Mutual Funds-Trusts and Trustees-Capital Gains Distributions From Mutual Funds: Income or Principal?

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MUTUAL FUNDS—TRUSTS AND TRUSTEES—Capital Gains Distributions From Mutual Funds: Income or Principal?

The growing prevalence of mutual fund shares in the assets of small and medium-sized estates has made the problem of allocating capital gains distributions between income and principal a matter of great concern to the trustees of such estates.[1] A "capital gains"

1. The mutual fund is an open-ended investment company in which shareholders contribute capital in return for shares in the fund. The professional security brokers who manage the fund use the capital to purchase securities. The main activity of the fund is the trading of such securities. Investment policies and goals vary widely among various funds depending upon the investment motives of the shareholders. The fund

distribution represents a gain resulting from the profitable sale of securities held by the mutual fund. The uncertain state of the law regarding capital gains distributions from mutual funds presents a serious dilemma to the trustee: if he distributes the capital gains to the life beneficiary, the remainderman may claim that such distributions represent a partial liquidation of the fund and therefore are allocable to the principal of the estate; if he allocates the distribution to principal, the life beneficiaries may claim that the distributions are the result of the normal operations of the fund and consequently represent income. Recent decisions and legislation indicate a trend toward resolving this issue by allocating capital gains distributions to principal.[2] This solution seems unsatisfactory for it fails to consider the essential characteristics of mutual funds and their distributions.

The recent case of *In re Estate of Brock*[3] is illustrative of the problem involved in allocating capital gains distributions. Testator had provided in his will that the income from his estate was to go to various life beneficiaries and, upon their deaths, the principal was to be distributed to the two institutions named as remaindermen. The trustee used part of the proceeds of the estate to purchase shares in a mutual fund and when the mutual fund made a distribution, a question arose as to whether it represented income, allocable to the life beneficiaries, or principal, allocable to the remaindermen. In affirming the decision of the Orphan's Court, the Supreme Court of Pennsylvania held that distributions from a mutual fund to a trust should be treated as if the trustee had held the securities owned by the mutual fund and that therefore a capital gains distribution represented a return of principal which should be allocated to the remainderman.

The majority opinion in *Brock* adopted the "conduit" theory, which is the theory most frequently advanced in support of the proposition that capital gains distributions from mutual funds are to be treated as a return of principal.[4] The basis of this theory is that the

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derives its income from both dividends on securities held and profits realized on the trading of securities. See generally WIESENBERGER, INVESTMENT COMPANIES (pt. I) (25th Annual ed. 1965).

Mutual funds are an excellent investment for the trustee of an estate with limited resources because they allow him to invest in reasonably high yield securities and at the same time enjoy the safety of diversification which he could not otherwise afford. Such funds also have the advantage of minimizing the administrative efforts needed by the estate, while providing constant supervision of the funds invested. See generally Putney, *Mutual Funds Make Small Trusts Possible,* 89 TRUSTS & ESTATES 836 (1950).

2. *E.g.,* Tait v. Peck, 346 Mass. 521, 194 N.E.2d 707 (1963); N.J. REV. STAT. § 3A:14A-5 (Supp. 1966); N.Y. PERS. PROP. LAW § 27-E-7; REVISED UNIFORM PRINCIPAL AND INCOME ACT § 6(c) (1962).

3. 420 Pa. 454, 218 A.2d 281 (1966).

4. See generally Note, 1964 DUKE L.J. 650.

mutual fund is a mere conduit for the securities held by it and that therefore the trustee should treat the proceeds from the fund as if he had held the securities in his own name.[5] This theory, however, fails to consider two basic characteristics of the mutual fund. First, the mutual fund is closely managed by professionals in the investment industry and therefore it is reasonable to expect far different results than would be obtained from a similar investment under the casual management of a trustee. Second, the mutual fund is set up as a corporate entity and, as in any other corporation, the stockholders do not have a claim to any specific asset but rather have a claim only to a part of the corporation's equity.[6] Proponents of the "conduit" theory point to the fact that the Internal Revenue Code follows this theory in allowing mutual fund shareholders to treat distributions from the fund as if they had held the securities themselves.[7] However, the Internal Revenue Code's treatment of mutual fund distributions is based on the policy that mutual fund shareholders should not be taxed twice on the earnings of the fund[8]—a policy which has no bearing on the problem of trust allocation of mutual fund distributions and was never intended as a guideline for the law of trusts.[9]

It has also been argued by those advocating the allocation of capital gains distributions to the remainderman that such distributions are the result of a diminution of the mutual fund assets and therefore represent a reduction in the corpus of the estate.[10] They point out that if a trustee were to sell mutual fund shares just prior to a capital gains distribution, the entire proceeds of the sale would be allocable to the corpus of the estate because the sale would represent a liquidation of estate assets, although the price received for the shares would reflect the expected dividend.[11] Indeed, the price

5. If a trustee for an estate held the securities himself, the only way he could realize a capital gain would be to sell the securities at a profit. Such a sale would be a liquidation of trust assets and the proceeds would be allocated to the corpus.

6. For criticism of the reasoning used by proponents of the conduit theory, see BOGERT, TRUSTS AND TRUSTEES § 858 (2d ed. 1962) [hereinafter cited as BOGERT]; Young, *A Dissent on Capital Gains Distributions*, 88 TRUSTS & ESTATES 280 (1949).

7. INT. REV. CODE OF 1954, § 852, provides that an investment company which distributes at least 90% of its taxable income will not be taxed on such income. Instead, the shareholder will be taxed as if he held the securities himself. That is, the distributions representing income from dividends will be taxed as normal income and the portion of the distribution designated capital gains will be taxed at the long term capital gains rate.

8. See Union Trusted Funds, Inc. v. Commissioner, 8 T.C. 1133, (1947). See generally Rubin, *Regulated Investment Companies*, 28 TAXES 541 (1950).

9. See generally BOGERT § 858; Anderson, *Principal or Income*, 90 TRUSTS & ESTATES 530 (1951).

10. See Shattuck, *Capital Gains Distributions, Principal or Income*, 88 TRUSTS & ESTATES 160 (1949).

11. It should be noted that the bulk of transactions in any type of corporation will involve a reduction in corporate assets. However, normal operations usually involve only a reduction of current operating assets and depreciation of noncurrent assets,

of any corporate stock tends to rise just prior to a dividend distribution—which dividends would clearly have to be allocated to income —and if the trustee were to liquidate his shares in the company, this increase in value also would have to be allocated to the corpus of the estate. However, repeated action of this type would constitute a breach of the trustee's fiduciary duty to the income beneficiary.[12]

Finally, it has been claimed that it is unfair to credit the life tenant with all of the gains of the mutual fund, while the remainderman suffers all of the administrative costs,[13] losses, and risks of loss. However, this argument is only partially valid. Since only *net* capital gains of the mutual fund for the period are distributed,[14] the remainderman would suffer only if, in a given period, the losses exceeded the gains. Furthermore, in the type of mutual fund that the trustee would be required by law to invest in,[15] the chances of loss are minimized and the long run increase in the value of the shares should be more than sufficient to cover administrative costs and losses.[16]

A major goal of any court decision or legislation dealing with the problem of allocating mutual fund capital gains distributions between principal and income should be to give effect to the intent of the testator wherever possible.[17] Under circumstances similar to those presented in *Brock*, where the life beneficiaries are friends and relatives of the testator and the remaindermen are institutions, it could normally be assumed that the testator's main concern in establishing such a trust was for the welfare of the life beneficiaries. The trustee, therefore, should be allowed to make investments which will maximize income for the life beneficiary, so long as he adequately protects the principal for the remainderman. Under a decision such as *Brock*, the diversification and professional management aspects of a mutual fund would provide adequate protection for the remainderman,[18] but the goal of income maximization would not be realized since the dividend income from a mutual fund is only about 2.55 per cent per

whereas liquidating transactions involve a reduction by sale of the capital or non-current assets. Therefore much of the issue in dispute actually revolves around the question of whether securities held by a mutual fund constitute current operating assets or capital non-current assets. See generally Young, *A Dissent on Capital Gains Distributions*, 88 TRUSTS & ESTATES 280 (1949).

12. See RESTATEMENT (SECOND), TRUSTS §§ 185, 187 (1959).

13. The principal bears the investment costs: BOGERT § 803, at 142-43; RESTATEMENT (SECOND), TRUSTS § 233, comment *f* (1959); REVISED UNIFORM PRINCIPAL AND INCOME ACT § 13(c)(2)(a) (1962).

14. See INT. REV. CODE OF 1954, § 852(3)(c).

15. A trustee should choose an investment fund which balances growth and income producing factors with relative safety to the investment. Security Trust Co. v. Mahoney, 307 Ky. 661, 668-69, 212 S.W.2d 115, 119 (1948).

16. See note 21 *infra* and accompanying text.

17. See RESTATEMENT (SECOND), TRUSTS § 4, comment *a* (1959).

18. See notes 1 & 15 *supra*.

year.[19] On the other hand, if capital gains distributions as well as dividend income were allocated to the life beneficiary, his yield from the mutual fund would be approximately 5 per cent[20]—certainly a reasonable rate of return. It should also be noted that under present economic conditions, the remainderman stands to gain by an investment in a mutual fund, even if the capital gains distributions are allocated to the life beneficiary, for the value of the shares of the mutual fund itself tend to increase in value after the distribution of the capital gains, thus increasing the corpus of the estate.[21]

Recently enacted and proposed legislation has, however, taken the position that capital gains distributions from a mutual fund should be treated as principal. Section 5(1) of the 1931 Uniform Principal and Income Act provides that if a trustee has an option of receiving either cash or shares of stock, he should treat the distribution as income. Relying upon this section, a majority of the courts had reached the conclusion that capital gains distributions of a mutual fund were income.[22] However, section 6(c) of the 1962 Revised Uniform Principal and Income Act, augmenting section 5(1) of the earlier act, specifically states that capital gains distributions from mutual funds must be treated as principal,[23] thus reversing

19. This figure represents the average rate of return for the five years ending July, 1966, on the fifty mutual funds listed in *Long's Index of Mutual Funds*, 105 TRUSTS & ESTATES 798 (1966). Since investments which are equally sound, such as high grade corporation bonds, could produce returns of 4 ½% or better for the income beneficiary, the trustee might be held liable to the income beneficiary for a breach of trust. See Moody's *Bond Yields by Rating Groups* (especially tables on Aaa and Aa Bonds) in MOODY'S INDUSTRIAL MANUAL a20-a21 (June 1966 ed.).

20. The average capital gains distribution from mutual funds for the years 1956 through 1965 was approximately 2.58% of invested capital per year. However, it should be noted that capital gains distributions tend to fluctuate considerably from year to year; of the ten years surveyed, capital gains distributions ranged from a high of 3.3% of invested capital in 1957 to a low of 1.9% of invested capital in 1963. All figures were compiled from *Statistical Summary of Open Ended Investment Companies (Mutual Funds)*, in MOODY'S BANK & FINANCE MANUAL a52 (1966 ed.).

21. The 36 mutual funds listed in *Comparison of Management's Performance of Open-end Investment Companies*, in MOODY'S BANK & FINANCE MANUAL a48 (1966), realized an average appreciation in their per share value of 140.6% after dividend and capital gains distributions, for the ten-year period from 1956 to 1965.

22. *E.g.*, Rosenberg v. Lombardi, 222 Md. 346, 160 A.2d 601 (1960); Coates v. Coates, 304 S.W.2d 874 (Mo. 1957); Lovett Estate (No. 2), 78 Pa. D. & C. 21 (Orphans' Ct. 1951). However, some courts have interpreted capital gains distributions as a disbursement of corporate assets allocable to the remainderman under § 5(3) of this act. *E.g.*, Tait v. Peck, 346 Mass. 521, 194 N.E.2d 707 (1963); Estate of Brock, 420 Pa. 454, 218 A.2d 218 (1966).

23. REVISED UNIFORM PRINCIPAL AND INCOME ACT § 6(c) (1962) provides:

> Distributions made from ordinary income by a regulated investment company . . . are income. All other distributions made by the company or trust, including distributions from capital gains, . . . whether in the form of cash or an option to take new stock or cash or an option to purchase additional shares, are principal.

See Barclay, *The Revised Uniform Principal and Income Act*, 101 TRUSTS & ESTATES 833 (1962). For a criticism of this section see Bogert, *The Revised Uniform Principal and Income Act*, 38 NOTRE DAME LAW. 50 (1962). To date the Revised Act has been adopted in six states: Michigan, Maryland, Wyoming, South Carolina, Kansas, and New York.

the results reached by a majority of the courts under the old act.[24]

The courts and legislatures have invoked several mechanical rules in order to arrive at a fair and workable method of distributing capital gains income. First, the Pennsylvania rule—the so-called "rule of fairness" which is no longer followed by the courts[25]—was based on the assumption that the settlor intended to treat the income beneficiary and the remainderman equally. Under this rule, regular cash dividends were allocated to income, but a capital gains dividend by a mutual fund was considered an "apportionable event." The trustee was to determine what portion of the capital gains dividend was attributable to the retained earnings of the fund since the inception of the trust or the trust's purchase of the mutual fund shares, and this portion was to be allocated to the income beneficiaries while the residual was allocated to the remaindermen. However, the difficulty of this rule was that it presented impossible accounting problems in that it required the trustee to trace the source of all capital gains distributions.[26] Second, the Massachusetts "rule of simplicity" was, until recently, the rule followed in most jurisdictions[27] and variations of it have been incorporated into both the Uniform Principal and Income Act and the Revised Uniform Principal and Income Act. This rule favored the life beneficiary by treating all mutual fund cash dividends from whatever source as income[28] and all dividends paid in stock as principal. If the trustee

24. NEW YORK PERS. PROP. LAW § 27-5-7, which became effective in June 1965, uses language which is almost identical to that found in § 6(c) of the Revised Principal and Income Act. The law represents a statutory reversal of a long line of New York decisions which had held capital gains to be income to the life beneficiary. *E.g.*, Matter of Hurd, 203 Misc. 966, 120 N.Y.S.2d 103 (Sup. Ct. 1953); Matter of Bruce, 192 Misc. 523, 81 N.Y.S.2d 25 (Sup. Ct. 1948); Matter of Byrne, 192 Misc. 451, 81 N.Y.S.2d 23 (Sup. Ct. 1948).

25. Originating with Earp's Appeal, 28 Pa. 368 (1857), this rule was followed by a majority of jurisdictions prior to 1935. See BOGERT § 842; 3 SCOTT, TRUSTS § 236.15 (2d ed. 1956); Flinkinger, *A Trustee's Nightmare: Allocation of Stock Dividends Between Income and Principal*, 43 B.U.L. REV. 199 (1963). See generally BOGERT §§ 846-48.

26. If a trustee were to follow the Pennsylvania rule, every time a mutual fund made a capital gains distribution the trustee would have to analyze the fund's books to determine the date of purchase and cost of stock sold, as well as the date of sale and sale price. He would then have to calculate what portion of the capital gains resulting from sales during the period would be attributable to the income beneficiary. This task would prove impossible in the case of large mutual funds that regularly trade their securities. See *In re* Catherwood's Trust, 405 Pa. 61, 173 A.2d 86 (1961); Note, *Effectuating the Settlor's Intent: A Formula for Providing More Income for the Life Beneficiary*, 33 U. CHI. L. REV. 783, 785 (1966).

27. Minot v. Paine, 99 Mass. 101, 108 (1868); see Powell v. Madison Safe Deposit & Trust Co., 208 Ind. 432, 196 N.E. 324 (1935); *In re* Joy's Estate, 247 Mich. 418, 225 N.W. 878 (1929); Hayes v. St. Louis Union Trust Co., 317 Mo. 1028, 298 S.W. 91 (1927); BOGERT § 850; 3 SCOTT, TRUSTS § 236.3 (2d ed. 1956, Supp. 1965); RESTATEMENT (SECOND), TRUSTS § 236 (1959).

28. It would appear, however, that if the cash dividend from a mutual fund were actually declared to be a liquidating dividend resulting from a termination of operations of the fund, the dividend would have to be treated as a return of principal. See Wehrhane v. Peyton, 133 Conn. 478, 52 A.2d 711 (1947) (dictum).

had an option to receive either cash or stock, the dividend was to be treated as income, regardless of how the trustee exercised his option.[29] While this rule was easy to administer, it failed to consider the circumstances giving rise to the dividend.[30] Finally, Delaware has adopted a "Prudent Man Rule"[31] pursuant to which a trustee should treat corporate distributions as income to the extent that he believes such distributions would have been regarded as income by "men of prudence, discretion, and intelligence in the management of their own affairs."[32] Under this rule, it is likely that a trustee would look upon capital gains distributions as income, but unfortunately the rule does not supply the trustee with very clear guidelines and this uncertainty is an open invitation for the disfavored party to bring suit to determine if the trustee has acted as a "prudent man."[33]

A better reasoned solution to this problem, one which was suggested by the minority opinion in *Brock*, would be to treat capital gains dividends from a mutual fund as income to the life beneficiary. In reaching his conclusion, the dissenting judge in *Brock* relied on the stock-in-trade theory.[34] He reasoned that a mutual fund is like any other business, that is, its normal operations are the buying and selling of securities, and that therefore the securities which it holds represent stock-in-trade or operating assets rather than capital assets.[35] It follows then that the income realized from the trading of these securities is income realized in the normal course of business and should be distributed as normal income. The professional management aspects of the mutual fund, its corporate structure, and the fact that securities behave much like any other commodity with fluctuating prices, are all factors which tend to substantiate this argument.

The most satisfactory way to solve the question of capital gains distributions is to have the testator state specifically in his will how such distributions should be handled.[36] Unfortunately too few testa-

29. See Smith v. Cotting, 231 Mass. 42, 120 N.E. 177 (1918); RESTATEMENT (SECOND), TRUSTS § 236(c) (1959).

30. Thus one transaction could lead to two opposite results depending upon the method of payment chosen by the mutual fund. For example, if the fund realized a capital gain on the sale of a block of securities and chose to distribute the proceeds only in additional shares of its own stock, the proceeds would be treated as principal allocable to the remainderman under the Massachusetts rule. On the other hand, if the fund decided to distribute the gain from the same transaction in cash or gave the option of cash or shares in the fund, the Massachusetts rule would dictate that the proceeds be treated as income allocable to the life beneficiary.

31. DEL. CODE ANN. tit. 12, § 3526 (Supp. 1964).

32. *Ibid.*

33. For criticisms of this rule, see Dunham, Scott & Wolf, *Uniform Revised Principal and Income Act*, 101 TRUSTS & ESTATES 894, 896 (1962).

34. 218 A.2d 281, 294 (Pa. 1966) (dissenting opinion). See generally Young, *A Dissent on Capital Gains Distributions*, 88 TRUSTS & ESTATES 280 (1949).

35. See note 11 *supra*.

36. See generally Rogers, *Capital Gains Distributions, Clauses to Eliminate Ques-*

tors foresee this problem and make adequate provisions for it. Uniform legislative action would be the most efficient and most certain, non-testamentary method of supplying the trustee with a concrete answer for his dilemma, but, unlike the Revised Uniform Principal and Income Act, such legislation must address itself to the practical circumstances surrounding mutual funds held by an estate which provides for both life beneficiaries and remaindermen. The history of this problem suggests that two features should be incorporated into such a statutory solution. First, a flexible,[37] easily determinable upper limit, based on a reasonable rate of return for the period involved,[38] should be placed on the amount of capital gains which can be allocated to the income beneficiary.[39] Second, such a statute should provide that, if the mutual fund sustains a capital loss in any period, capital gains will not be distributed to income beneficiaries in following periods unless and until the loss has been repaid to the principal. A statute which incorporates these provisions would be beneficial to all of the parties involved. The trustee would be given definite guidelines to follow and would therefore be free to take advantage of the opportunity to invest in mutual funds. The life beneficiary would realize a reasonable rate of return. Finally, some of the risk of loss would be shifted away from the remainderman and the chances for accretion to his principal would be increased.

tions of Allocating Investment Company Dividends, 90 TRUSTS & ESTATES 300 (1951); Rogers, *Capital Gains Dividends, A Suggestion for Draftsmen*, 20 FORDHAM L. REV. 79 (1951).

37. Since changes in economic conditions would tend to make obsolete any fixed limit, it is desirable to establish a flexible limit that will fluctuate to reflect economic conditions. The "6% Rule" and similar statutes recently adopted by several states to control the distribution of stock dividends are examples of inflexible limitations. *E.g.*, N.J. REV. STAT. § 3A:14A-4 (Supp. 1964); N.Y. PERS. PROP. LAW § 27-e-2; PA. STAT. ANN. tit. 20, § 3470.5(1) (1964).

38. Determining a satisfactory guidepost to be used in setting the upper limit would be the biggest obstacle in winning acceptance for a statute of this type. However, there appears to be a great number of readily ascertainable standards. One possible method might be to set the limit at ½% higher than the yield for the period for a specific class of bonds which the trustee would have been permitted to invest in. A standard reporting system, such as Moody's Investor Yield Tables, see, *e.g.*, notes 19-21 *supra*, could be specified as the official source for such information.

39. This limit should be measured against total distributions from the mutual fund, including both dividends and capital gains. But if the dividend distribution alone exceeded the limit, the entire amount would still be allocable to the income beneficiary.