New Zealand
Property Law and
Equity Reform
The treatment of
increases in
livestock on the
death of a life

...TY LAW AND EQUITY REFORM COMMITTEE

...atment of Increases in Livestock on ... death of a life tenant under a Trust

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Working Paper

INTRODUCTION:

1. The Committee has been requested by the Minister of Justice to consider the implications of the decision of Cooke J. in Re Richards deceased (1974) 2 N.Z.L.R. 60 on the method of treating increases in livestock on the death of a life tenant under a trust and whether or not any changes in the law are desirable.

BACKGROUND:

2. In New Zealand there are many trusts of which a farm is an asset and under the trust the trustees carry on the business of livestock farming. It frequently happens that under the terms of the trust the income derived from the farming business is payable to one or more persons and upon a certain event their interest terminates and entitlement to the farm and future income derived from it passes to another person or persons.

3. The terms of such trusts can vary greatly: the person entitled to the income may be the wife or widow of the settlor or testator a child or children of the settlor or testator or indeed any person or charity; likewise the event upon which that interest terminates can be the expiration of a fixed period of time or the death of that or some other person or the attainment by that or some other person of a particular age or an event such as the marriage or even the divorce of that or some other person.

4. Despite these many possible variations, the principles of law by which the respective rights and duties of the beneficiaries and trustees are determined are the same. To simplify the following discussion, the context will refer

throughout to a common form of such a trust namely that where a farmer has died leaving his farm to trustees upon trust to carry on the business of farming and pay the income to his widow for life and upon her death the farm then passes to another person. Here the settlor or testator is the farmer, the income beneficiary (the life tenant) is the widow and the event upon which her interest terminates is her death. The person who becomes entitled to the farm upon the widow's death is the remainderman. The discussion of the relevant principles of law is equally applicable for all variants where the farm is settled upon several persons in succession.

5. For reasons of simplicity it will be assumed that at his death the testator was carrying on the farming business and that there were on the farm certain livestock. Again the following discussion is equally applicable even if the facts be more complicated, e.g., where the farm is purchased after the trust commences or where a crop farm is converted into a livestock farm during the life tenancy.

6. At the testator's death there will be a certain number of livestock on hand on the farm. The numbers of livestock on hand at the testator's death can vary greatly depending upon the type of farm and the time of the year when the testator died - whether ewes are in lamb or have lambs at foot etc. Whatever the livestock on hand may be at the date of the testator's death, that is the capital livestock at the commencement of the trust and that is the corpus from which the income is derived that is to be paid to the life tenant.

7. Given that a trust exists whereunder a farming business is to be carried on, the income from which is to be paid to a life tenant and on her death the capital is to pass to a remainderman, there are 3 possible ways in which this can be done:

   (a) the trust can be constituted a company by the testator's will, the company will carry on the farming business, the trustees will be the directors and shareholders of the company and in that capacity will declare dividends from the profits of the farm which dividends will constitute the income payable to the life tenant

(b) the trustees can allow the life tenant to take possession of the farm and livestock implements etc. and herself carry on the farming business keeping the profits for herself and being obliged at the termination of the life tenancy to redeliver to the trustees the assets they had originally delivered to her

(c) the trustees can themselves carry on the farming business, pay the income to the life tenant and at the termination of the life tenancy, transfer the assets to the remainderman

This working paper is not concerned with any of the issues which arise in implementing alternatives (a) or (b) above; it is concerned only with alternative (c) and within that limitation, with the calculation of the "income" which is to be paid to the life tenant and in particular with what adjustment, if any, should be made on the death of the life tenant if the numbers of livestock at that time exceed the numbers carried at death of the testator. In this working paper the term "surplus stock" is used to refer to the numbers of livestock on hand at the death of the life tenant in excess of the numbers of livestock on hand at the death of the testator.

<u>THE POSITION prior to Re Richards:</u>

8. The practice of many accountants advising trustees of trusts where livestock farming was conducted has been to value the surplus stock and to credit the life tenant's estate with the full market value of the surplus stock. The life tenant pays income tax on income calculated as the difference between the standard values of the surplus stock and their market value on the basis of a notional sale. The market value of the surplus stock is an asset in the estate of the life tenant upon which estate duty may be assessed and the amount of the income tax payable is deductible as a debt owing by the estate to determine

the final balance of the estate for estate duty purposes.

9. Increases in livestock numbers arise in the following ways:

(a) Capable farm management subsequent to the creation of the trust makes it necessary for there to be a permanent increase in the numbers of livestock that must be carried to continue farming efficiently. This is done in the case of a breeding property by retaining stock bred so that a certain number are not realised as income for the benefit of the life tenant. In the case of a fattening property the numbers purchased exceed those sold so that there is a net increase in stock retained in the farm which are not realised for the benefit of the life tenant. The increased stock are then used as part of the stock permanently retained on the farm which produce income which is payable to the life tenant.

(b) Due to seasonal climatic or market conditions more stock are held at the end of the year than at the commencement. These stock are later sold and there is no net increase in the numbers of livestock carried. The life tenant receives as income the proceeds of the sale of these livestock in the year in which they are actually sold.

10. Standard values for livestock fixed for income tax purposes vary considerably. Market values can be used, nil values chosen, or any value in between these extremes. At first the Inland Revenue Department permitted farmers to fix a value less than market value as a standard or average value for the purpose of calculating income. Later, as a tax concession to farmers, a nil standard value was permitted. In fact, accountancy practice in fixing standard values in farming trusts has, in many cases, become more concerned with their effect on income tax than the relative positions of the life tenant and the remaindermen. While such a practice is permissible for income tax purposes, it is contrary to the decision of <u>In re Bassett</u>, (1934) N.Z.L.R. 690 which required, for the purpose of

determining the income of the trust estate, that standard values be fixed at the same value as the values placed on the stock for probate purposes.

11. The position between the life tenant and the remaindermen also varies considerably according to the time of year that the death of the life tenant occurs, e.g., whether sheep are in wool or shorn and whether ewes are in lamb or have lambs at foot. The amount of the income calculated as described in paragraph 8. depends on the relationship between the market value ruling at this time and the standard value which has been adopted in the accounts. Thus the amount of the "income" so calculated and to which the life tenant's estate will be entitled bears no necessary relationship to the market value of the stock which was not realised in the year or years in which the numbers were increased and which would, had that stock then be realised, have been income during that year in the hands of the life tenant. On the other hand, the numbers of livestock which existed at the commencement of the trust (the farmer's death) may no longer bear any true relationship to the permanent winter carrying capacity of the land (i.e. the livestock actually carried as the permanent flock or herd which produced the annual income).

11A. The Committee recognizes that life tenancies in farming trusts are not unique in principle - they are merely an instance of a life tenancy of a business which may, as a business, be a farming business but could equally well be business catering to tourist or holiday seasonal traffic, to gold mining or be a suburban grocery. The problems which could occur in life tenancies in businesses were highlighted in Re Richards as they arise in a particular type of farm (a high country sheep farm) but the same problems can arise in every business life-tenancy with only the features peculiar to the type of business concerned distinguishing one from another. The more regular throughout the year and the more stable from year to year the particular type of business the less the likelihood of acute problems of adjustment as between life-tenant and remainderman arising; but in all cases the principles by which such problems are to be resolved remain constant. Therefore the Committee concluded that it would be wrong to treat life tenancies in farming trusts as a unique species - whatever changes in the law are found desirable should be equally applicable to all trusts where there are life tenancies in a business enterprise. Because the problems tend to arise frequently in farming trusts, farming trusts are at least as common as trusts of other types of businesses, the decision in Re Richards concerned a farming business, and the problems are relatively easily explained in the contexts of farming trusts, this paper is expressed in terms applicable to farming trusts. But it must be always recalled that the issues highlighted, the legal principles involved and the proposed solutions are of equal significance in trusts of other types of businesses.

11B. The Committee considers that any amendments to the Trustee Act to effect any of the proposed remedies should apply both to existing as well as future trusts.

THE EFFECT OF IN RE RICHARDS:

12. In his decision in Re Richards Cooke J. enunciated the following principles in dealing with the adjustments necessary as between the estate of the life tenant and remainderman as at the termination of the life tenancy which were necessary because of surplus stock:

(a) The paramount principle is even-handedness between the life tenant and the remaindermen. It is not necessarily inconsistent with this principle for the trustee to carry out a policy of improving the carrying capacity of the farm and to incur expenditure in so doing which is charged against income. If such a policy be adopted the trustee must exercise his discretion in incurring expenditure which is charged against income in a responsible way having regard to the paramount principle.

(b) To arrive at the amount of income to be paid to the life tenant on account of increases in the numbers of livestock over theyears, the income in each year should be calculated taking into account the opening and closing stock numbers at standard values. That part of the net income so found which is represented by increases in livestock numbers at the end of the year may be placed in a suspense account. Insofar as this suspense account has not been diminished by the sale of the additional livestock in the lifetime of the life tenant, the balance in the suspense account at the end of the life tenancy becomes due on the death of the life tenant and payable to her estate.

(c) The increases in livestock numbers retained as "permanent" livestock because of a successful farm improvement policy carried out by the trustee during the life tenancy become part of the corpus of the trust and the life tenant cannot, during the life tenancy, insist on an acutal or notional sale of such increases in livestock numbers.

13. It is important to note that the question of what values should be used as the standard values of the livestock was not in issue in Richard's case. It was, however, held In re Angas (1906) S.A.L.R. 140 that the standard value of stock should be the same value as the capital value placed on them for probate purposes. This decision was adopted in In re Bassett (1934) N.Z.L.R. 690, wherein Ostler J. disapproved of adopting market values or alternative values permissible under the Land and Income Tax Acts for determining the respective rights of the life tenant and the remaindermen under the trust.

14. Re Richards recognised that where the livestock carried on the farm had been increased, the increased numbers became part of the capital of the trust. It also recognised that the increased numbers could only be obtained through increased purchases being charged against income at cost, or alternatively, through there being fewer sales due to livestock being retained to increase the flock or herd with the result that the life tenant was deprived of income in those years. During the life tenancy the trustee had created a suspense account to which was credited the value of the net increases in livestock carried each year at standard values. The case was brought

to determine what proportion of the value of the increased numbers of livestock as at the death of the life tenant (the surplus stock) belonged to the life tenant and what proportion was due to the remainderman.

STANDARD VALUES

15. It is suggested that the standard values adopted for income tax purposes which can vary from market values to nil values according to a decision of the trustees made to take advantage of tax concessions, are likely to be quite unsuitable as a basis for maintaining even-handedness between the life tenant and the remainderman. (This does not mean that a trustee is precluded from adopting as the standard value for taxation purposes whatever value he considers most advantageous for the trust. It does mean that if the trustee adopts as the standard value for taxation purposes a value which is not the best standard value to maintain an even-handed balance as between the life tenant and the remainderman and does so without the consent of the party prejudiced by his decison, then he should keep separate accounts for the respective interests of the beneficiaries under the trust and may not use for trust administration purposes as between the beneficiaries, accounts prepared for taxation purposes which are ex hypothesi biassed in favour of one beneficiary at the expense of the other.)

16. The standard values used in the annual accounts in Re Richards were the probate values of the stock and no objection was raised by any of the parties or by the Court to the adoption of such values. The use of probate values as standard values means that if there is a permanent increase in stock values over the period of the life tenancy, the life tenant does not share in the increase in value of the numbers of stock on hand at the date of death of the testator (which is proper) but also does not share in any increase in the value of stock retained to increase the original numbers.

THE PROBLEM

17. The problem is to decide whether a life tenant is entitled only to that part of the profits of a business which is realized in cash during the life tenant's lifetime or is entitled either on the basis of Re Richards or on some other basis to an interest in the unrealized assets which have been built up at the expense of income;

ALTERNATIVE METHODS OF TREATMENT:

18. The following appear to be alternative methods of treating increases of livestock numbers theoretically possible:

(a) To value the "surplus stock" at the date of death of the life tenant at the net realisable values and to pay the life tenant's estate the full value of the surplus stock.

(b) To value the increased numbers of livestock at their net realisable values annually. The value of such stock would be placed in a suspense account each year. On realisation of any of the increased numbers of livestock the income so produced would be credited to the life tenant. On the death of the life tenant any credit in the suspense account would belong to the estate of the life tenant. In practice, the increased numbers of livestock would have to be valued each year. This would itself raise a number of problems:

(i) The manner in which the values of each year's increases in livestock numbers would be calculated. A valuation by a stock valuer would be expensive and have practical difficulties due to the number of valuations required.

(ii) A decline in numbers, especially if there had been a change in classes of livestock would give rise to difficulties in identifying which which previous increases in numbers were realised.

(iii) If a change in farming policy caused sufficient previous increases in livestock numbers to be realised so that there was a deficiency in value the life tenant would be liable for this although there was still an increased number of livestock.

(c) To arrive at the net income from the farming business for the financial year in which the death of the life tenant occurs (being either the full twelve month period or the period up to which the farming operations cease) by using standard values and to apportion the income so calculated between the estate of the life tenant and the trustees for the remaindermen. If farming operations ceased on the death of the life tenant because, for example, a lease of the land then terminated, and the life tenant died before any income was realised, the livestock on hand could be valued with values apportioned to show what part of the value was income and what part capital. For example, a ewe might be ready to drop a lamb or might have a lamb at foot, or all sheep could have six months' growth of wool at the death of the life tenant. It should not be difficult for livestock which were not part of the capital stock to be treated as income at valuation.

INCOME APPORTIONMENT

19. The Committee considered that the alternative of apportioning the income for the farming year in which the death of the life tenant occurs on a pro rata basis was preferable for the following reasons:

(a) The true basis for arriving at the income due to the life tenant should be the assumed intention of the testator or the creator of the trust. The raison d'etre of a life tenancy is to provide income for the life tenant during the lifetime of the life tenant which the life tenant can enjoy. The purpose of a life interest is for actual income to be applied as income. As a corrollary no income which has been converted into capital and used to produce income should be accounted for to the life tenant's estate for the benefit of the life tenant's beneficiaries.

(b) If this principle of income apportionment be accepted, another problem would be overcome. Where a trust commences in say, September or October, that is, after the progeny have been born, such progeny are part of the capital of the trust. Because the proceeds of normal sales must be credited to capital, the result can be a much reduced income or even a loss on the income account for the income year which commences with the commencement of the trust. The life tenant consequently receives little or no income for this period through to the winter balance date.

The approach favoured by the Committee would result in a proper proportion of the proceeds of the realization of the progeny, wool clip etc being paid to the life tenant as income of the first year of the trust and not credited to capital.

PROPOSED REMEDY

20. To authorise a trustee to apportion the income it is recommended that legislative provision be made on the following lines.

> Where trust property be held for different persons or objects in succession and the trust property include a trading enterprise then the trustee may if he considers it expedient so to do in order better to determine the net income of the trading enterprise considered as a continuing entity available for appropriation and distribution to or amongst the person or objects of the trust entitled to all or part of the income derived from that trading enterprise over a period -
>
> (a) instead of commencing the accounting period to determine such income at the date of commencement of trust, adopt the annual accounting period used by the trading enterprise immediately prior to the commencement of the trust and continue the accounting period current at the commencement of the trust and apportion the income determined on such basis as if it had accrued evenly over the accounting period.

(b) instead of making up accounts as at the termination of an interest limited to receive all or an aliquot part of the income derived from the trading enterprise, make up accounts for the trading enterprise at the end of the accounting period current at such termination and apportion the income determined on such basis as if such income had accrued evenly over the accounting period.

21. An apportionment of income in the manner suggested either at the commencement or termination of a life tenancy will enable the trustee to ascertain the income due to the life tenant in a fair and reasonable way which would not be subject to the inequities and anomalies that can arise because of the time of year at which the testator or life tenant happens to die.

THE SURPLUS STOCK QUESTION

22. Apportioning income does not, however, finally answer the question whether the life tenant should share in the surplus stock. Any business, be it a farming business or some other kind of business, can only remain viable if it maintains and improves its productive capacity. While the owner of a business is alive he can plough back part of his profits into his business. In times of high inflation it is courting disaster to borrow at high rates of interest for the purpose of maintaining and improving the assets of the business. If the stock carried on a farm be increased by retention of part of the stock bred, a trustee can avoid the necessity to borrow additional capital. If at the termination of the life tenancy the life tenant's estate is to be credited with the value of the surplus stock, the remaindermen may have to borrow substantial sums of money which may make the business unprofitable or may have to see the business sold and pass from family ownership.

CONSIDERATION OF PREVIOUS PROPOSALS

23. In its preliminary working paper the committee's proposed solution was to treat the surplus stock as part of the capital of the business with the result that the life tenant's estate would not have received

any share in the surplus stock.

24. The submissions received from those to whom the preliminary working paper was circulated did not show unqualified support for this proposal. In particular, the New Zealand Society of Accountants opposed the proposal that increases in livestock accrued to capital on the ground that it deprived a life tenant of what had been given to her merely because she was not in a position personally to enjoy it. The proposal assumed she would never be in this position and that "enjoyment" included only the spending of money and not the ability to dispose of it by will. Federated Farmers of New Zealand considered the proposed remedy went too far in favour of the remaindermen.

SOLUTION PROPOSED

25. As a result of these and other criticisms the Committee considered an alternative remedy which is to confer upon the individual trustee a discretion to appropriate increased numbers of livestock held on the farm to the capital of the trust (and a corresponding provision for other business trusts) to use in such cases and to such extent as the trustee considered necessary to preserve even-handedness between the life tenant and the remaindermen.

25A. Accordingly the Committee intends to recommend that a new sub-section be included in the Trustee Act 1956 to the following effect:

> 15 (3). Where in the administration of any property settled by way of succession and employed by the trustees to carry on the business of farming livestock the trustee while carrying on the farming business increases the numbers of livestock by an increase in winter carrying capacity and the trustee considers that in the interests of good husbandry and of the persons entitled or who may become entitled to the income or capital of the property it is fair and reasonable that the whole or any part of such increases in the numbers of livestock shall be capital then notwithstanding any rule of law to the contrary it shall be lawful for but not obligatory upon him to credit the whole or any part of the increased numbers of

livestock to capital. Any increased numbers of livestock so credited to capital shall become part and follow the destination of the capital of the property and shall be subject to all the trusts powers and provisions applicable thereto. Where any increase in the number of livestock is so credited to capital, no subsequent adjustment in favour of those entitled to the income shall thereafter be made unless the trustee in his discretion or the Court so determines.

15 (4). Where in the administration of any property settled by way of succession and employed by the trustee to carry on any business (other than the business of farming livestock) the trustee increases the revenue earning capacity of the business (whether by improvement of machinery employed, increase in the range or quantity of trading stock carried or otherwise) by reason of carrying on the business in accordance with good business practice and the trustee considers that in the interests of the business and of the person or objects who or which are or may become entitled to the income or capital of the property

+ fair and reasonable

it is + that the whole or any part of the increased earning capacity of the business shall be capital then notwithstanding any rule of law to the contrary it shall be lawful for but not obligatory upon him to credit the whole or any part of the increased earning capacity to capital. Any increased earning capacity so credited to capital shall become part of and follow the destination of the capital of the property and shall be subject to all the trusts powers and provisions applicable thereto accordingly. Where any increase in the revenue earning capacity of the business is so credited to capital no subsequent adjustment in favour of those entitled to the income shall be made unless the trustee in his discretion or the Court so determines.

or revenue earning capacity

15(5) Any increases in the numbers of livestock/which are credited to capital by the trustee exercising his discretion pursuant to such a power shall be separately clearly recorded in the accounts of the trust and each year the trustee shall inform the beneficiaries of the exercise of the discretion, the approximate financial effect thereof and the extent to which the trustee envisages exercising the discretions in the same way in the succeeding years.

26. Any beneficiary who considered he was prejudicially affected could challenge the trustee's decision in the Court under Section 68 of the Trustee Act.

FAIRNESS AND REASONABLENESS AS A CRITERI

27. This proposal was foreshadowed in the draft working paper. It was criticised by several learned commentators on the ground that this criterion was too vague - that trustees would be loathe to exercise their discretion and applications to the Court for directions as to the basis upon which the discretion should be exercised would abound.

28. This criticism is insubstantial. It is preoccupied with the word and neglects the substance. The fundamental principle is that the trustee must exercise all his discretionary powers so as to be even-handed as between life tenant and remainderman: not favouring one at the expense of the other when a less biassed result would result from another available alternative. When the concept of even-handedness be examined it is found to be merely a synonym for fairness, equality, equity, balance etc. All these nouns are susceptible to the same criticism of vagueness. The duty to be even-handed as the paramount duty of a trustee has been accepted for two hundred years. A principle of positive import (as distinct from a prohibition) is necessarily general - in that way it is applicable to diverse circumstances. The Committee sees no reason why the criterion of "fairness and reasonableness" should prove a major source of difficulty in practice. A trustee carrying on a business for the trust must be prepared to exercise his discretionary powers in the administration of the business. If he be not prepared to do this he should retire from the trusteeship. The criterion of fairness and reasonableness will not be a problem for a conscientious trustee.