interest, dividends or capital growth.

Risk is reduced over the whole of the portfolio by diversification of investment holdings. Diversification involves the acquisition of securities that are subject to different risk factors, i.e. different influences on market value, in order to offset potential losses with gains in other sectors.

B. Total Return Investment

The essential elements of portfolio theory are not completely incompatible with capital/income considerations, but the traditional strict distinction imposes additional constraints on the degree to which portfolio theory can be employed to advantage. Freed from the requirement to select investments with regard to the legal category of the returns they will bring, trustees would be free simply to maximize the gain to the trust portfolio within risk parameters dictated by the duty of prudence. This method of "total return" investment is successfully used by many charitable organizations, which are not usually burdened with income and capital remainder interests.(6) The Committee has been urged strongly to recommend amendments to the *Trustee Act* enabling all charitable trusts and foundations to invest on a total return basis and capitalize unspent returns.

The advantages of total return investment are reflected in the adoption by the National Conference of Commissioners on Uniform State Laws of the *Uniform Principal and Interest Act 1997*. This statute, which has been enacted in twenty-five U.S. states so far and is currently under consideration by five other state legislatures, is designed to allow investment decisions to be taken by trustees on a total return basis. The Act also gives the power to allocate receipts between income and capital accounts to achieve even hand objectives if

(a) the "prudent investor" standard governs the investment duties of the trustee (i.e., investment is not restricted to certain categories of securities by the express terms of the instrument or by statute);

(b) the terms of the trust describe the amount of distributions that may or must be made by referring to the "income" of the trust; and

(c) the trustee is otherwise unable to administer the trust impartially, based on what is fair and reasonable to all beneficiaries.(7)

Acceptance of the concept of total return investment was illustrated by the recent decision of the Supreme Court of Nova Scotia in *Re Killam Estate,* where the court exercised its inherent jurisdiction to vary administrative powers under a charitable trust so as to give approval to a proposal that would permit capital growth as well as income to be distributed among the objects of several charitable trusts. The original trust terms had allowed the distribution of "income" only.(8) *Re Killam*, however, involved the exercise of a discretionary jurisdiction regarding the administration of charitable trusts that already exists in superior courts. The case does not represent a change in the general law of trusts concerning principal and income, made in order to accommodate total return investing.

Achieving a general change of that kind in Canada is not free of difficulty, since the *Income Tax Act* uses the traditional categorization of trust revenues as either income or capital. This means that trustees of taxable trusts must maintain traditional income and capital accounting for tax purposes. Express powers to reallocate between the income and capital accounts are ineffective insofar as taxing legislation is concerned.[(9)] Trustees who have powers of reallocation must still distinguish between income and capital receipts in the internal administration of the trust so as not to lose sight of the effect of the tax burden in making adjustments to maintain evenhandedness. Reforms have been recommended by both the Ontario and Manitoba Law Reform Commissions to facilitate total return investment where it is possible under the existing tax structure. We turn now to consider them.

C. The Ontario Law Reform Commission Recommendations

1. The Percentage Trust

In 1984 the Ontario Law Reform Commission proposed a means of separating investment strategy from even hand considerations, so that both trustee functions could be fulfilled more effectively. The OLRC's mechanism for accomplishing this was the percentage trust, under which the assets of the trust are valued periodically and the life tenant is paid a percentage of that value corresponding to a fair rate of return for the period as measured by some external benchmark such as the yield obtainable on high quality bonds.[(10)] The Commission recommended that a "default" percentage and valuation frequency be fixed by regulation and kept under review. These would apply if the instrument was silent.[(11)]

While the duty of evenhandedness would continue to apply under a percentage trust, that duty would be much easier to perform because it would not matter if the proportions of income and capital receipts differed from what the trustees had predicted. The income and capital distinction would be effectively abolished insofar as the trust's internal administration was concerned.

The Commission recognized that the income tax system limited the usefulness of the percentage trust. It noted in particular that a spousal trust would lose its exemption if any excess income were credited to capital because of the income exceeding the percentage having to be paid to the life tenant. However, as there are many private trusts in which the interests are not successive, and charitable public trusts which are exempt from income tax, the Commission thought that the percentage trust should still be made readily available to those settlors who could use it. It accordingly recommended that the *Trustee Act* of Ontario contain a provision allowing settlors to adopt a percentage trust model by simply employing the phrase "on percentage trusts."[(12)]

2. The Discretionary Allocation Trust

The Commission also recommended that the *Trustee Act* contain a further optional power for trustees to allocate receipts and disbursements between the income and capital accounts on a basis the trustees consider just, subject to the duty of evenhandedness. This could be invoked by use of the term "on discretionary allocation trusts" in the trust instrument.[(13)]

The Commission observed that a similar power is often found in sophisticated trust instruments. It assists the trustee in dealing with difficulties created by the income/capital distinction in trying to maintain an even hand between classes of beneficiaries and aids in separating investment decisions from distributional constraints.

D. Manitoba Law Reform Commission Recommendations

In a 1999 report,[(14)] the Manitoba Law Reform Commission also recommended amendments to Manitoba's *Trustee Act* to facilitate total return investment, but concluded that the income tax structure in Canada prevented the extension of total return investment to private trusts generally. The Commission limited the scope of its recommendation to a provision enabling charitable and non-profit institutions to invest their endowment funds on a total return basis unless the governing documents or trust terms expressly withheld this power. The provision would apply to existing charitable trusts and foundations as well as to those formed after its enactment.

The Manitoba Law Reform Commission also agreed with the Ontario Law Reform Commission's recommendation that the Act should allow the percentage trust to be invoked by using the terms "on percentage trusts" in an instrument. Its report includes a recommendation to this effect.

III. The Committee's Recommendations: Total Return Investment Under the British Columbia *Trustee Act*

A. General

Evenhandedness as between classes of beneficiaries in administrating trusts continues to be a valid principle, but it should not be applied in a manner that forces trustees to invest inefficiently. Inefficiency in this context means the inability to obtain the maximum overall gain to the trust estate within risk levels dictated by the duty of prudence. Traditional income and capital allocation rules should not stand in the way of efficient investment either. If they do, then they are likely to have got in the way of the settlor's fundamental intention to confer benefits on an individual, a class of individuals, or a charitable object.

In our view, total return investment is a corollary of modern portfolio theory. Total return is necessary for trustees to be in the best position to employ the risk/return analysis effectively to obtain the maximum advantage for the trust. If they are constrained by even hand considerations that require estimates of probable "income" or "capital" receipts, trustees cannot make the kind of choices that other prudent investors would make. Investment decision-making needs to be separated from distributional issues.

We agree with the Ontario Law Reform Commission that the percentage trust is a useful device through which the even hand principle can be applied more readily, without reducing the level of efficiency in investment. The Ontario Law Reform Commission's recommendations for the discretionary allocation trust also bear serious consideration. In commenting on the Consultation Paper[(15)] that preceded this report, one major trust industry organization suggested that the discretionary allocation trust could be a solution to inequitable situations produced by the traditional income/capital distinction where a percentage trust is not desired or is inappropriate.

Although a settlor may choose to have the trustee pass all income to the life tenant by employing careful drafting and giving a power of encroachment, and thereby avoid the problem of the capital/income distinction, general reform of capital and income rules governing the allocation of revenues and expenses of trusts like the U.S. *Uniform Principal and Income Act* is impractical as long as the Canadian income tax system continues to require their application for tax purposes. Until the general trust law is modified to facilitate total return investment and vehicles allowing for its use such as the percentage trust, however, there will be no impetus for change in the income tax structure. We believe that settlors and testators should have the option to create a total return or percentage trust in situations where taxation is not an obstacle. This could well be the case with discretionary trusts that are now extremely popular among estate planners. In the charitable and non-profit sector in particular, the *Income Tax Act* does not, for the most part, interfere with the manner of investment. To maximize their efficiency, charitable trusts and foundations should have full access to total return investing in the absence of any express prohibitions against this approach in the governing instrument or statute. It is possible to accomplish this change even with the present tax legislation. Employee pension and health plans should be able to take advantage of full access to total return investment as well.

In the case of charitable trusts, the ability to invest on a total return basis should be automatic and should be available to all charities, regardless of the time of their creation.

The Committee recommends:

1. (a) The Trustee Act *should be amended to provide that the property of a charitable trust or the endowment fund of a charitable or non-profit organization may be invested, subject to the overriding duty of prudence, so as to obtain the maximum return without regard to the income or capital nature of the return, unless the terms of the trust or the document or legislation governing the use of the endowment fund provide otherwise.*

(b) The amendment described in recommendation 1(a) should apply to all charitable trusts and charitable or non-profit organizations, whenever created.

Legislative provisions introduced to facilitate total return investment cannot be extended indiscriminately to private trusts under the current income tax system, however, as they might have the effect of indirectly tainting trusts that would otherwise be entitled to benefit from the spousal rollover provisions in the *Income Tax Act*. Thus, the furthest that provincial trustee legislation could go in extending total return investment powers in the private trust context is to provide machinery facilitating the operation of trusts on a total return basis where the settlor or testator expressly authorizes investment on that basis. The power to invest on a total return basis and to ignore the income/capital distinction cannot be made automatic for all private trusts without a change in the income tax system at the federal level.

B. Facilitating Access to Total Return Investment: A Statutory Percentage Trust

1. General

The most direct route to total return investment is to employ the percentage trust model.

We agree fully with the Ontario and Manitoba Law Reform Commissions that the *Trustee Act* should allow the basic principles on which a percentage trust operates to be invoked by use, in a trust instrument or will, of the phrase "on percentage trusts." Those principles are: (a) periodic valuation of the trust assets and (b) distribution of a percentage of the total value in each year or other fiscal period without regard to the distinction between income and capital. The payment comes first from revenues of the trust in the fiscal period, with any deficiency being made up from capital. Revenues in excess of what is needed to meet the percentage payout are added to capital. Other machinery required for the operation of percentage trusts should be included in the *Trustee Act* and regulations under the Act. This would include "default" terms concerning the frequency of valuations and the payout percentage, which settlors could either adopt simply by employing the phrase "on percentage trusts," or vary by using express terms.

The Consultation Paper preceding this Report proposed that a default valuation interval be fixed by the Act and be variable by regulation. Two organizations from whom comments were received urged that the interval itself be prescribed by regulation. We accept this comment as well-founded. As the feasibility of a default valuation interval and payout rate depends on the conditions affecting the investment market, and may require revision as those conditions change, it is appropriate to place the specifics of the valuation interval and payout rate in a regulation which can be amended more readily than the Act.

The Committee recommends:

2. The Trustee Act *should be amended to provide that a trustee, where expressly authorized to do so by the settlor, may invest the trust property without regard to whether the return is of an income or capital nature so as to obtain the maximum return consistent with the general duty of prudence.*

3. (a) The Trustee Act *should be amended to provide that where the settlor or testator employs the term "on percentage trusts," the trustee shall cause the trust assets to be evaluated at intervals specified by the settlor or testator and pay a percentage of the value so obtained annually to the person who would otherwise be entitled to receive the income of the trust.*

(b) The percentage should be paid from revenue received by the trust during each year and if revenues are insufficient to pay the percentage, the balance should be drawn from the corpus of the trust.

(c) Where revenues of the trust are in excess of the percentage payable in a given year, the balance shall be added to the corpus of the trust.

(d) The Trustee Act *should provide that if the settlor or testator does not specify the intervals at which the trust assets are to be valued or the percentage of the value of the trust assets to be paid in each accounting period, the maximum inverval between valuations and the percentage shall be those fixed by regulation under the* Trustee Act.

2. The Default Valuation Interval

The statutory "default" interval should neither be so short as to make periodic valuation overly costly and impractical, nor so long that valuations are not representative of the market value over the intervening period. What interval is appropriate depends largely on the characteristics of the trust and the nature of the assets. A trust consisting entirely of publicly traded securities may be easily valued on the basis of market data. Annual valuations of trusts of this kind may not be unduly expensive or time-consuming. Valuation of trusts in which other kinds of assets predominate is a more complicated exercise. This is particularly true of trusts of shares in

private companies and real estate. The default valuation interval should be set so as to produce a satisfactory result in as wide a range of circumstances as possible. It should not impose undue cost burdens on trusts that require complicated valuations. For this reason, we do not think it is feasible for the statutory default provision to require valuation annually or in each accounting period of the trust.

The Consultation Paper contained a proposal that the default valuation interval be fixed at three years. This was criticized by some of our correspondents as too long, and likely to lead to unfair results if the valuation coincided with a peak or trough in the market. Numerous alternatives were proposed by correspondents. They included giving trustees the discretion to determine the timing subject to a maximum of three years between valuations, annual valuation with discretion to postpone, and use of average values over a three-year period. These and others were considered by the Committee before forming the recommendation that appears below.

The Committee has concluded that there should be a valuation at least once every three years in order to ensure that distributions are based on assumptions concerning asset values that are reasonably current. Subject to this minimum frequency, settlors should be able to specify how often valuations should be carried out. It should also be open to trustees to carry out valuations more frequently than once every three years, if the trust terms are silent on the point. This should give sufficient leeway to settlors and trustees to create and administer percentage trusts. The three-year period should commence from the first date on which there is trust property capable of being valued. This would be the date of settlement in the case of *inter vivos* trusts. In testamentary trusts, which may not actually be funded until after other acts of administration are carried out, the valuation period should start at the end of the "executor's year," i.e. one year from the death of the testator.

The Committee recommends:

4. (a) The maximum interval between valuations of the trust property under a percentage trust should be prescribed by regulation under the* Trustee Act *as being three years, running initially from

(i) the date of the settlement in the case of an* inter vivos *trust, or

(ii) one year from the date of the testator's death in the case of a testamentary trust,

(b) A settlor who creates a percentage trust should be able to stipulate in the terms of the trust that valuations be carried out more frequently than required by regulation.

(c) If the terms of a percentage trust are silent as to how often valuations of the trust property should be carried out, the trustee should be able to determine the frequency of valuations, subject to the maximum length of time between valuations allowed by regulation.

3. The Default Payout Percentage

(a) General

Fixing an appropriate percentage to be applied to the value of the trust assets to determine the size of periodic distributions is a complex matter. It requires consideration of many factors, including the effects of taxation, inflation, trustee remuneration, administrative expenses, and the expected duration of the trust, as well as the intentions of the settlor. It is obvious that too low a rate of payout can result in the income beneficiary being shortchanged, while too high a rate of payout is prejudicial to the capital beneficiary and may even exhaust the trust fund prematurely to the detriment of both classes. The ideal payout rate will provide the highest after-tax income to the income beneficiary as well as preserving the value of the capital for the eventual benefit of the capital beneficiary. Computer simulations carried out in the U.S. by Wolf using payout rates ranging from three to six per cent over the period from 1960 to 1997 suggested that the highest payout rate that would protect both income and capital beneficiaries from inflation was five per cent.(16)

Garland, another U.S. writer, recommended a payout rate fixed at the level of the annual dividend yield of the S&P 500.(17) The "Garland Rule" and its variants have been criticized as extremely conservative and likely to favour capital beneficiaries at the expense of income beneficiaries.(18)

In the U.S., opinion tends to gravitate around four per cent as the optimal rate to meet the objectives of providing the highest after-tax income without premature depletion of the fund, at least for all-equity portfolios.(19)

There are dangers, however, in relying too heavily on American financial analyses because of differences between the U.S. and Canadian economies, particularly in respect of rates of inflation and taxation. Without the benefit of simulations like those done by Wolf in the U.S., but with reference to Canadian economic conditions, there is little guidance available in fixing a statutory default payout percentage.

We see a valid theoretical basis for fixing a statutory default percentage at the estimated real rate of return on investment. The real rate of return is the rate at which a fund would be expected to grow after the effect of future inflation is taken into account. If no more than this percentage is paid out in a given year, the value of the capital should theoretically be preserved.

In British Columbia, there is a statutory benchmark for the estimated real rate of return. It is the discount rate prescribed under section 56(2)(b) of the *Law and Equity Act*(20) for calculating the present value of future damages. That rate is based on the estimated future difference between the market rate of interest on investment less the rate of general price inflation. It has been fixed by regulation since 1981 at 3.5 per cent.(21) This rate has apparently been accepted for twenty years as a reasonably accurate standard. We believe it is sensible in the interests of legislative consistency to accept the actuarial assumptions reflected in the discount rate under the *Law and Equity Act* and adopt that rate as the standard payout rate for percentage trusts, subject to variation by the settlor in express terms.

(b) Should the Payout Rate Be Indexed for Inflation?

The Consultation Paper contained a proposal for a composite payout percentage formula consisting of the discount rate under section 56(2)(b) of the *Law and Equity Act* coupled with an

inflation indexing component based on average rates of price inflation or deflation from the all-item Consumer Price Index. After much deliberation we have concluded that the default payout rate should not be indexed to inflation.

Our reasons for recommending against indexing the basic payout rate under a reformed *Trustee Act* are twofold. First, indexing to inflation holds dangers for the sustainability of trusts. Second, if the payout rate is already linked to the estimated real rate of return it would doubly compensate for the effect of inflation.

Indexing may result in a higher payout than is warranted, depleting the trust prematurely, unless care is taken to employ a low base percentage to which the inflation adjustment is added.[(22)] Rates of price inflation do not necessarily correlate directly with market rates of return, and linking them to the annual rate of payout may distort the relationship between the investment market and the payout. If the payout rate is higher than the actual return, the income component of the blended payout will be reduced and the payout will begin to drain the capital.

To find a sustainable formula for an inflation-indexed payout requires an assessment of the individual characteristics of the particular trust, especially its intended duration. A default term implied by the *Trustee Act* must be suited to very wide use. For that reason, and because the prediction of future inflation is necessarily uncertain, we prefer to err on the side of simplicity and avoid indexing.

An additional ground for rejecting an inflation-indexed payout rate is that, as we have explained, if the base rate is fixed at the equivalent of the discount rate under section 56(2)(b) of the *Law and Equity Act*, the income beneficiary has already obtained compensation for the effect of inflation. The discount rate is a prediction of the long-term rate of return *after* the portion of the nominal market rate of return represented by inflation has been removed. To add any portion of the inflationary component back in over-compensates the income beneficiary and erodes the capital. While it is quite true that settlors who create a life interest, usually for a spouse or other dependant, followed by a gift of capital frequently intend the trust principally to benefit the holder of the life interest, we believe that the percentage rate under a reformed *Trustee Act* should be oriented towards an evenhanded approach. Departures from the even hand rule should be left to the settlor's own choice.

4. Should the Percentage Rate Be Applied to a Rolling Average Value or the Value as of the Last Preceding Valuation Date?

Periodic distributions under a percentage trust may vary significantly due to fluctuations in market value from one valuation period to the next. In order to level out the peaks and troughs in value due to market volatility and make distributions more even, many U.S. foundations use a rolling average or "smoothing rule." The payout percentage is applied to the average of trust asset values over several accounting periods, typically three to five years.[(23)]

In New York, the Legislative Advisory Committee proposed an annual payout rate of four per cent applied to a rolling average over a three-year period as a statutory default provision for percentage trusts. This recommendation has now been enacted into law in New York.[(24)]

The rolling average holds attraction as a means of sustaining the level of benefits paid under percentage trusts, but as past value is reflected in the average, it requires frequent valuations so that the payout is not too divorced from current market values of the trust assets. It is best-suited to percentage trusts that can readily be valued by reference to market information or that undergo annual valuations. For the reasons already stated, we would be reluctant to have annual valuations forced on smaller trusts and trusts that do not consist predominantly of publicly traded securities. We have recommended valuations once every three years as a statutory minimum. A rolling average based on valuations carried out less frequently than in each year or accounting period of the trust might produce a payout that is not sufficiently in keeping with the current worth of the trust. If trust revenues decline and a rolling average value affected by valuations carried out more than several years in the past results in a higher payout than is warranted in the current period, capital will be eroded to an undue degree. We do not recommend that use of a rolling average value be imposed as a statutory default term for percentage trusts.

The Committee recommends:

***5. The* Trustee Act *should be amended to provide that unless the settlor or testator specifies a different percentage, the percentage of the value of trust assets to be paid to the person who would otherwise be entitled to receive the income of the trust shall be the discount rate fixed under section 56(2)(b) of the* Law and Equity Act.**

C. The Statutory Discretionary Allocation Trust

Not all settlors will employ the percentage trust. In many cases, the settlor does not intend that distributions be made on a regular basis. Settlors often intend that their trustees will exercise discretion with regard to the size and frequency of distributions, whether they should come from income or capital, and the particular beneficiary or beneficiaries who are to receive them. The percentage trust model is not well-adapted to trusts of this kind, nor to trusts primarily intended to enlarge the capital over the course of time for ultimate distribution in the future, such as an educational trust. In cases where the percentage trust is not likely to be adopted, the *Trustee Act* should provide a means to overcome the inefficiencies that traditional income and capital accounting rules can produce.

Trust instruments often contain an express power to allocate receipts and disbursements to either the income or capital accounts in the trustee's discretion. This power assists the trustee in maintaining an even hand between classes of beneficiaries. It can also facilitate more efficient investment by relieving the trustee of having to select the portfolio on the basis of the strict legal classification between "income" receipts like dividends and "capital" ones like capital gains from the sale or redemption of mutual funds.

As the Ontario Law Reform Commission did, we believe the *Trustee Act* should contain a statutory power to allocate or apportion receipts and outgoings between the income and capital accounts as the trustee considers just and equitable, without regard to the traditional legal categories. The exercise of the power should be subject to the general duty to maintain an even hand between classes of beneficiaries.

Leaving the statutory power open to be exercised by all trustees could nevertheless have the

effect of disqualifying some trusts from the benefit of the rollover provisions of the *Income Tax Act*. It might conflict with the intentions of settlors in a greater number of cases than other general administrative powers under the *Trustee Act*. These disadvantages could be overcome by incorporating a feature also recommended by the Ontario Law Reform Commission, namely that the statutory power should not be at large, but rather capable of being invoked if the settlor specified that the trustee was to hold the trust property "on discretionary allocation trusts."

To create a full and effective statutory power to allocate on a discretionary basis between the income and capital accounts, the Ontario Law Reform Commission also recommended the inclusion of certain related statutory powers. One of these was the ability to recover disbursements from either income or capital, regardless of the account from which a disbursement was paid or to which it was allocated. The other was the power to deduct an allowance for depreciation and obsolescence from income and add an equivalent amount to capital in order to protect the capital beneficiary. We agree that these additional powers should be present in the *Trustee Act* in order to make the discretionary allocation trust a fully self-contained scheme.

The Committee recommends:

6. (1) The* Trustee Act *should be amended to provide that where the settlor specifies that the trustee is to hold the trust property "on discretionary allocation trusts" the trustee may allocate or apportion receipts and disbursements to either the income or capital accounts as the trustee considers just and equitable, subject to an overriding duty of evenhandedness between different classes of beneficiaries.

(2) The* Trustee Act *should be amended to provide that disbursements may be recovered from either the income or capital accounts as the trustee considers just, regardless of the account to which the disbursement was charged or from which it was paid.

(3) The* Trustee Act *should be amended to provide that the trustee may deduct an allowance for depreciation and obsolescence from income and add an equivalent amount to capital when necessary to protect the capital beneficiary.

D. Other Issues Concerning Total Return Investment

1. Definition of 'Income' in Charitable Context

As the governing documents of charitable trusts and charitable organizations often refer to payment of "income," which limits them to distributing only those receipts that fall within the traditional legal meaning of this term, a redefinition of "income" is required in order for these bodies to overcome the problem illustrated by *Re Killam* and take full advantage of total return investment techniques. In the context of charitable gifts in trust, the term "income" should be deemed to include funds reflecting a portion of the total value of the trust or endowment fund.

The Committee recommends:

7. The* Trustee Act *should be amended to provide that unless the terms of a charitable gift provide

otherwise, the income from the gift and the word "income" in the terms of the gift shall be deemed to include a percentage of the total value of the trust assets.

2. Conflict of Laws and Extraprovincial Trusts and Charities

In the Consultation Paper[(25)] that preceded this Report it was suggested that any legislation permitting total return investment should apply only to trusts and charitable bodies corporate governed by the law of British Columbia. This suggestion reflected a concern to avoid any constitutional issues that might arise if such legislation were to apply where the governing law was other than that of British Columbia.

The Manitoba Law Reform Commission took a less restrictive approach to this issue. It recommended:[(26)]

[R]egistered charities and non-profit institutions, whether organised by incorporation or trust, which are engaged in investment decision-taking within Manitoba, whether at a head office or branch office, shall be subject to the investment law of Manitoba, subject to the expression of a contrary intent in a statute of another jurisdiction or the organisation's documentation.

The Manitoba Report does not address the constitutional implications of this approach. It is possible that the Commission was proceeding on the basis that the province has constitutional authority over assets wherever situate that are under investment in the province.

If it is desirable that total return investing be available to charities, is it necessary to restrict its availability as we suggested in our Consultation Paper? Are the constitutional implications indeed prohibitive? Or is it feasible to extend the benefits of total return investing generally to charitable organisations active in British Columbia, including those governed by the law of another jurisdiction?

(a) Constitutional Implications

Our first concern over extending total return investing to all trusts and charitable organizations active in the province is that, arguably, it operates extraterritorially and, as such, would be beyond the constitutional powers of the province to enact. In other words, it could be held to be *ultra vires* and invalidated by the courts. While a valid provincial law may affect extraprovincially situated rights, liabilities, and entities, this is permissible only where that effect is incidental to its "pith and substance."[(27)]

(b) Practical Problems

The constitutional issue is real and cannot be ignored, but it has been suggested that the practical problems for trustees posed by a broader provision, applicable to charities governed by extra-provincial law, would be the more significant problem. If there is confusion over which system of law governs the investment activity of an extraprovincially constituted charitable trust or foundation that is being administered in whole or in part in British Columbia, and the standards of return by which the trustees' performance is judged, internal division and dissension, and potential harassment by stakeholders or interest groups, may interfere with effective administration. A "British Columbia only" provision would protect trustees from this conflict, in addition to resolving potential constitutional issues.

(c) Conclusion

While it may be unfortunate that some trustees whose investment activity takes place within British Columbia could not take advantage of the legislative provisions recommended in this Report, the practical and constitutional concerns cannot be ignored. The Committee therefore adopts as its final recommendation the position tentatively suggested in the Consultation Paper.

The Committee recommends:

8. The amendments to the Trustee Act *permitting total return investment should be accompanied by a provision clarifying that those amendments apply only to trusts and charitable bodies corporate governed by the law of British Columbia, as determined by applicable conflict of laws rules.*

IV. The *Howe* v. *Lord Dartmouth* Rules Under A Total Return Regime

Several legal rules pertaining to the application of the "even hand" principle require examination in light of Recommendations 1 to 8. These rules, sometimes referred to collectively as the rule in *Howe* v. *Lord Dartmouth,* impose requirements to convert particular forms of assets to authorized trustee investments and to apportion income or deemed income from them between the income and capital beneficiaries. They apply during the period of administration of a deceased person's estate. The rules are summarized below:[(28)]

1. The first branch of the rule in *Howe* v. *Lord Dartmouth*:[(29)] Where a will contains a residuary gift of personal property, or a future or reversionary property interest for persons in succession, the trustee must convert all wasting, hazardous and speculative assets to authorized trustee investments. The rule applies only to testamentary trusts. It does not apply to residuary gifts of real property. Any securities that are not included in the "legal list" of authorized investments in section 15 of the *Trustee Act* are considered "hazardous" for the purposes of this rule.[(30)]

2. The second branch of the rule in *Howe* v. *Lord Dartmouth,* or the rule of apportionment pending conversion: Whenever original assets of the estate other than authorized trustee investments in the legal list are to be converted under an express or implied trust for sale, the income from those assets must be apportioned between the capital and income beneficiaries until conversion to the authorized investments actually takes place. The income beneficiary receives the income that the assets would yield if they had already been converted. The balance of the actual income from the unauthorized assets, if any, is added to capital.

3. The rule in *Re Chesterfield's Trusts*: [(31)] if future or reversionary property is included in a residuary gift under a will, and it is not yielding income prior to the time it is sold, the proceeds of sale after it comes into possession must be apportioned between the income and capital beneficiaries. The amount that would be equivalent to the sale proceeds, if invested at the testator's death at the rate payable on

the legal list investments, compounded annually or semiannually before income tax, is treated as capital and the rest is treated as income.

In a total return environment, the income/capital distinction on which the application of these rules depends is essentially irrelevant. In addition, if a required percentage of the value of the estate, supplemented by drawings on the capital of the trust estate if the investment returns are not sufficient to meet it, is being paid to a life tenant, this is by definition a proper allocation. There is no need to go through an exercise of apportionment when assets are converted from one form to another.

There is a further reason why the rules should not be maintained, even outside the context of a total return trust. They are based on the concept of a legal list of authorized trustee investments and the level of income the authorized investments would generate. Once the legal list in section 15 of the *Trustee Act* is repealed and replaced by a general duty of prudence, as we recommended in our report *Trustee Investment Powers*, the rules cannot be applied in a consistent manner.[(32)] In a regime of trust law which focuses on diversification of the portfolio as a means of reducing the risk rather than classifying investments either as "authorized" and "unauthorized," the rules lose their meaning.

The general duty of evenhandedness, which applies to both testamentary and *inter vivos* trustees, should remain entrenched. It is relevant after all not only when there are income and capital beneficiaries, but whenever there is more than one beneficiary. As crystallized expressions of that duty, however, the rule in *Howe* v. *Lord Dartmouth* and the rules requiring apportionment pending conversion should not be retained.

The Committee recommends:

9. (1) The rules known as the first and second branches of the rule in Howe *v.* Lord Dartmouth*, and the rule in* Re Chesterfield's Trusts *should be abrogated.*

(2) The general duty of evenhandedness with respect to different classes of beneficiaries in the administration of a trust should persist despite the abrogation of the rules referred to in Recommendation 9(1).

V. Conclusion

We believe the reforms we have recommended in this Report will assist trustees to achieve maximum investment returns within risk parameters consistent with their overriding obligation of prudence. We also believe they are necessary to complete the reforms we recommended in our earlier *Report on Trustee Investment Powers*.

We thank all the organizations and individuals who responded to the Consultation Paper. We have greatly benefitted from the views they expressed on the proposals it contained and we have fully considered all submissions received in formulating the recommendations in this Report.

VI. Summary of Recommendations

1. (a) The Trustee Act *should be amended to provide that the property of a charitable trust or the endowment fund of a charitable or non-profit organization may be invested, subject to the overriding duty of prudence, so as to obtain the maximum return without regard to the income or capital nature of the return, unless the terms of the trust or the document or legislation governing the use of the endowment fund provide otherwise.*

(b) The amendment described in recommendation 1(a) should apply to all charitable trusts and charitable or non-profit organizations, whenever created.

2. The Trustee Act *should be amended to provide that a trustee, where expressly authorized to do so by the settlor, may invest the trust property without regard to whether the return is of an income or capital nature so as to obtain the maximum return consistent with the general duty of prudence.*

3. (a) The Trustee Act *should be amended to provide that where the settlor or testator employs the term "on percentage trusts," the trustee shall cause the trust assets to be evaluated at intervals specified by the settlor or testator and pay a percentage of the value so obtained annually to the person who would otherwise be entitled to receive the income of the trust.*

(b) The percentage should be paid from revenue received by the trust during each year and if revenues are insufficient to pay the percentage, the balance should be drawn from the corpus of the trust.

(c) Where revenues of the trust are in excess of the percentage payable in a given year, the balance shall be added to the corpus of the trust.

(d) The Trustee Act *should provide that if the settlor or testator does not specify the intervals at which the trust assets are to be valued or the percentage of the value of the trust assets to be paid in each accounting period, the maximum inverval between valuations and the percentage shall be those fixed by regulation under the* Trustee Act.

4. (a) The maximum interval between valuations of the trust property under a percentage trust should be prescribed by regulation under the Trustee Act *as being three years, running initially from*

(i) the date of the settlement in the case of an inter vivos *trust, or*

(ii) one year from the date of the testator's death in the case of a testamentary trust,

(b) A settlor who creates a percentage trust should be able to stipulate in the terms of the trust that valuations be carried out more frequently than required by regulation.

(c) If the terms of a percentage trust are silent as to how often valuations of the trust property should be carried out, the trustee should be able to determine the frequency of valuations, subject to the maximum length of time between valuations allowed by regulation.

5. The Trustee Act *should be amended to provide that unless the settlor or testator specifies a different percentage, the percentage of the value of trust assets to be paid to the person who would otherwise* *be entitled to receive the income of the trust shall be the discount rate fixed under section 56(2)(b) of the* Law and Equity Act.

6. (1) The Trustee Act *should be amended to provide that where the settlor specifies that the trustee is to hold the trust property "on discretionary allocation trusts" the trustee may allocate or apportion receipts and disbursements to either the income or capital accounts as the trustee considers just and equitable, subject to an overriding duty of evenhandedness between different classes of beneficiaries.*

(2) The Trustee Act *should be amended to provide that disbursements may be recovered from either the income or capital accounts as the trustee considers just, regardless of the account to which the disbursement was charged or from which it was paid.*

(3) The Trustee Act *should be amended to provide that the trustee may deduct an allowance for depreciation and obsolescence from income and add an equivalent amount to capital when necessary to protect the capital beneficiary.*

7. The Trustee Act *should be amended to provide that unless the terms of a charitable gift provide otherwise, the income from the gift and the word "income" in the terms of the gift shall be deemed to include a percentage of the total value of the trust assets.*

8. The amendments to the Trustee Act *permitting total return investment should be accompanied by a provision clarifying that those amendments apply only to trusts and charitable bodies corporate governed by the law of British Columbia, as determined by applicable conflict of laws rules.*

9. (1) The rules known as the first and second branches of the rule in Howe *v.* Lord Dartmouth*, and the rule in* Re Chesterfield's Trusts *should be abrogated.*

(2) The general duty of evenhandedness with respect to different classes of beneficiaries in the administration of a trust should persist despite the abrogation of the rules referred to in Recommendation 9(1).

Appendix

Further Information on the Project and the Committee

This report is the fourth made by the *Trustee Act* Modernization Committee of the British Columbia Law Institute. The earlier reports made by the Committee recommended changes to the provisions of the *Trustee Act* dealing with investment by trustees, their statutory remuneration and their powers of delegation. Since this report is one of a series, we thought it appropriate to provide a brief explanation of project and the Committee's objectives and methodology.This is one of the first projects undertaken by the British Columbia Law Institute after its formation in 1997. The Committee, through which the Institute is carrying out this project, is addressing various aspects of the *Trustee Act* that are in need of reform in a series of short consultative documents and reports. The consultative documents, which will contain proposals for reform and the explanation for them, are circulated to interested sectors such as the trust and fiduciary industry, the Bar, and non-profit foundations to obtain comment on the proposals. They are also be made available to the public upon request. Following this consultation phase, the Committee develops a final position on the matters addressed by the proposals and presents recommendations for legislative change in a report that is submitted to the Attorney General.The ultimate aim of the Committee is to prepare a comprehensive draft of a reformed *Trustee Act* in modern, easily comprehended language. The Statute will contain new provisions required for the legal and financial climate in which trustees now fulfil their duties as well as those elements of the existing Act that must be retained.

The members of the *Trustee Act* Modernization Committee are:

Dr. Donovan Waters, Q.C. (Chair)
Professor James MacIntyre, Q.C.
Arthur L. Close, Q.C.
Margaret Mason
Kathleen Cunningham
Professor Keith Farquhar
Scott Sweatman
Greg Blue (Reporter)

Footnotes

1
Hill v. *Permanent Trustee Company of New South Wales Ltd*., [1930] A.C. 720 (P.C.) (Aus.).

2
See for example, Re Smith, [1971] 2 O.R. 541 (C.A.); varying [1971] 1 O.R. 584 (H.C.). Here the oil shares that formed the corpus of the trust appreciated enormously in value but paid only two-and-one-half per cent dividends, leaving the life tenant with an inadequate income. The trustee had clearly failed to maintain an even hand and was removed by the court.

3
R.S.C. 1985 (5th Supplement), c. 1.

4
See Trustee Act, R.S.B.C., c. 464, s. 15.

5
British Columbia Law Institute, Report no. 6 (1999).

6
In 1998 the statutes governing the Vancouver and Victoria Foundations were amended to clarify the ability of those bodies to invest on a total return basis. *See Vancouver Foundation Amendment Act*, *1998*, S.B.C. 1998, c. 48, s. 3; *Victoria Foundation Amendment Act*, *1998*, S.B.C. 1998, c., ss. 1 (definition of "returns"), 4.

7
See s. 104 of the *Uniform Principal and Interest Act, 1997* and Comment following.

8
Re Killam Estate, (1999) 185 N.S.R. (2d) 201, (1999) 38 E.T.R. (2d) 50.

9
Riddell v. *Minister of National Revenue*, [1938] Ex. C.R. 135 at 141.

10
The percentage trust is referred to in the U.S. as the "unitrust." It was first proposed in Lovell, "The Unitrust - A New Concept to Meet an Old Problem" (1966), 105 Tr.& Est. J. 215.

11
Ontario Law Reform Commission, *Report on the Law of Trusts*, [1984], 301-304.

12
Ibid, p. 304, Recommendation 65; *Draft Trustee Act*, s. 42.

13
Ibid, p. 298-300, Recommendation 60; *Draft Trustee Act*, s. 41.

14
Manitoba Law Reform Commission, *Trustee Investments; The Modern Portfolio Theory* (Report 101, June 1999).

15
British Columbia Law Institute, Consultation Paper on Total Return Investing by Trustees (2000), 20 E.T.P.J. 47; (2001), 15 The Philanthropist 65.

16
Wolf, "Total Return Trusts - Can Your Client Afford Anything Less" (1998), 33 Real Prop. Prob. and Trust J. 131 at 157.

17
Garland, "A Market-Yield Spending Rule for Endowments and Trusts" (July/August 1989) Financial Analysts J. 45.

18
Mittelman, "The Total Return Trust Revolution: The Opportunity and the Challenge" (2000), 54(3) J. of Financial Serv. Prof. 66 at 78.

19
Wolf and Leimberg, "Total Return Unitrusts: The (TRU) Shape of Things To Come" (2000);

Diamond, "Trust Design and Investment Strategy for the Next Millennium: Pulling the Plug on Income Rule Trusts" (2000), both found at http://www.leimberg.com; see also Dobris, "Real Return, Modern Portfolio Theory, and College and University and Foundations Decisions on Annual Spending From Endowments: A Visit to the World of Spending Rules" (1993), 28 Real Prop. Prob. and Trust J. 49 at 80.

20
R.S.B.C. 1996, c. 253.

21
B.C. Reg. 352/81.

22
Wolf, note 16 at 159-161.

23
Dobris, note 19, at 68-79.

24
An Act to Amend the Estates, Powers and Trusts Law and the Surrogate's Court Procedure Act, in Relation to Trust Accounting Income, Laws of N.Y., 2001, c. 243, s. 4 (adding s. 11-2.4 to the Estates, Powers and Trusts Law).

25
Supra n. 15.

26
Supra n. 14, recommendation no. 15.

27
The modern law is that legislation will be valid if the main purpose or "pith and substance" of that legislation falls within the field of provincial legislative competence ("Property and Civil Rights in the Province" within the scope of s.92(13) of the Constitution Act 1867). See Re Upper Churchill Water Rights Reversion Act, [1984] 1 S.C.R. 297; Quebec (Sa Majeste du Chef) v. Ontario Securities Commission, (1992) 10 O.R. (3d) 577 (C.A.), application for leave to appeal denied, S.C.C. Bulletin, 1993, 1077; Global Securities Corp. v. British Columbia (Securities Commission), [2000] 1 S.C.R. 494. Legislation will be ultra vires where its pith and substance is in relation to extra-provincial rights, but will not be rendered invalid where the effect on extra-provincial interests is incidental. The "pith and substance" of the legislation may be explained in terms of its purpose, or its dominant or most important characteristic. See Global Securities Corp. v. British Columbia, Ibid. If the main purpose or dominant characteristic of a total return investment provision is the regulation of charities in British Columbia, Trusts Act, R.S.B.C. 1996, c. 65 provide that the law applying to trusts is the "governing law" as defined in those statutes. See Rowland v. Vancouver College Ltd., [2001] B.C.J. No. 1901 (C.A.). The difficulty is that the pith and substance of a provision similar to that recommended by the Manitoba Law Reform Commission is ambiguous. Arguably, its main purpose is the regulation of the investment powers of trusts engaged in investment in the province including trusts governed by the law of the province rather than the regulation of trusts governed by the law of

the province.

28
(A fourth rule, the rule in Allhusen v. Whittel, (1867) 4 Eq. 295 was abrogated by s. 10 of the Trustee Act.).

29
Howe v. Earl of Dartmouth, [1802] 7 Ves. Jun. 137, 32 E.R. 56.

30
Re Lloyd, [1949] 4 D.L.R. 99, at 102 (Ont. H.C.).

31
(1883) 24 Ch.D. 643.

32
Fixing an acceptable percentage to be paid to life tenants under a percentage trust by regulation might afford a benchmark for the rate of notional income pending conversion, but this does not really detract from the argument that these rules are too closely connected with the concept of "authorized" investments to be easily applied once the legal list is repealed.