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David G. McLane

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Trusts — Mutual Funds — Allocation of Capital Gains Distributions

I. THE OBLIGATIONS OF THE TRUSTEE

The fundamental premise underlying the allocation of all trust receipts is that any return of capital (including accretions thereto) constitutes principal, whereas ordinary earnings on investments are income.¹ Since the maintenance of this distinction determines which party or parties will benefit, the trustee is under an obligation to carefully and correctly allocate receipts between the life beneficiary and the remainderman.² Likewise, the trustee must exercise a reasonable degree of care, skill, and caution in investing the funds entrusted to him.³ He has a duty to make such investments as a prudent man would make with his own funds having as a primary concern both the preservation of the estate and the amount and regularity of the income to be derived therefrom.⁴ Absent a contrary indication in the trust instrument, this goal should be maximum income consistent with the preservation of the trust res.⁵ The propriety of each investment is judged as of the time such investment was made, ignoring subsequent effects not reasonably susceptible of knowledge or anticipation at that time.⁶ The trustee naturally may rely on the advice of others, but such reliance is no excuse for an imprudent investment.⁷ Several factors which the trustee should consider in formulating his investment policy are the settlor's intent; the term and marketability of the particular investment and the nature of other investments made; the value and probable duration of the trust; the probable market conditions upon dissolution; and the needs of the individual beneficiaries considering their tax situations, other income, and earning capacities. The result is that the trustee is limited in the types of investments he may make by three determinants—the trust instrument, applicable statutes, and the "prudent man" rule.⁸

¹ 3 Scott, Trusts § 233.1 (2d ed. 1956).

² 3 Scott, Trusts § 233 (2d ed. 1956).

³ The trustee is liable to the beneficiary whose trust estate has been harmed by his imprudence or lack of skill in the making or disposing of investments. The extent of the trustee's liability is the amount necessary to rectify the error and place the beneficiary in the financial position he would have occupied had the duty been performed with reasonable care and skill. Bogert, Trusts and Trustees 706 (2d ed. 1951).

Both direct and consequential damages may be awarded. *In re Cook's Will*, 136 N.J. Eq. 123, 40 A.2d 805 (Prerogative Ct. 1945); see also Bogert, Trusts and Trustees 701 (2d ed. 1951).

⁴ *King v. Talbot*, 40 N.Y. 76 (1869); Restatement, Trusts § 227 (2d ed. 1959).

⁵ Bogert, Trusts and Trustees 611 (2d ed. 1951).

⁶ *Purdy v. Lynch*, 145 N.Y. 462, 40 N.E. 232 (1895).

⁷ Bogert, Trusts and Trustees § 541 (2d ed. 1951).

⁸ 3 Scott, Trusts § 277 (2d ed. 1956).

II. ALTERNATIVES FOR TRUST INVESTMENT

The trustee desiring to invest trust capital in securities has three alternatives. He may (1) purchase directly on the open market, (2) enter into a common trust fund, or (3) purchase mutual fund shares. Within each of these categories he also must choose, in light of the particular duties owed to his beneficiaries, between those companies or funds emphasizing growth and those emphasizing income. The first investment alternative is fitting for the larger trust which can successfully achieve diversification, and thereby minimize its risk of loss. On the other hand, the trust with less available capital should find the latter alternatives more advantageous. By pooling his resources with those of other trusts under a single common trustee or by investing in a mutual fund, the trustee can avoid the hazards of a limited portfolio and at the same time gain the benefits of expert management. In the mutual fund the trustee purchases shares, receiving thereon dividends and distributions from interest, dividends, and capital gains earned by the mutual on its portfolio. In the common trust fund, each contributing trustee has a proportionate interest in the portfolio determined by the amount of capital he has invested.⁹

III. MUTUAL FUNDS—TWO VIEWS

The primary purpose of investment in open-end regulated investment companies¹⁰ (so-called "mutual funds") is diversification or spreading of the risk. A second purpose is the access to expert management. Payments are in the form of "dividends" (ordinary income from the investment portfolio) and "distributions" (capital gains on sale of securities). A factor that will influence the trustee greatly in deciding whether to invest in a mutual fund is the manner in which payments from the fund are to be allocated between principal and income, for this allocation will affect the manner in which he has carried out the duty of providing the life beneficiary with maximum

⁹ "[The] trustee invests the funds of several trusts in a group of securities, each estate having a fractional interest in the whole group of securities . . ." determined by the respective amount it has advanced. 3 Scott, Trusts § 227.9 (2d ed. 1956).

The Revenue Service defines the common trust fund as "a fund maintained by a bank— (1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian; and (2) in conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System. . . ." Int. Rev. Code of 1954, § 584(a).

¹⁰ "The open-end company is *obligated* to redeem or repurchase its shares from holders upon request. . . . [T]he amount received by a shareholder, upon turning in his share, is roughly the amount he would have received if the company had been liquidated on the day of redemption." The closed-end company is under no such obligation, and the value of its stock is determined by the market factors of supply and demand. Prentice-Hall Encyclopedic Dictionary of Business Finance 353-54 (1960). (Emphasis added.)

income consistent with preservation of the trust res. The crux of the allocation difficulty with respect to trusts lies in the theory of the *nature* of the mutual fund. It must be determined whether a mutual fund is analogous to an ordinary industrial corporation—a “separate entity”—or to a common trust fund—a mere “conduit.” This determination is crucial because, under the separate entity theory, sales of securities by the fund are treated as sales from inventory and thus as ordinary income to the trust allocable to the life beneficiary. Under the conduit theory, such distributions are returns of capital allocable to principal, just as if the trustee had invested *directly* rather than through a mutual fund intermediary.

Professor Bogert,¹¹ in propounding the separate entity view, reasons that the investment company does *not* dispose of a capital asset when it sells part of its portfolio because it deals with securities as its stock in trade. He draws an analogy between the mutual fund and the ordinary corporation. Since any sales from “inventory” generate ordinary income, any distributions arising therefrom should not belong to the trust corpus but to the life beneficiary. Following this rationale, previous decisions, notably those of New York¹² and Maryland,¹³ have allocated *both* “dividends” and “distributions” to income wherever payment in cash rather than stock is possible. As pointed out by the late Mayo A. Shattuck,¹⁴ however, difficulties arise under this approach with respect to the allocation of net capital losses. The trustee either must charge such losses to the income beneficiary, subjecting him to the extreme ups and downs of mercantile prosperity, or allow the corpus to bear all net capital losses, thereby penalizing the remainderman.¹⁵ Professor Scott is in accord with Mr. Shattuck on the above views.¹⁶ He argues also that there is no logical reason for a different result in the case in which an investment is made by means of a mutual fund rather than by direct investment in the securities. “[C]apital gains received by trustee on sale of securities held by him as trustee are principal . . . ,” and distributions of capital gains by an investment company should also be principal.¹⁷

A more accurate analogy than that drawn by Bogert is the com-

¹¹ Bogert, *Trusts and Trustees* § 858 (2d ed. 1951).

¹² *In re Byrne's Estate*, 192 Misc. 451, 81 N.Y.S.2d 23 (Surr. Ct. 1948); *In re Bruce's Trust*, 192 Misc. 523, 81 N.Y.S.2d 25 (Sup. Ct., 1948).

¹³ *Rosenberg v. Lombardi*, 222 Md. 346, 160 A.2d 601 (1960).

¹⁴ Shattuck, *Capital Gain Distributions*, 88 *Trusts & Estates* 429 (1949).

¹⁵ “Why should they [the remaindermen] suffer all the penalties of investment hazard and gain none of the fruits of actual accretions to capital?” *Ibid.*

¹⁶ 3 Scott, *Trusts* § 236.14 (2d ed. 1956).

¹⁷ *Ibid.*

mon trust fund.¹⁸ Its purpose likewise is that of achieving diversification of risk, but it is merely a "conduit" through which this purpose is attained. The similarity between the common trust fund and the mutual fund in this respect is substantiated by an examination of several factors. First, the usual method of stock valuation lends itself readily to conduit analysis. The per share value of the fund is equivalent to the net market value of the fund's portfolio, including both net unrealized capital gains and gains which are realized but undistributed, divided by the total number of shares outstanding. Ignoring nominal management fees, any net capital gain of the fund results in an identical proportionate gain in the value of the mutual fund shares. Likewise, any distribution of realized capital gains necessarily must cause a reduction in per share value which is identical in amount to the per share distribution. Following this line of reasoning, the Investment Company Act of 1940 requires mutual funds not to make distributions except from undistributed net income, exclusive of profit and loss on sale of securities, unless they are "accompanied by a written statement which adequately discloses the source or sources of such payment."¹⁹ The investment company stockholder thereby always will know (1) whether the per share value of his stock is affected and (2) whether he is entitled to favorable income tax treatment.

Secondly, the Internal Revenue Code allows the mutual fund shareholder to treat any capital gain "distribution" as a gain from the sale or exchange of a long term capital asset; but any "dividend," stemming from interest and dividends earned on portfolio securities, must be treated as ordinary income.²⁰ Moreover, unlike the ordinary corporation, no surtax is payable by the fund as long as it distributes at least ninety per cent of earnings from interest and dividends.²¹ The dividend-distribution dichotomy thus is maintained, and all tax consequences pass through the fund to the shareholder unchanged. Furthermore, this distinction is generally accepted within the mutual fund industry itself. The Investment Company Institute states that dividends from ordinary income and capital gains distributions are

¹⁸ See note 9 *supra*.

¹⁹ 15 U.S.C. § 80a-19 (1958).

²⁰ Int. Rev. Code of 1954, § 852(b)(3)(B) (Subchapter M-Regulated Investment Companies).

²¹ Int. Rev. Code of 1954, § 852(a)(1). Neither is there surtax on capital gains which are distributed to shareholders. Tax is paid by the fund on any capital gains retained, but payment is credited to the shareholder upon distribution. Int. Rev. Code of 1954, § 852(b)(3)(D).

"different in character and should be viewed differently."²² Citing the Internal Revenue Code treatment, the Institute continues, "If it is desired, despite these differences, to have both dividends and capital gains paid to the life-tenant, the instrument should provide for it."²³

Finally, adding further substantiation to this point, the Uniform Revised Principal and Income Act provides that all distributions by a regulated investment company, other than those from ordinary income, "including distributions from capital gains, . . . whether in the form of cash or an option to take new stock . . . , are principal."²⁴ This section *replaces* Section 5 of the Uniform Principal and Income Act, which set out only the general "Massachusetts rules" regarding the allocation of distributions received by a trustee.²⁵ The more explicit rules set forth in the new section to deal with investment companies reflect a complete rejection by the Commissioners of the separate entity theory in favor of the conduit theory. Professor Scott publicly reaffirmed his approval of this reasoning by stating that "the revised draft²⁶ has adopted the proper rule."²⁷

IV. TAIT V. PECK²⁸

In 1935 the plaintiff's husband executed an inter vivos trust in which he gave his wife a life estate in certain shares of Linden Associates, a Massachusetts trust, (later converted into 55,434 shares of Broad Street Investing Corporation, an open-end regulated investment company), with remainder over to the defendants. The trust instrument gave no indication whatever of settlor's intent with respect to allocation of mutual fund payments. In 1961 Broad Street paid to the trustees certain cash "dividends from income" and, subsequently, delivered 1,463 of its shares pursuant to a cash-stock option as "distribution of capital gain." These shares were added to the trust corpus. Trustees maintained that such "distribution" was a return of capital allocable to corpus and stated that they would take the same position with respect to similar distributions in the

²² Investment Company Institute, *Mutual Fund Shares—An aid to Attorneys* 24 (1962). (The Institute filed an amicus curiae brief in the instant case.)

²³ *Ibid.*

²⁴ Uniform Revised Principal and Income Act § 6(c) (adopted Aug. 2, 1962). It is interesting to note that Professor George G. Bogert, a leading advocate of the separate entity analysis, headed the committee which adopted this revision.

²⁵ See text accompanying notes 47 and 48 *infra*.

²⁶ Uniform Revised Principal and Income Act § 6(c).

²⁷ 101 *Trusts & Estates* 894, 897 (1962). See also Shattuck, *Capital Gains Distributions*, 88 *Trusts & Estates* 160 (1949) for a good statement of the rationale by the late Mayo A. Shattuck, one of the most knowledgeable and experienced Massachusetts attorneys in the fields of trusts and estates.

²⁸ — Mass. —, 194 N.E.2d 707 (1963).

future. Plaintiff sought a declaratory judgment to ascertain whether this "distribution of gain" should be considered income or principal for trust accounting purposes. The probate court "reserved and reported" the evidence and all questions of law to the Supreme Judicial Court. In the latter hearing the court placed much emphasis on the nature of mutual funds and the purposes of investment therein. The conduit theory²⁹ was expressly adopted, the court noting that utilization of this theory by the Commissioners on Uniform State Laws "can be taken as reflecting a considered current view of what is in the public interest."³⁰

Consequently, the analogy drawn by the court is that of the common trust fund,³¹ which, like the mutual fund, achieves diversification and minimization of risk along with expert management. Opponents of this analogy argue that a material difference exists between the two types of funds in that the realized gains of an investment company are distributed to its shareholders (primarily for tax reasons), whereas those of a common trust fund are not. The court pointed out, however, that this difference stems not from a dissimilarity in substance but merely from a dissimilarity in manner of administration. It noted that if the trustee elects to take all capital gain distributions in stock, he effects the *identical* substantive result as does the common trust fund, because he *maintains* his proportionate ownership in the mutual fund's portfolio. The contrary argument of Professor Bogert states that allocating only *dividends* to the life beneficiary yields a "sub-normal trust investment yield."³² This, however, "does not change the substance of the investment as a reasonable attempt at risk diversification similar to that of the common trust fund."³³ For these reasons, the court adopted the rule that distributions by a regulated investment company from capital gains, in whatever form, are to be allocated to principal. It thereby repudiated the separate entity theory on which the previous decisions in other jurisdictions³⁴ were grounded and indicated their decreasing precedential value.³⁵ It should be noted that the instant case was decided on common law principles, as Massachusetts has not adopted

²⁹ See notes 18-27 *supra* and accompanying text.

³⁰ 194 N.E.2d at 713.

³¹ See note 9 *supra* and accompanying text.

³² Bogert, *Trusts and Trustees* § 858 (2d ed. 1951).

³³ 194 N.E.2d at 713.

³⁴ See notes 12 and 13 *supra*.

³⁵ Of particular significance is the new N.Y. Pers. Prop. Law § 17a (effective June 1, 1964) incorporating the "conduit" analysis recently adopted in the Uniform Revised Principal and Income Act (see note 24 *supra*). This constitutes a complete statutory reversal of the rule engendered by prior New York decisions.

the Uniform Revised Principal and Income Act. However, significant weight is afforded this Act³⁶ as persuasive authority in the court's opinion.

An important factor in the determination of allocation to principal was the Internal Revenue Code. It is interesting to observe its pervasive influence. First, the Code affects the mutual fund industry by causing practically total distribution of net gains.³⁷ This greatly affects the concept of the *nature* of the mutual fund as a conduit. Likewise, the Code has a manifest effect on trust administration because from a tax standpoint capital gains of the investment company are capital gains to its shareholders.³⁸ Because this treatment achieves lower tax rates, it increases the desirability of mutual fund investment. At the same time it is of consequence in resolving allocation problems, as evidenced by the weight afforded it in the instant case.

Since the capital gains distributions remain in corpus, the income beneficiary's return may be inadequate.³⁹ Professor Scott attributes this inadequacy primarily to management fees and suggests that, if the trustee invests substantially in mutual funds, his fees be reduced by an appropriate amount because he thereby delegates his duties of investment management.⁴⁰ In the alternative, as the court says, "It may be a sound reason for a trustee to *refrain* from investing in investment company shares. . . ."⁴¹ But this fact does *not* change the nature of the investment itself, and in light of the substance of the transaction (the capital gains distribution) there is no logical or practical basis for a different allocation in direct investment than in investment by means of a conduit.

V. CONCLUSION

Thus, it is clear that money derived from sales out of the portfolio of a mutual fund is allocated to principal. But acceptance of the analysis of the mutual fund as a conduit raises a further problem. Is the *source* of the dividend received by the fund from its investments to be considered in a determination of the proper method of allocation to principal and to income? If, for example, the fund re-

³⁶ Uniform Revised Principal and Income Act § 6(c).

³⁷ Int. Rev. Code of 1954, § 852(a)(1) allows investment companies which distribute at least 90% of earnings from interest and dividends to be exempt from taxation on the earnings so distributed. See text accompanying note 21 *supra*.

³⁸ Int. Rev. Code of 1954, § 852(b)(3)(B). See also note 20 *supra* and accompanying text.

³⁹ See note 32 *supra* and accompanying text.

⁴⁰ 3 Scott, Trusts § 227.9A (2d ed. 1956). The trustee has a duty not to delegate his investment duties to others. 3 Scott, Trusts § 171 (2d ed. 1956).

⁴¹ 194 N.E.2d at 712. (Emphasis added.)

ceives and passes on to its shareholder a dividend from a corporation which is in fact the result of sales of the corporation's capital assets, the correct allocation by a trustee once again is uncertain. Theoretically, the answer should be determined by applying whatever rule obtains in the particular jurisdiction with respect to dividends received from direct investment, most notably, either the Massachusetts⁴² or the Pennsylvania rule.⁴³ However, the already complex Pennsylvania rule becomes inconceivably demanding in this situation, because it would require the trustee holding mutual fund shares to determine the true source of every dividend received by the fund throughout its portfolio. According to this rule "ordinary" dividends (those paid out of net earnings of the corporation) are allocable to the life beneficiary, but "extraordinary" dividends (representing a depletion of the corporation's capital assets and thus of the "intact value" of the shares) are returned to the trust res.⁴⁴ Under the Massachusetts rule, or "rule of simplicity," on the other hand, there would be no such necessity. This view, endorsed both by the *Restatement of the Law of Trusts*⁴⁵ and by the Commissioners on Uniform State Laws,⁴⁶ regards "cash dividends, however large, as income, and stock dividends, however made, as capital."⁴⁷ Since any cash dividends would be distributed as a "dividend" to fund shareholders, the allocation would always be to income as the Massachusetts rule prescribes. Any stock dividends would be retained by the fund and allocated to corpus upon "distribution" to the trustee. However, a corollary to the basic Massachusetts rule is that if the trustee has an option to receive either cash or stock, the option is treated as a cash dividend and thus as income.⁴⁸ Should the fund, given such option, elect payment in stock, the ultimate result upon sale of the stock by the fund would be allocation to principal—a result that seems to be contrary to the dictates of the Massachusetts rule. Because of its workability this rule is clearly preferable to the Pennsylvania rule in connection with the mutual fund, but the uncertainty which exists in the option situation must be clarified. One remedy would be to require the mutual fund to designate what part of the capital gains distribution, if any, resulted from the sale of such "elected" stock.

⁴² *Minot v. Paine*, 99 Mass. 101 (1868).

⁴³ *Earp's Appeal*, 28 Pa. 368 (1857).

⁴⁴ See 3 Scott, *Trusts* §§ 236.3-236.6 (2d ed. 1956); Bogert, *Trusts and Trustees* § 844 (2d ed. 1951).

⁴⁵ *Restatement, Trusts* § 236 (2d ed. 1959).

⁴⁶ *Uniform Revised Principal and Income Act* § 6(a).

⁴⁷ *Minot v. Paine*, 99 Mass. 101, 108 (1868).

⁴⁸ *Smith v. Cotting*, 231 Mass. 42, 120 N.E. 177 (1918); *Restatement, Trusts* § 236(c) (2d ed. 1959).