

**PROPERTY LAW
AND EQUITY
REFORM COMMITTEE**

**REPORT ON THE DECISION
IN RE RICHARDS**

WELLINGTON NEW ZEALAND

REPORT
OF THE
PROPERTY LAW AND EQUITY REFORM COMMITTEE
ON
THE DECISION IN RE RICHARDS

Presented to the Minister of Justice

December 1978

PROPERTY LAW AND EQUITY REFORM COMMITTEE

REPORT ON THE DECISION IN RE RICHARDS

TO: The Minister of Justice

1. In August 1975 you requested the Committee to consider the effects of the decision In re Richards [1974] 2 NZLR 60. In carrying out its brief, the Committee issued two working papers and has received submissions from the N.Z. Society of Accountants and local accountants societies, various district law societies, trustee companies, Federated Farmers of New Zealand Inc., the Public Trustee, the N.Z. Technical Institute and interested individuals. (Appendix II lists all the submissions received.)

2. In the Richards' case the trustee had carried on a farming business for a period of some 16 years from the death of the deceased until the death of his widow, the lifetenant. During this period the livestock on the farm increased markedly. The method of accounting used by the trustee to determine the farming profit each year was to bring in stock on hand at the beginning and end of each year at standard value. The standard value adopted by the trustee was the probate value which in that case was the market value of the stock at the date of death. This value was not changed throughout the period of the lifetenancy and at the date of death of the lifetenant was very much less than the market value. That part of the annual profit which was realised in cash was paid to the lifetenant but no payment was made to the lifetenant in respect of that part of the profit which was represented by an increase in the livestock. Following the death of the lifetenant the Court was asked to determine whether the lifetenant was entitled to the value of the increase in livestock or to some other interest in the unrealised profits. The Court held that the increase in stock formed part of the capital of the estate, that the lifetenant

had no interest in specie in the increase and was entitled to the unrealised profit shown in the accounts. In effect this meant in the Richards' estate that the lifetenant's estate received the value of the increase in stock at standard value or \$20,000 whereas the market value of the increase in stock was \$52,000.

3. The first working paper issued by the committee proposed that increases in livestock due to an increase in winter carrying capacity be included in the capital of the business and that trustees be given power to make advances from capital to lifetenants in anticipation of income and on the termination of a life interest to make equitable adjustments having regard to the flow of income in that year.

4. These proposals met with a mixed reception. The N.Z. Society of Accountants in particular considered that the lifetenant's estate should receive the market value of any increase in livestock. The Federated Farmers thought the proposals went too far in favour of the remaindermen. Other submissions gave support to the proposals, some with reservations.

5. A further working paper was prepared in the light of these submissions. This working paper contained two principal proposals:

- (a) That both at the date of death of the testator and at the date of death of the lifetenant the trustee be empowered to apportion the income for the whole year in which the death occurs. This would alleviate the difficulties that can arise because of the point of time in a farming year at which a death occurs.
- (b) Where in any farming business there is an increase in stock as a result of an increase in the winter carrying capacity the trustee may, if it is considered in the interests of good husbandry and of the persons entitled to income or capital of the property to be fair and

reasonable that the whole or any part of such increases in number of livestock shall be capital, credit the whole or part of the increased number to capital.

6. While the proposal to apportion the income on a more equitable basis than is possible at present was generally supported, submissions received showed a considerable divergence of opinion on how best to deal with increases in livestock. The N.Z. Society of Accountants reiterated its previous view that the lifetenant's estate should receive the value of any increase in livestock. There was other support for this view, support for the principals laid down in the Richards' decision and support for the proposal made by the Committee.

7. There is such a divergence of opinion as to the way in which the profits of a farming business where there has been a permanent increase in livestock should be ascertained and disposed of that it seems to be impossible to arrive at a solution which would meet with general acceptance. The determination of business profits particularly of farming businesses requires a separate study which is beyond the resources of this Committee. The Committee does however suggest certain action which could be taken to give trustees wider powers to do justice between the lifetenant and remaindermen. If these proposals were given statutory effect they would go some way towards alleviating injustices that can arise as the result of the strict application of the existing rules including the Richards decision.

8. Section 15(2) of the Trustee Act 1956 authorises a trustee to set up a depreciation fund or replacement fund in respect of property employed in the production of income or in respect of any asset comprised therein. This is a useful power but it is limited to existing assets and the amount that can be credited to such funds is determined by the value of such assets. If an estate business were controlled by a company the directors of the company could create reserves out of income and the lifetenant would only be entitled to the dividends declared by the directors. No matter how desirable

it may be in an unincorporated business to plough back part of the profits into the business to improve its profitability, such a power is not available to trustees except to a limited extent under s.15(2). The Public Trustee has suggested that trustees be given a general power to set aside reserves out of profits for the purpose of providing additional capital for the more convenient working of the business or to provide a fund out of which the business may be developed to improve profitability. The Committee sees such a power as a useful tool for a trustee carrying on a business and which would reduce the need to borrow additional capital at high rates of interest whenever it was necessary to make improvements. It is envisaged that the amount to be reserved would be entirely in the trustee's power but as this would be a statutory power the trustee's discretion would be subject to a review by the Court under s.68 of the Trustee Act. It is considered that the reserve fund should be available for such things as:

- (i) Improvement or development of the business.
- (ii) Repayment of debts of the business.
- (iii) Repairs, replacements or renovations of business assets.
- (iv) Building up income payable to the lifetenant in poor years; companies sometimes pay dividends out of reserves where current profits are insufficient, and we would like to see incorporated and unincorporated businesses producing similar results as between income and capital so far as possible.
- (v) Meeting losses of the business.

but would otherwise form part of the capital of the trust. The Committee sees the advantages of this proposal as being:

- (a) Unincorporated businesses carried on by trustees will produce similar results as between capital

and income to those carried on by companies or partnerships in which the trustees have an interest, and thus will avoid a difficult problem for trustees in deciding whether or not to incorporate a business under the powers in s.33 of the Trustee Act.

- (b) Allows sums of income to be capitalised permanently to finance the acquisition of increased livestock, additional or improved equipment etc, which would otherwise have to be purchased out of capital, subject in some cases perhaps to capital being recouped out of income.
- (c) Enables tax equalisation payments, wool retention moneys etc to be capitalised where desirable and, more importantly as a result, to be spent on capital items with consequential tax savings.
- (d) Enables reserves to be built up prior to the actual improvement or development of the business.
- (e) Could be applied immediately to existing trusts with little difficulty.

9. Where a lifetenant is dependent on the income arising from a business she can be subject to wide fluctuations in income from year to year and at times suffer severe financial hardship as a result of an unexpected drop in the business income. To ameliorate this difficulty the Committee considers that a trustee should be empowered to apply estate capital (including money in any reserves that have been created) for the maintenance of the lifetenant in any year when the income is insufficient. Any capital so applied would be recouped out of the income of subsequent years when the income is adequate. In exercising the powers to create reserves and to apply capital it is considered that the trustee should have regard to the desirability of ensuring the proper maintenance and support of the lifetenant and the preservation and improvement of the business assets.

10. At present when a testator dies the trustee must ascertain the testator's income to the date of his death by preparing accounts to that date. The income derived to that date is treated as part of the capital of the estate and the income earned after the testator's death belongs to the life tenant. Unreal results can arise depending on the time of death of the testator, e.g. if the testator dies before the sheep are shorn the whole of the proceeds of the wool clip will belong to the life tenant as income and no part thereof will be credited to the estate capital. On the other hand if the testator dies after the sheep are shorn the life tenant does not share in the proceeds and would have to wait up to 12 months before adequate income would be available for her support. Similar problems arise in respect of lambs and the same kind of problems arise at the death of the life tenant. The Committee proposes that the trustee be authorised in the year in which the testator dies to prepare accounts for the whole of that period and apportion the income so ascertained as if it had accrued evenly over the year. A similar authority would apply to the year in which the life tenant dies. There should be no significant alteration in revenue as a reduction in one estate would be balanced by an increase in another estate. One objection which was made was that if the death of the testator or life tenant occurred near to the commencement of the accounting period there would be a delay of up to 12 months before the year's income could be ascertained and an apportionment made. What is proposed is a power which the trustee could use at his discretion. A competent trustee in such circumstances may well decide not to use the proposed power and to determine the respective shares in income on the basis of the present rules in order to avoid any such delay.

11. What is recommended is the creation of desirable statutory powers. Such powers along with other statutory powers conferred by the Trustee Act would be subject to any contrary intention expressed in a testator's will. Thus a testator would be free to negate, add to or vary such statutory powers to suit his circumstances and the circumstances of his beneficiaries. The existence of such

powers while not abrogating the effect of the Richards' decision will enable a trustee to administer a business and distribute its profits in a way which would benefit all the beneficiaries. The exercise of such powers would also be subject to review by the Court pursuant to s.68 of the Trustee Act.

12. The powers proposed are not limited to farming businesses and the Committee sees no reason for such a limitation. Draft clauses for incorporation in the Trustee Act are annexed.

Charles Hutchinson

C.P. Hutchinson: Chairman

1st. December 1978

MEMBERS:

Mr C.P. Hutchinson Q.C. M.B.E. (Chairman)
Mr R.G.F. Barker
Dr G.P. Barton
Mr G. Cain
Mr S.F. Drummond
Mr V.R.W. Gray
Professor G.W. Hinde
Mr L.H. McClelland
Mr K.U. McKay
Mr W.M. Taylor
Ms R. Corbett (Secretary)

APPENDIX I

TRUSTEE AMENDMENT

A BILL INTITULED

An Act to amend the Trustee Act 1956

BE IT ENACTED by the General Assembly of New Zealand in Parliament assembled, and by the authority of the same, as follows:

1. Short Title - This Act may be cited as the Trustee Amendment Act 197 , and shall be read together with and deemed part of the Trustee Act 1956* (hereinafter referred to as the principal Act).

2. New heading and sections (relating to trustees' powers) inserted - The principal Act is hereby amended by inserting in Part III, after section 42, the following heading and sections:

"Special Powers in Respect of Businesses

"42A. Power to set aside reserves out of income or profits of business - (1) Where any property settled by way of succession is employed in a business that the trustee is empowered or authorised to carry on, and the trustee considers that in the interests of the persons entitled to the income or capital of the property, and in accordance with good business practice, it is expedient to set aside and retain as a capital reserve part of the income or profits arising therefrom in any period, then, notwithstanding any rule of law to the contrary,

* Reprinted 1968, Vol. 4, p.3279
Amendments: 1969, No. 110; 1974, No. 15; 1977, No.176

and without in any way affecting any other power conferred on him by this Act or any other enactment (including, without limiting the generality of the foregoing, the power to set up a depreciation or replacement fund under section 15(2) of this Act), or by the instrument creating the trust, it shall be lawful for but not obligatory upon the trustee to direct that such part of the income or profits arising from the property in that period as he determines shall cease to be income and shall become a capital reserve of the business.

"(2) Any income or profits reserved by the trustee under this section may be applied by him in his discretion either immediately or at any time or times thereafter in, for, or towards all or any of the following purposes:

"(a) The payment or discharge of any debts or liabilities of the business that are properly payable out of capital:

"(b) The improvement or development of any of the assets of the business, including the acquisition of trading stock or livestock:

"(c) The replacement, repair, maintenance, upkeep, or renovation of any of the assets of the trust used in the business, whether the cost of such replacement, repair, maintenance, upkeep, or renovation would otherwise have to be paid out of capital or out of income or partly out of capital and partly out of income:

"(d) The acquisition by purchase or otherwise of property or assets of like nature to any of the assets used in the business or that may advantageously be employed in conjunction therewith:

"(e) The provision of additional capital for the more efficient working of the business and a fund to enable the business to be developed:

"(f) Meeting any losses notwithstanding that under any rule of law or enactment or provision in the trust instrument to the contrary such losses should be borne or partly borne by income:

"(g) Any purpose or other purpose to which or for which in the exercise of any power, trust, or authority conferred upon him by this Act or any other enactment, or rule of law or by the trust instrument creating the trust, or Court order the trustee may pay or apply the income or capital of the property or of any other assets held by him upon the same trusts.

"(3) All income or profits reserved by the trustee under this section shall, subject to the provisions of this section, follow the destination of the capital of the property and shall be subject to all the trusts, powers, and provisions applicable thereto.

"42B. Power to apply capital of business for maintenance

- (1) Where any property settled by way of succession is employed in a business that the trustee is empowered or authorised to carry on, and the trustee considers in any period that the income arising from the business and available for distribution to the person entitled to receive it (in this section referred to as the income beneficiary) is insufficient for the proper maintenance of the income beneficiary, having regard to any other income received or to be received during that period by the income beneficiary from whatever source and to all the other circumstances of the case, then, notwithstanding any rule of law to the contrary, and without in any way affecting any other power conferred on him by this Act or any other enactment (including, without limiting the generality of the foregoing, the power to make advances out of income and capital under sections 40 and 41 of this Act) or by the instrument creating the trust, it shall be lawful for but not obligatory upon the trustee to pay or apply any capital money or other capital asset subject to the trust and employed in the business (including any money for the time

being standing to the credit of any fund established by the trustee under section 15(2) or section 42A of this Act) for the maintenance or benefit, in such manner as he may in his absolute discretion think fit, of the income beneficiary.

"(2) If, in any such case, the trustee pays or applies any capital money or capital asset for the maintenance or benefit of the income beneficiary in accordance with subsection (1) of this section, and, in any subsequent period, the trustee considers that the income available from the business for distribution to the income beneficiary is more than sufficient for the proper maintenance of the income beneficiary, having regard to any other income received or to be received during that subsequent period by the income beneficiary from whatever source and to all the other circumstances of the case, then the trustee may recoup the whole or such part as he thinks fit of the sum so paid (or of a sum equivalent to the value of the capital asset so applied) from the income arising from the business during that period and available for distribution to the income beneficiary.

"42C. Matters to be taken into consideration when exercising powers - In considering whether or not to exercise, or in what manner he should exercise, any power conferred on him by section 42A or section 42B of this Act, the trustee shall have regard to the desirability of ensuring both -

"(a) The proper maintenance and support of the beneficiary entitled to the income arising from the business; and

"(b) The preservation and improvement of the business enterprise in the interests of the beneficiaries entitled to the capital thereof.

"42D. Apportionment of income - Where any property settled by way of succession is employed in a business that the trustee is empowered or authorised to carry on, and the trustee considers that, in order better to determine the net income of the business that is available in any period for

appropriation and distribution to the person or persons entitled under the trust to the income therefrom, it is expedient to do so, he may -

"(a) Instead of commencing the accounting period to determine such income with the date of the commencement of the trust, adopt the accounting period employed in respect of the business immediately before the commencement of the trust, continue the accounting period so employed and current immediately before the commencement of the trust, and apportion the income so determined on such basis as if it had accrued evenly during that accounting period:

"(b) Instead of preparing final accounts, in respect of any interest in the whole or any part of the income arising from the business, as at the date of the termination of that interest, prepare such accounts at the end of the accounting period employed in respect of the business immediately before the date of the termination of the interest and current at that date, and apportion the income so determined on such basis as if it had accrued evenly during that accounting period."

APPENDIX II

Submissions on the first working paper were received from the following:

Auckland District Law Society
Canterbury District Law Society
East Coast Permanent Trustees Ltd
Federated Farmers of New Zealand
Hamilton District Law Society
Mr C.R. Latta (Chartered Accountant, Hawera)
Manawatu District Law Society
N.Z. Insurance Co Ltd
N.Z. Society of Accountants
The Perpetual Trustees Estate and Agency Co Ltd
The Public Trustee
Pyne Gould Guinness Ltd
Mr P.F. Robinson (Nolan & Skeet, Gisborne)
The South British Guardian Trust Co Ltd
Southland District Law Society
Trustee Executors and Agency Co N.Z. Ltd

Submissions on the second working paper were received from the following:

Professor H. Barton (Visiting Fellow, Department of
Accountancy, Victoria University)
Hamilton District Law Society
Hawkes Bay District Law Society
Inland Revenue Department
N.Z. Technical Correspondence Institute
N.Z. Society of Accountants
The Perpetual Trustees Estate and Agency Co of N.Z. Ltd
The Public Trustee
The South British Guardian Trust Co Ltd
South Canterbury Branch of the N.Z. Society of Accountants
(Ashburton and Timaru Sub-Committees)
Southland District Law Society
Wellington District Law Society

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