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The Discretionary Allocation Clause in a Trust Instrument - Broad or Narrow Construction by Texas Courts

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been created by drafting the agreement so as to state that the business arrangement was in fact a joint venture and that the parties were joint venturers. Pounds should have been given a twenty-five per cent interest in the land and a right to say when and to whom the land would be sold. If this had been done, there would have been no doubt that a joint venture would have been created and that the gain realized by the joint venture and the joint venturers would have been a capital gain.

V. Conclusion

When a capital gains question can be decided on the sale or exchange issue, as a matter of convenience the courts usually do not determine the validity of an alleged capital asset. But, because this is an area aided by few guidelines and containing many unanswered questions and considerable vagueness,[64] it is desirable for the courts to answer both questions.

The court in *Pounds* correctly concluded that the gain Pounds reported was ordinary income because of the lack of a sale or exchange. The contract rights held by Pounds were merely extinguished when the claims were satisfied by payment from Gilson. For this reason, the monies collected under the contract right received by Pounds in return for his services rendered were not capital gain even though the contract right might constitute ordinary income at the time of receipt. The same is true concerning the identical contract right Elrod sold to Pounds, even though a capital asset was created by the purchase. To alleviate all these problems, the parties should have created a joint venture by express language in the written agreement by giving Pounds an interest in the land instead of an interest in the profits from the sale of the land.

Michael M. Gibson

The Discretionary Allocation Clause in a Trust Instrument — Broad or Narrow Construction by Texas Courts?

The testatrix left her residuary estate in trust for the benefit of her mother and her brother for their respective lives with remainder over to an organization for cancer research to be selected by the trustees.[1] The instrument creating this trust granted to the trustees discretion to allocate receipts and expenses between principal and income.[2] At the inception of the trust, the trustees received from the executor of the decedent's estate one debenture having a face value of $2,950.00 and 110 shares of stock

[64] Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962).

[1] The testatrix died on February 2, 1963, and her will was duly admitted to probate. At the time of this action, the brother was deceased, leaving Mrs. Thorman as the only income beneficiary.

[2] The will provided: "The Trustees shall, in their discretion, determine what is principal or income of said trust and apportion and allocate receipts and expenses between the principal and income accounts." Thorman v. Carr, 408 S.W.2d 259, 260 (Tex. Civ. App. 1966) *error ref. n.r.e., aff'd per curiam*, 412 S.W.2d 45 (1967).

having an aggregate value of $1,522.73. Subsequently, they received an additional seven shares of stock as a dividend paid on the initial 110 shares. The trustees allocated the debenture to income; then they sold the 117 shares of stock for $2,268.38[3] and allocated the entire proceeds to income, including a gain of $745.65 realized since the inception of the trust.[4] The gain was attributable to proceeds from the sale of the seven shares of stock acquired as a stock dividend plus proceeds resulting from an appreciation in the value of the initial 110 shares.[5] A suit for declaratory judgment was brought by the trustees to determine if they had acted within their discretion. The trial court found that the trustees should have allocated to principal the debenture and the total proceeds less the gain from the sale of stock, but that they had properly allocated the gain on the stock to income. *Held, affirmed*: Through a discretionary allocation clause,[6] a trustee may be granted discretion to allocate to principal or to income the gain realized on the sale of a trust asset during the time that asset was held in the corpus of the trust; however, the trustee may not arbitrarily allocate to income an asset which is a part of the trust corpus or the total proceeds less the gain from the sale of an asset which was a part of the trust corpus prior to the sale. *Thorman v. Carr*, 408 S.W.2d 259 (Tex. Civ. App. 1966) *error ref. n.r.e., aff'd per curiam*, 412 S.W.2d 45 (1967).

I. Allocation of Trust Receipts in the Absence of a Discretionary Allocation Clause

When there is no discretionary allocation clause in the trust instrument, the general rule is that benefits received for the use of or revenue produced by the trust property are income; whereas, substitutes for or mere changes in form of the original trust *res* are principal.[7] A problem arises, however, in applying this general rule to a particular receipt such as a stock dividend or proceeds received from the sale of trust property.

Dividends on Stock. Three rules have evolved for allocating receipts from corporate stock which is owned by the trust. The Kentucky rule provides that all cash and stock dividends declared within the period of the trust are income, regardless of whether they are ordinary or extraordinary in nature.[8] Even though this rule is very simple, requiring consideration only of the timing of the dividend rather than its nature or source, it has not been widely followed and has been changed by statute even in Kentucky.[9]

Under the Pennsylvania rule, a distinction must be made between the

[3] File on Thorman v. Carr, Attorney General's office, State of Texas.

[4] Brief for Appellee at 3, 6, Thorman v. Carr, 408 S.W.2d 259 (Tex. Civ. App. 1966) *error ref. n.r.e., aff'd per curiam*, 412 S.W.2d 45 (1967).

[5] File on Thorman v. Carr, Attorney General's office, State of Texas.

[6] The term "discretionary allocation clause" is used to indicate that clause in a trust instrument granting to the trustee power within his sound discretion to allocate trust receipts to principal or to income.

[7] Restatement (Second) of Trusts § 233, comments *a* and *b* (1959). *See also* G. Bogert, Handbook of the Law of Trusts § 111 (4th ed. 1963).

[8] Hite v. Hite, 93 Ky. 257, 20 S.W. 778 (1892). *But see* Bowles v. Stilley's Ex'r, 267 S.W.2d 707 (Ky. 1954).

[9] Ky. Rev. Stat. § 386.230 (1962).

ordinary dividend, occurring regularly in relatively consistent amounts, and the extraordinary dividend, occurring sporadically in unpredictable amounts under unusual circumstances or as an "extra" in addition to the ordinary dividend. The rule provides that extraordinary cash or stock dividends are income to the extent declared out of earnings accruing to the corporation during the period of the trust and are principal to the extent declared out of earnings accruing prior to the inception of the trust.[10] In the absence of unusual circumstances, ordinary cash dividends are treated as income,[11] with no attempt being made to discover the source of such dividends.[12] Thus the income beneficiary is entitled to the entire ordinary cash dividend unless the remainderman proves the existence of an unusual circumstance requiring a division of the dividend between principal and income.[13] It is not clear, however, if regular stock dividends are treated wholly as principal or income, or are allocated between principal and income. Perhaps the ordinary stock dividend should be treated the same as an extraordinary dividend and divided between principal and income when the circumstances require such an allocation.[14]

Thus, under the Pennsylvania rule, the nature and the source of the dividend are the criteria for determining its allocation in whole or in part to principal or to income. One means for applying the rule is to compute an intact value for the stock which is usually the book value (capital and surplus per share) on the date the stock was acquired by the trust.[15] The trustee must maintain the integrity of the trust corpus by allocating to principal all or any portion of an extraordinary dividend to the extent that the declaration of that dividend impaired the initial intact value.

Under the Massachusetts rule, the form of the dividend is the criterion for determining its allocation to principal or to income. The rule provides that all cash dividends and those stock dividends payable in the stock of a corporation other than the declaring corporation are income; stock dividends payable in the stock of the declaring corporation are principal.[16]

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[10] *In re* Flinn's Estate, 320 Pa. 15, 181 A. 492 (1935); *In re* Waterhouse's Estate, 308 Pa. 422, 162 A. 295 (1932); *In re* Smith's Estate, 140 Pa. 344, 21 A. 438 (1891). *See also In re* Traung's Estate, 30 Cal. 2d 811, 185 P.2d 801 (1947).

[11] *In re* Knox's Estate, 328 Pa. 177, 195 A. 28 (1937); *In re* Waterhouse's Estate, 308 Pa. 422, 162 A. 295 (1932).

[12] *In re* Boyle's Estate, 235 Wis. 591, 294 N.W. 29 (1940).

[13] *In re* Knox's Estate, 328 Pa. 177, 195 A. 28 (1937). *See In re* Opperman's Estate, 319 Pa. 455, 179 A. 729 (1935), where directors reduced the number of shares of stock to create surplus out of which the dividend was paid. The court held that the payment of the dividend constituted a return of contributed capital and was thus an unusual circumstance requiring an allocation of the dividend between principal and income.

[14] *In re* Valiquette's Estate, 122 Vt. 350, 173 A.2d 832 (1961), where Eastman Kodak Company declared small stock dividends relatively regularly. The court held these dividends apportionable under the Pennsylvania rule.

[15] Soles v. Granger, 174 F.2d 407 (3d Cir. 1949). Intact value as a term of art employed by the courts may not always remain a constant figure. *See In re* Hostetter's Estate, 319 Pa. 572, 181 A. 567 (1935) (changing intact value); *In re* Waterhouse's Estate, 308 Pa. 422, 162 A. 295 (1932) (intact value determined at time trust is created); *In re* Baird's Estate, 299 Pa. 39, 148 A. 907 (1930) (discussion of the determination of intact value).

[16] Minot v. Paine, 99 Mass. 101, 108 (1868), where the court said that "[a] simple rule is to regard cash dividends, however large, as income, and stock dividends however made, as capital." This rule has been followed in a large number of cases. *See* Towne v. Eisner, 245 U.S. 418 (1918);

If the trustee has the option of receiving the dividend in stock or cash, it is treated as a cash dividend and thus income, regardless of the choice made by the trustee.[17]

The recent trend has been in favor of the Massachusetts rule perhaps because of its relative simplicity in application and because of the similar approach followed by the Internal Revenue Service,[18] and it has been incorporated into the Uniform Principal and Income Act.[19] Even though the Massachusetts rule was previously rejected by Pennsylvania,[20] that state now follows it,[21] as does the *Restatement*[22] and the Texas Trust Act.[23]

Proceeds From the Sale of Trust Property. When the trustee sells a trust asset, any money or property received as proceeds of the sale or in exchange for the trust asset is generally treated as principal because there is only a change in the form of trust corpus.[24] Since the principal account bears the risk of a decrease in the value of trust property, it should receive the benefit of an increase in that value.[25] Therefore, any profit included in the proceeds from a sale of trust property is usually treated as principal,[26] even though it may be a capital gain and subject to an income tax.[27] Even if the entire profit is placed in the trust corpus, it should be noted that the income beneficiary and the remainderman participate in the benefits therefrom, the former receiving more income from the increased corpus and the latter more corpus.[28] Similarly, if the increase in value of the trust corpus has not been realized via a sale or exchange, the income beneficiary has no claim to the unrealized gain.[29]

It would seem that corporate stock should be treated as any other trust

Gibbons v. Mahon, 136 U.S. 549 (1890); Old Colony Trust Co. v. Aymar, 317 Mass. 66, 56 N.E.2d 889 (1944); Creed v. McAleer, 275 Mass. 353, 175 N.E. 761 (1931); Trefry v. Putnam, 227 Mass. 522, 116 N.E. 904 (1917); Hyde v. Holmes, 198 Mass. 287, 84 N.E. 318 (1908); Hemenway v. Hemenway, 181 Mass. 406, 63 N.E. 919 (1902).

[17] Davis v. Jackson, 152 Mass. 58, 25 N.E. 21 (1890). *See* Newport Trust Co. v. Van Rensselaer, 32 R.I. 231, 78 A. 1009 (1911), where the corporate dividend was to be paid wholly in cash or one-half in cash and one-half in stock as the stockholder desired.

[18] INT. REV. CODE of 1954, §§ 61(a)(7), 301(a) and (c), 316(a), 317(a) (regarding the taxability of dividends) and 305(a) and (b) (regarding the nontaxability of stock dividends).

[19] UNIFORM PRINCIPAL AND INCOME ACT §§ 3(1), 5(1), as reproduced in G. BOGERT, TRUSTS AND TRUSTEES § 816 n.38 (2d ed. 1962).

[20] *See In re* King's Estate, 355 Pa. 64, 48 A.2d 858 (1946); *In re* Fisher's Estate, 344 Pa. 607, 26 A.2d 192 (1942).

[21] PA. STAT. tit. 20, §§ 3470.1-.15 (1964).

[22] RESTATEMENT (SECOND) OF TRUSTS § 236 (1959).

[23] TEX. REV. CIV. STAT. ANN. art. 7425b-29 (1960).

[24] RESTATEMENT (SECOND) OF TRUSTS § 233, comment *b* (1959). It is often said that the entire proceeds of such a sale are principal. Long v. Rike, 50 F.2d 124 (7th Cir.), *cert. denied*, 284 U.S. 657 (1931); *In re* Fera, 26 N.J. 131, 139 A.2d 23 (1958); *In re* Roebken's Will, 230 Wis. 215, 283 N.W. 815 (1939).

[25] *In re* Davis' Estate, 75 Cal. App. 2d 528, 171 P.2d 463 (Dist. Ct. App. 1946); *In re* Koffend's Will, 218 Minn. 206, 15 N.W.2d 590 (1944).

[26] Buder v. Franz, 27 F.2d 101 (8th Cir. 1928); Guthrie's Trustee v. Akers, 157 Ky. 649, 163 S.W. 1117 (1914); Old Colony Trust Co. v. Walker, 319 Mass. 325, 65 N.E.2d 690 (1946); Brown v. Sperry, 182 Miss. 488, 181 So. 734 (1938); Berger v. Burnett, 97 N.J. Eq. 169, 127 A. 160 (Ch. 1924); *In re* Graham's Estate, 198 Pa. 216, 47 A. 1108 (1901).

[27] RESTATEMENT (SECOND) OF TRUSTS § 233, comment *f* (1959). *See, e.g.*, Holcombe v. Ginn, 296 Mass. 415, 6 N.E.2d 351 (1937); Chase v. Union Nat'l Bank, 275 Mass. 503, 176 N.E. 508 (1931); Trefry v. Putnam, 227 Mass. 522, 116 N.E. 904 (1917).

[28] *In re* Graham's Estate, 198 Pa. 216, 47 A. 1108 (1901).

[29] *In re* Buist's Estate, 297 Pa. 537, 147 A. 606 (1929). *See also* Tubb v. Fowler, 118 Tenn. 325, 99 S.W. 988 (1907).

asset when sold at a profit. However, some courts have treated a trustee's sale of stock differently.[30] This is true especially when the increase in value has been attributed in whole or in part to accumulated earnings retained by the corporation which could have been distributed as dividends. For example, in the leading case of *In re Nirdlinger's Estate*,[31] the Pennsylvania Supreme Court clearly followed an intact-value approach for allocating the profit realized on the sale of stock. The court emphasized that if the trustee sold stock at a price greater than its value when acquired by the trust, such increase being due to accumulation of earnings, the proceeds should be apportioned between the income beneficiary and the remainderman, provided the intact value of the corpus was not disturbed.[32] The court pointed out that when the increase in value (profit) was due to enhancement of original value through the stock's earning power, good will, or intrinsic worth, or when due to enhanced market value, and not accumulated earnings, the increase was part of the trust corpus.[33]

The Pennsylvania approach has been followed by courts in other states.[34] However, it has been termed impractical and unsound because of the difficulty of determining what portion of the price received for the stock was due to the undistributed earnings of the corporation.[35] This approach as applied to the proceeds from the sale of securities has been rejected in other jurisdictions,[36] even where the jurisdiction has applied the Pennsylvania rule in regard to the allocation of extraordinary cash or stock dividends.[37] It is doubtful that Pennsylvania will continue to follow the apportionment rule in regard to trusts created after its adoption of the Uniform Principal and Income Act,[38] which treats profits from the sale of trust property as principal and makes no special exception of the sale

[30] *See* note 34 *infra*.

[31] 290 Pa. 457, 139 A. 200 (1927).

[32] The income beneficiary was entitled to that part of the proceeds representing income earned during the trust period but retained by the corporation, provided that the intact value of the corpus was not disturbed. 139 A. at 205. *See In re* Hostetter's Estate, 319 Pa. 572, 181 A. 567 (1935); *In re* Heaton's Estate, 89 Vt. 550, 96 A. 21, 30 (1915), where it was emphasized that if the remainderman received the corpus, undiminished in value from what it was at the inception of the trust, he had received all he could justly claim unless the creator of the trust expressed an intention that he should receive more.

[33] *In re* Nirdlinger's Estate, 290 Pa. 457, 139 A. 200, 208 (1927).

[34] *In re* Sherman, 190 Iowa 1385, 179 N.W. 109 (1920) (increase in value over "principal sum" allocated to income); Simpson v. Millsaps, 80 Miss. 239, 31 So. 912 (1902) (gain in value allocated to income); *In re* United States Trust Co., 190 App. Div. 494, 180 N.Y.S. 12 (Sup. Ct.), *aff'd mem.*, 229 N.Y. 598, 129 N.E. 923 (1920) (proceeds apportioned between principal and income); Cothran v. South Carolina Nat'l Bank, 242 S.C. 80, 130 S.E.2d 177 (1963) (profit allocated to income).

[35] G. BOGERT, HANDBOOK OF THE LAW OF TRUSTS § 120 (4th ed. 1963).

[36] Guthrie's Trustee v. Akers, 157 Ky. 649, 163 S.W. 117 (1914); *In re* Merrill's Estate, 196 Wis. 351, 220 N.W. 215 (1928).

[37] *In re* Traung's Estate, 30 Cal. 2d 811, 185 P.2d 801 (1947); Safe Deposit & Trust Co. v. Bowen, 188 Md. 482, 53 A.2d 413 (1947).

[38] PA. STAT. tit. 20, §§ 3470.1-.15 (1964). A statute treating the profit from the sale of stock as principal has no application to trusts created prior to the effective date of the statute, unless the statute provides otherwise. *In re* Fera, 26 N.J. 131, 139 A.2d 23 (1958); *In re* Wehrhane's Estate, 41 N.J. Super. 158, 124 A.2d 334 (Super. Ct. 1956); *In re* Crawford's Estate, 362 Pa. 458, 67 A.2d 124 (1949); *In re* Valiquette's Estate, 122 Vt. 350, 173 A.2d 832 (1961). *But see* WIS. STAT. ANN. § 231.40 (1967), providing that the Uniform Principal and Income Act applies to trusts in effect on the date the Wisconsin statute became effective, July 10, 1957.

of corporate stock.[39] The weight of authority is distinctly against the apportionment of proceeds from the sale of trust property between principal and income.[40] The Uniform Principal and Income Act[41] and the Texas Trust Act[42] both provide that the entire proceeds shall be allocated to principal, provided the asset sold was a part of the trust corpus.

II. Construction of the Discretionary Allocation Clause

The cardinal rule of testamentary construction is to ascertain and give effect to the testator's intention.[43] If the will creating the trust is unambiguous, the testator's intention must be ascertained from the language construed as written within the four corners of the instrument.[44] If the testator's intention is not clearly expressed, it may be ascertained by looking to the provisions of the will as a whole and the circumstances surrounding its execution.[45]

In expressing his intention regarding the allocation of trust receipts between principal and income, the trustor may follow one of three courses: anticipate types of receipts and specify in the instrument which shall be principal and which income; remain silent and invoke the local rules of construction regarding such allocations; or, use a discretionary allocation clause as a device for giving to the trustee the power to make such allocations.

When the discretionary allocation clause has been used, courts have established two opposing views for its construction. Some courts have

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[39] Uniform Principal and Income Act § 3(2), as reproduced in G. Bogert, Trusts and Trustees § 816 n.38 (2d ed. 1962), provides: "Any profit or loss resulting upon any change in form of principal shall enure to or fall upon principal." Almost identical language appears in Pa Stat. tit. 20, § 3470.3 (1964), which provides: "Any profit or loss, resulting from any change in form of principal, shall enure to or fall upon principal, unless otherwise expressly provided in this act."

[40] *See* authorities cited in notes 24-29 *supra.*

[41] Uniform Principal and Income Act § 3(2), as reproduced in G. Bogert, Trusts and Trustees § 816 n.38 (2d ed. 1962).

[42] Tex. Rev. Civ. Stat. Ann. art. 7425 (1960). Article 7425b-4 (1960) provides:

> F. 'Principal' means any real or personal property which has been set aside or limited by the owner thereof, or a person thereto, legally empowered that it and any substitutions for it are eventually to be conveyed, delivered, or paid to a person, while the return therefrom or use thereof, or any part of such return or use is in the meantime to be taken or received by or held for accumulation for the same or another person.
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> G. 'Income' means the return derived from principal.

Article 7425b-27 (1960) provides:

> A. All receipts of money or other property paid or delivered . . . in return for the use of principal, shall be deemed income.
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> B. All receipts of money or other property paid or delivered as the consideration for the sale or other transfer . . . of property forming a part of the principal . . . or otherwise as a refund or replacement or change in form of principal shall be deemed principal unless otherwise expressly provided in this Act. Any profit or loss resulting upon any change in form of principal shall enure or fall upon principal.

[43] Guilliams v. Koonsman, 154 Tex. 401, 279 S.W.2d 579 (1955); Ellet v. McCord, 41 S.W.2d 110 (Tex. Civ. App. 1931) *error ref.* The testator's intention is paramount. *In re* Young's Will, 25 Iowa 110, 93 N.W.2d 74 (1958); *In re* Talbot's Will, 170 Misc. 138, 9 N.Y.S.2d 806 (Sur. Ct. 1939).

[44] Atwood v. Kleberg, 163 F.2d 108 (5th Cir.), *cert. denied,* 332 U.S. 843 (1947); Atkinson v. Kettler, 372 S.W.2d 704 (Tex. Civ. App. 1963), *aff'd,* 383 S.W.2d 557 (1964).

[45] Robison v. Elston Bank & Trust Co., 113 Ind. App. 633, 48 N.E.2d 181 (App. Ct. 1943); Guilliams v. Koonsman, 154 Tex. 401, 279 S.W.2d 579 (1955).

taken the narrow view, often indicating that the trustee's exercise of discretion extends only to situations where there is some honest doubt as to whether the trust receipt was principal or income, and, in this regard, there can be no "question" or "honest doubt" where the local rule is settled.[46] This limited construction means in effect that the trustee can properly exercise his discretionary power only when the receipt is neither clearly principal nor clearly income. Under this view, the trustor may avoid local rules of construction only by specifically indicating his intention in the trust instrument; however, it appears that he cannot achieve this same result merely by using a discretionary allocation clause alone.

Other courts have followed the broad view that the discretion conferred upon the trustee was intended to enable him to ignore local rules of construction in the allocation of trust receipts; therefore, his exercise of discretion will not be interfered with as long as it was made in good faith and with reasonable judgment.[47] When the discretion granted to the trustee is very broad, in that the trustor has used language such as "absolute" or "uncontrolled" discretion, perhaps the trustee may disregard the standard of reasonableness;[48] however, he is still limited by the bounds of good faith.[49]

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[46] Commissioner v. O'Keeffe, 118 F.2d 639 (1st Cir. 1941); American Security & Trust Co. v. Frost, 73 App. D.C. 75, 117 F.2d 283 (D.C. Cir. 1940); Commissioner v. Waterbury, 97 F.2d 383 (2d Cir.), *cert. denied*, 305 U.S. 638 (1938); *In re* Watland, 211 Minn. 84, 300 N.W. 195 (1941); Mercantile-Commerce Bank & Trust Co. v. Morse, 356 Mo. 336, 201 S.W.2d 915 (1947); Industrial Nat'l Bank v. Rhode Island Hospital, 207 A.2d 286 (R.I. 1965); *In re* Clarenbach's Will, 23 Wis. 2d 71, 126 N.W.2d 614 (1964).

[47] White v. Rose, 73 F.2d 236 (5th Cir. 1934); Colt v. Duggan, 25 F. Supp. 268 (S.D.N.Y. 1938); *In re* Bixby's Estate, 55 Cal. 2d 819, 362 P.2d 43, 13 Cal. Rptr. 406 (1961); Dumaine v. Dumaine, 301 Mass. 214, 16 N.E.2d 625 (1938); Chase Nat'l Bank v. Chicago Title & Trust Co., 246 App. Div. 201, 284 N.Y.S. 472 (Sup. Ct. 1935), *aff'd mem.*, 271 N.Y. 602, 3 N.E.2d 205 (1936); Sherman v. Sherman, 32 Ohio Op. 2d 334, 202 N.E.2d 443 (Prob. Ct. 1962). *See also* American Security & Trust Co. v. Frost, 73 App. D.C. 75, 117 F.2d 283 (D.C. Cir. 1940) (dissenting opinion of Rutledge, J.).

[48] *See In re* Heard's Estate, 107 Cal. App. 2d 225, 236 P.2d 810, 815 (Dist. Ct. App. 1951), quoting from RESTATEMENT (SECOND) OF TRUSTS § 187, comment *j* (1959):

> These words are not interpreted literally but are ordinarily construed as merely dispensing with the standard of reasonableness. In such a case the mere fact that the trustee has acted beyond the bounds of a reasonable judgment *is not* a sufficient ground for interposition by the court, *so long as the trustee acts in a state of mind in which it was contemplated by the settlor that he would act.* But the court will interfere if the trustee acts in a state of mind not contemplated by the settlor. (Emphasis added.)

See Sherman v. Sherman, 32 Ohio Op. 2d 334, 202 N.E.2d 443 (Prob. Ct. 1962), indicating that by the use of such words as "absolute," "full," or "sole" discretion, reason and good faith are dispensed with. This illustrates the confusion caused by use of the terms "reasonableness" and "good faith" interchangeably. Reasonableness refers to the standard of reasonable judgment of the prudent man which may be dispensed with by the use of such words as "absolute," "full," or "sole" discretion. Good faith refers to the fiduciary relation of the trustee, whereby he must always act with good faith in carrying out the trustor's intention (*i.e.*, the trustee must always act in a state of mind in which it was contemplated by the trustor that he should act), provided the trustor's intention and purpose are not contrary to public policy. For examples of broad language in a discretionary clause, see Carrier v. Carrier, 226 N.Y. 114, 123 N.E. 135 (1919) (absolute and uncontrolled discretion to invest fund; held, discretion abused); *In re* Canfield's Estate, 80 Cal. App. 443, 181 P.2d 732 (Dist. Ct. App. 1947) (absolute discretion in application of net income of trust beyond $1,200 per year; held, discretion not abused). *Compare* Boyden v. Stevens, 285 Mass. 176, 188 N.E. 741 (1934) (discretion to invade corpus as trustee may deem advisable; held, discretion not abused) *with* Corkey v. Dorsey, 223 Mass. 97, 111 N.E. 795 (1916) (discretion to invade corpus within judgment of trustee; held, discretion abused).

[49] *In re* Clarenbach's Will, 23 Wis. 2d 71, 126 N.W.2d 614 (1964). *See also* Gilmore v. Commissioner, 213 F.2d 520 (6th Cir. 1954).

III. THORMAN V. CARR

In *Thorman v. Carr* the trustees had before them a debenture acquired at the inception of the trust and gross proceeds from the sale of 117 shares of stock, including a gain realized on the sale. The gain was composed of proceeds from the sale of the seven shares acquired as a stock dividend after the creation of the trust and proceeds resulting from appreciation in the value of the initial 110 shares since the inception of the trust. The trust instrument contained a clause giving the trustees discretionary power to allocate trust receipts between principal and income. Therefore, the trustees were confronted with the problem of making a proper disposition of these particular receipts, all of which they allocated to income.

The Texas Trust Act provides that all proceeds from the sale or exchange of trust assets and any profit or loss resulting from any change in form of principal shall become part of the trust corpus.[50] Thus in the absence of a discretionary allocation clause, it is clear that the trustees in *Thorman* should have allocated the debenture and total proceeds to corpus.[51] However, the trust instrument contained a discretionary allocation clause; therefore, the principal question in *Thorman* was whether Texas followed a broad or a narrow construction of the clause.[52] The answer to this question depended upon the proper disposition of the gain realized on the stock sale. If the trustees were allowed to allocate the gain to income even though the Texas Trust Act provided that it should go to corpus, a broad construction would be effected. On the other hand, a narrow construction would be followed if the trustees were not allowed to allocate the gain to income because the local rule of law provided for its disposition to principal.

The court of civil appeals held that the trustees had improperly allocated the debenture and the total proceeds less the gain from the stock sale to income, but had properly allocated the gain to income. As authority for upholding the trustees' discretionary allocation of the gain to income, the court of civil appeals cited *Dumaine v. Dumaine*[53] and *Sherman v. Sherman*,[54] Massachusetts and Ohio cases following the broad view.

Dumaine v. Dumaine[55] concerned the construction of a very broad clause granting to the trustee "full power and discretion to determine whether any money or other property received by him [was] principal or income without being answerable to any person for the manner in

[50] TEX. REV. CIV. STAT. ANN. art. 7425b-27 (1960). *See* note 42 *supra* for the specific language of the Act.

[51] The testatrix directed that her residuary estate, including the debenture and 110 shares of stock, be placed in trust. Assuming there was no discretionary allocation clause in the trust instrument, the debenture should have remained a part of the trust corpus since it was a part of the residuary estate placed in trust and since it did not change form at any time. The proceeds from the sale of the stock constituted only a change in the form of trust property; consequently, they should have been allocated to corpus.

[52] No Texas case was found construing the discretionary allocation clause as applied to the receipts of a trust.

[53] 301 Mass. 214, 16 N.E.2d 625 (1938).

[54] 32 Ohio Op. 2d 334, 202 N.E.2d 443 (Prob. Ct. 1962).

[55] 301 Mass. 214, 16 N.E.2d 625 (1938).

which he [exercised] that discretion."[56] The court held that the trustee's allocation of a gain on the sale of trust stock to income was not an abuse of discretion even though the local rule applicable in the absence of a discretionary allocation clause provided that gains realized on trust corpus belonged to corpus. However, since the clause in *Dumaine* was much broader in scope than the clause in *Thorman,* the cases may be distinguished.[57]

Sherman v. Sherman[58] concerned the construction of a discretionary allocation clause very similar to the clause in *Thorman.* In that case, the trustees had allocated to principal the gain on the sale of certain stock and the additional shares of stock resulting from a stock split. Before allocating a stock dividend, they sought court direction concerning the proper disposition of that receipt. The court determined that the trustees were free in the reasonable exercise of their discretion to allocate trust receipts to principal or to income. The court then upheld the trustees' allocation of the gain from the stock sale and the additional shares from the stock split to principal as a proper exercise of discretion. The court also provided that the trustees were free to allocate the stock dividend to income, even though under local rules of law in the absence of a discretionary allocation clause it was properly a part of the principal. Use of these authorities and approval of the trustees' allocation of the gain to income indicate that the court of civil appeals in *Thorman* was following a broad construction of the discretionary allocation clause.

Perhaps the court of civil appeals reached its decision in regard to the gain by employing some form of an inventory-value approach.[59] Since $1,522.73 was the initial value of the original 110 shares and since this was also the amount of the proceeds from the sale of the 117 shares which the court provided should be allocated to principal, it appears that the trustees' exercise of discretion was allowed only in regard to that part of the proceeds which was greater than the original value of the 110 shares.[60] Since the gain of $745.65 was composed of proceeds from the appreciation in the value of the initial 110 shares and proceeds from the sale of the seven-share stock dividend, the court of civil appeals, in upholding the trustees' allocation of the gain to income, in effect upheld a trustee's discretionary allocation of a stock dividend and the appreciation in the value of trust stock to income. This is significant because in the absence of a discretionary allocation clause the local rule of law classified the stock dividend and the sale proceeds including the appreciation in value as principal.[61]

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[56] 16 N.E.2d at 626.

[57] *See* notes 2 and 56 *supra* and accompanying text.

[58] 32 Ohio Op. 2d 334, 202 N.E.2d 443, 446 (Prob. Ct. 1962), where trustees were granted power "[t]o determine in their discretion how all receipts and disbursements shall be credited, charged or apportioned between income and principal . . . ." *See* note 2 *supra* for the language of the *Thorman* clause.

[59] Inventory value may be interpreted as the value of the asset at the time it entered the asset inventory of the trust corpus.

[60] *See* notes 3-5 *supra* and accompanying text.

[61] TEX. REV. CIV. STAT. ANN. art. 7425b-29 (1960) provides that "[a]ll dividends on shares

It is also significant to note, however, that the holding of the court of civil appeals regarding the gain was not before the Texas Supreme Court for review.[62] Consequently, the supreme court upheld the judgment of the court of civil appeals only to the extent that the debenture and the stock proceeds, excluding the gain, were properly a part of the principal.

IV. Conclusion

Narrow construction of a discretionary allocation clause is advantageous because it requires the trustor to be explicit in the trust instrument, spelling out in detail how the trustee is to allocate receipts between principal and income and thus how he may deviate from established rules of law. On the other hand, however, it is difficult for the trustor to foresee all situations that might arise regarding allocations between principal and income; therefore, he may be unable to clearly spell out the duties of the trustee. Also, it is often difficult to determine when a sufficient "honest doubt" exists to allow the trustee's exercise of discretion under the narrow view.

Broad construction is advantageous because it permits the trustee to exercise his discretion within the bounds of reasonableness, even if contrary to local rules of law. Thus broadly construed, the discretionary allocation clause is a flexible device enabling the trustee to more efficiently protect the interests of the parties and to achieve more fully the objective of the trustor, especially when unforeseen or changing situations arise. In addition, the words "in the discretion of the trustee" have little significance if narrowly construed to mean a discretion to be exercised only in situations where there is no settled rule of law to guide the trustee. Since the trust relationship is a fiduciary one, it seems that the reason underlying the trustor's grant of discretion to the trustee is to acquire the benefit of his sound judgment and discretion in the allocation process.

However, the discretionary allocation clause should not be construed so broadly as to enable the trustee to invade the corpus for the income beneficiary's benefit and perhaps defeat the remainderman's interest by devoting all property to income.[63] The consequences of such action by the trustee under the discretionary allocation clause would be profound. A clause granting the trustee the power to invade corpus for the benefit of the income beneficiary is readily available if the trustor wishes to confer such power upon him; therefore, the discretionary allocation clause should not be expanded to include a purpose which is already well served by another type of clause.

It seems clear that the discretionary allocation clause should be inter-

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of a corporation . . . forming a part of the principal which are payable in its own shares shall be deemed principal." *Id.* art. 7425b-27 (1960) provides that "[a]ny profit or loss resulting upon any change in form of principal shall enure to or fall upon principal."

[62] Thorman v. Carr, 412 S.W.2d 45, 46 (Tex. 1967).

[63] *In re* Watland, 211 Minn. 84, 300 N.W. 195 (1941). Likewise, the clause should not be so broadly construed as to allow the trustee to defeat the income beneficiary's interest by diverting all property to principal. If the trustee is to have such power, the trustor should specifically so provide in the trust instrument.

preted with the view of carrying out the trustor's intention unless contrary to public policy. An inventory-value approach within the broad view is perhaps a useful solution for interpreting such a clause when it alone is employed by the trustor without any further expression of intention—a situation exemplified by *Thorman*. Under this restricted form of broad construction, the clause could be construed to allow application of the trustee's discretion to that portion of the realized value of a trust asset above and beyond its initial inventory value at the time it entered the corpus of the trust. In the testamentary trust situation, when the discretionary allocation clause constitutes the only expression of the testator's intention, this approach offers to the trustee a means of occupying an equitable medium between two competing ends: Should any accretions in the value of trust property go to principal and hence to the remainderman, or should the initial trust property or its equivalent constitute principal and any accretions thereto go to the income beneficiary? However, this approach is certainly no panacea. It could involve difficult accounting problems of determining what constitutes the proper inventory value of the particular asset (*e.g.*, gift acquisition of stock of a closely held corporation having no defined market value).

In *Thorman* the court of civil appeals based its decision on the narrow wording of the clause.[64] The Texas Supreme Court, however, made it quite clear that it attached "no significance to the absence of such words as 'absolute,' 'full,' or 'uncontrollable' in describing the discretionary powers of the trustees."[65] Thus it seems that regardless of the breadth of a discretionary allocation clause, the trustee would not be relieved of the standard of reasonableness in his exercise of discretion.[66]

A distinct answer to the principal question of whether Texas follows a broad or a narrow construction of the discretionary allocation clause in a trust instrument depended upon a clear enunciation of the proper disposition of the gain on the sale of the trust stock in *Thorman*. Since the supreme court did not have the issue of the gain before it for review, the principal question was not fully answered. Therefore, under present Texas law, when the trust instrument contains a discretionary allocation clause, the proper disposition of a gain realized on the sale of property forming a part of the trust corpus, and thus the full extent of the trustee's discretion, remain unclear.

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[64] Thorman v. Carr, 408 S.W.2d 259, 261 (Tex. Civ. App. 1966) *error ref. n.r.e., aff'd per curiam*, 412 S.W.2d 45 (1967).

[65] 412 S.W.2d at 46.

[66] *See* note 48 *supra* and accompanying text.