**Trusts (Capital and Income) Act 2013: what does it mean for trustees?**

STEP’s UK Practice Committee has drawn up the following guidance note to explain the impact of the *Trusts (Capital and Income) Act 2013* on practitioners.

The *Trusts (Capital and Income) Act 2013* deals with a number of well-established rules about distinguishing income from capital. There are effectively four sections:

- ss 1, 2 and 3 came into effect on 1 October 2013¹ (the Effective Day)
- s 4 came into effect on 6 April 2013 for the purposes of making the regulations under s 104B *Charities Act 2011* only, and on 1 January 2014 for all other purposes².

**Summary**

**s1:** Apportionment – applies only to trusts created on or after the Effective Date, abolishes statutory apportionment (s 2 *Apportionment Act 1870*), and all equitable apportionment other than under the Rule in *Re Atkinson (1904)*³.

**s2:** Treatment of tax-exempt corporate distributions (demergers) – applies to all trusts, whenever created, in respect of demergers taking effect after the Effective Date. Assets received from a demerger are capital in the hands of the trustee (subject to any contrary intention in the trust instrument or any other power under which the trust arises). N.B. This only applies to a distribution exempt under ss 1076, 1077 or 1078 *Corporation Tax Act 2010*⁴.

**s3:** Power to compensate income beneficiary – where s 2 creates unfairness between the capital and income beneficiaries, this enables the trustee to restore the income beneficiary to the position they would have been in had the demerged assets not passed wholly to capital. This is not an ‘all or nothing’ provision, and the trustees must use their judgment to decide on the extent to which the income beneficiary should be compensated⁵.

**s4:** Total return investment by charities – introduced new ss 104A and 104B *Charities Act 2011*, providing for the investment of permanent endowment funds on a total return basis and for the setting down of regulations to govern such investment. The appropriate regulations were made by the Charity Commission and came into effect on 1 January 2014. They are subject to review every five years.

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¹ The *Trusts (Capital and Income) Act 2013* (Commencement No.1) Order 2013 SI 2013/676
² The *Trusts (Capital and Income) Act 2013* (Commencement No.2) Order 2013 SI 2013/2461
³ *Re Atkinson* (1904) 2 Ch 160, where with a mortgage or debenture, the security is insufficient to redeem the debt in full, the proceeds are divisible between income and capital in proportion to the arrears of interest and capital.
⁴ (a) While the Secretary of State can prescribe other forms of distribution, this power has not yet been exercised
(b) The recent distribution of Verizon shares by Vodafone was not a qualifying distribution to which the 2013 Act applied
⁵ The 2013 Act does not address the tax consequences of applying capital as income and trustees should seek their own advice on this aspect before exercising the power
Investment of permanent endowment funds on a total return basis

‘Total return approach to investment’ means an approach to investment that gives trustees flexibility in the way they allocate the total return arising from the trust for investment between the trust for allocation (income/revenue) and the trust for investment (capital)\(^6\).

The Charities (Total Return) Regulations 2013 (the Regulations) create a new power for charity trustees (the s104B Power), which sits alongside the existing power of the Charity Commission to make an order permitting permanent endowments to be invested for total return. Charity trustees can effectively discharge such an order\(^7\) by exercising the power under the Regulations, subject to the continued payment of any amounts agreed to be repaid by way of recoupment.

The s104B Power is exercisable by resolution and can apply to the whole, or any part, of a charity’s permanent endowment held under a trust for investment. This does not extend to permanent endowments consisting of, say, a village hall given to the charity on condition that it would only be used for the benefit of the local inhabitants\(^8\).

Before exercising the s104B Power, the trustees must be satisfied that:

- it would be in the best interests of the charity
- they are acting within their powers
- they are adequately informed, having taken into account all relevant factors and disregarded any irrelevant factors
- they are acting in good faith and have managed any conflicts of interest
- they are acting only in the interests of the charity and within a range of decisions that a reasonable trustee body make, and
- they are able to demonstrate they have addressed each of these points, which will be fact-specific to the charity.

When exercising the s104B Power, the trustees need to identify:

- the assets now held, representing the value of the original endowment, including additions (but not any investment return)
- the assets now held representing the unapplied investment return (including the investment return).

There is no specific format for the trustees’ resolution (s104B Resolution), although it should state:

- the power under which it is made
- the fund(s) to be subject to total return investment
- if any existing Charity Commission Order is being discharged
- if there are any outstanding recoupment provisions
- the valuation, and date of valuation, of the fund(s) in question.

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\(^6\) The Charities (Total Return) Regulations 2013, Regulation 2
\(^7\) made under s26 Charities Act 1993, or s105 Charities Act 2011
\(^8\) Charity Commission: Total return investment for permanently endowed charities, example @ D.1
The Charity Commission does not need to be informed of the adoption of any such resolution, which will be reflected in the charity’s annual report⁹.

Once a s104B resolution is made, the trustees decide how to allocate the returns on investment for the charity’s purposes. To the extent they are not applied to support the charity’s aims, funds can be held as unallocated return, to be applied in future years, or to augment the permanent endowment. While there is no limit on the amount of the investment return that can be applied for the charity’s purposes, the trustees’ ability to add to the permanent endowment is restricted¹⁰. The Charity Commission recommends that trustees take appropriate legal and accountancy advice when exercising the discretion to allocate the investment return.

Monies can only be applied to support the charity’s aims once they have been allocated to the ‘income’ fund. The unallocated return is to be treated as though it were a part of the permanent endowment until, or unless, it is so allocated. Even if the total return for a particular year is negative, trustees can draw upon the accrued unallocated total return (if any) to allocate funds to the ‘income’ fund.

Trustees can also draw on the endowment to support the charity’s aims, up to a maximum of 10 per cent, but in doing so, must put in place a programme of recoupment from future returns to ensure the capital value is restored within a period not exceeding ten years¹¹.

Where the value of the permanent endowment is less than the value identified in the s104B resolution (adjusted for any further gifts), while the charity can spend unapplied return, any further receipts will reduce the negative unapplied total return brought forward from the previous accounting year.

Trustees can decide to revoke a s104B resolution, where it is considered to be in the interests of the charity to do so, although it is expected that this should be a rare occurrence. Should this happen, though, the trustees will need to consider how any unapplied return should be allocated and, if there is a negative unapplied total return, put in place appropriate provision to recoup that loss¹².

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⁹ The Charities (Total Return) Regulations 2013, Regulation 6.(4)
¹⁰ The Charities (Total Return) Regulations 2013, Regulation 3.(5)
¹¹ The Charities (Total Return) Regulations 2013, Regulation 8.(2)
¹² The Charities (Total Return) Regulations 2013, Regulation 8.(2)