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## COMMENTS

### CAPITAL GAIN DIVIDENDS — A SUGGESTION FOR DRAFTSMEN

DWIGHT ROGERS†

The trustee who has purchased shares of an investment company or mutual fund for his trust is likely to be gratified when December rolls around by the generous dividend sent him by the company. He may be puzzled when he learns that a part of it is called a Capital Gain Dividend.<sup>1</sup> Perhaps he will call his lawyer to ask whether he should send on the entire dividend to the income beneficiary of his trust. His lawyer may have some difficulty with the question. Although he will find two lower court cases in New York<sup>2</sup> to support that action, he will find leading authorities at the bar diametrically opposed in their views as to his conduct.

If the trustee chooses to follow *In re Byrne's Estate*<sup>3</sup> and continue to pay out as "income" the capital gain dividends, it is not unlikely that over a period of time he will find that he has distributed as such "income" a not inconsiderable portion of the capital he started with.<sup>4</sup>

More and more, trustees are being urged to use investment company shares as trust investments, especially in smaller trusts.<sup>5</sup> The great majority of these companies are "regulated investment companies" under the Internal Revenue Code which, if they pay out in dividends 90% or more of net income for the year, pay ordinary corporate income taxes only on the balance of net income and on any capital gains retained by the company. Although net realized capital gains are not included in the computation of net income for the 90% rule the normal practice of the regulated investment company is to distribute them in the year in which they occur, in order first to avoid corporate income tax on them and second because if distributed later they would be probably taxed as ordinary income to the shareholder. To the extent, however, that the dividend distributions represent current capital gains they are identified as capital gain distributions, and the shareholder may treat them on his own return as long term capital gain regardless of how long he has owned his investment company shares. Thus for Federal income tax purposes a clear distinction is made between ordinary dividend and capital gain dividend distributions.

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† Member of the New York Bar.

1. Despite this statutory language from § 362 (6) (7) of the Internal Revenue Code it is reported that certain state security commissioners vigorously object to calling these distributions "dividends."

2. *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).

3. 192 Misc. 451, 81 N. Y. S. 2d 23 (Surr. Ct. 1948).

4. State Street Investment Co., for example, has paid capital gain dividends in the ten years ending December 31, 1949 amounting to 45.5% of its estimated cost price at the beginning of the period on January 1, 1940. Long, *Index of Mutual Investment Companies*, 89 TRUSTS AND ESTATES 39 (Jan. 1950).

5. See Putney, *Mutual Funds Make Small Trusts Possible*, 89 TRUSTS AND ESTATES 836 (Dec. 1950).

To relieve the managements of such companies from the necessity of deciding in advance at their peril, or more properly at the tax peril of their numerous shareholders, how much income may be earned during the closing days of the year, Congress included Section 222 in the Revenue Act of 1950 adding a new subsection (8) to Section 362 (b) of the Internal Revenue Code as a relief measure to provide in substance that the 90% requirement will be met if any deficiency in that required proportion of net income is made up by a distribution in the following year to be paid not later than the first regular dividend.

This comment will shed no light on the interesting question Messrs. Shattuck and Young<sup>6</sup> have been discussing as to the true nature of these distributions, nor will it enlighten the trustee of an unamendable trust already in existence as to his duty to the life tenant or to the remainderman. It merely urges three points which will be separately considered:

First: In new trusts, especially small ones, it may be a great help to the trustee, and permit otherwise unobtainable advantages to the beneficiaries, to include in the investment powers a power to acquire for investment and to hold shares of investment companies and participations in common trust funds, without duty to diversify.

Second: Whether or not such a power is specifically granted it may assist any trustee who at any time receives or purchases investment company shares if a guide to his actions in respect to capital gain distributions is included in the instrument.

Third: Wills establishing small trusts and revocable and amendable inter vivos trusts should be reviewed and appropriate language be inserted while the instrument is still fluid.

#### I.

To be more specific, adaptations of the following phrases are suggested for trust agreements or wills which create trusts, especially for those where one or more trusts are likely sooner or later, and possibly that includes almost all, to have some share or fund of less than \$100,000 total for general investment, or are likely to have funds ordinarily available for common stock investment of less than \$50-75,000. The examples suggest that leading draftsmen are aware of the desirability of giving trustees specific power to use investment company shares, which they call by their popular name of investment trusts. The first is an excerpt from the Forms accompanying the 1950 Report of the Committee on Standards of Draftsmanship, Wills and Trusts, of the American Bar Association.

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6. Shattuck, *Capital Gains Distributions*, 88 TRUSTS AND ESTATES 160 (Mar. 1949), and Young, *A Dissent on Capital Gain Distributions*, 88 TRUSTS AND ESTATES 280 (May 1949). See also Shattuck, *Further Comment on Capital Gain Distributions*, 88 TRUSTS AND ESTATES 429 (July 1949) and Young, *Correspondence*, 88 TRUSTS AND ESTATES 467 (Aug. 1949). It is interesting to note that Mr. Young is listed in the October, 1950 prospectus as a director of Delaware Fund which paid out 65% of its January 1, 1940 offering price as capital gain dividends in the ten years ending December 31, 1949. Long, *supra* note 3, at 39.

"CLAUSE NUMBER: I grant to my executors and trustees power to do everything they deem advisable, even though it would not be authorized or appropriate for fiduciaries (but for this power) under any statutory or other rule of law, including in this grant (without impairing its plenary nature) power to:

(1) acquire by purchase or otherwise, and retain, temporarily or permanently, any kind of realty and personalty—even stocks and unsecured obligations, undivided interests, *interests in investment trusts and discretionary common trust funds*, property which produces much, little or no income, or which is wasting, or is outside of my domicile or abroad—all *without diversification as to kind or amount*. . . ."<sup>7</sup>

The second is suggested by Harrison Tweed and William Parsons.

"SECOND: The Trustee is hereby expressly authorized and empowered, in its sole and absolute discretion:

1. To purchase or otherwise acquire and to retain, whether originally a part of the trust estate or subsequently acquired, any and all stocks, bonds, notes or other securities, or any variety of real or personal property, *including stocks or interests in investment trusts and common trust funds*, as it may deem advisable, whether or not such investments be of the character permissible for investments by fiduciaries, or be unsecured, unproductive, underproductive, overproductive or of a wasting nature. *Investments need not be diversified* and may be made or retained with a view to a possible increase in value. The Trustee may at any time render liquid the trust estate, in whole or in part, and hold cash or readily marketable securities of little or no yield for such period as it may deem advisable."<sup>8</sup>

Some might prefer to follow or adapt the language of the proposed amendment to the Model Prudent Man Statute, which in place of the words "interests in investment trusts" in the examples quoted above, specifies:

". . . securities of any open-end or closed-end management type investment company or investment trust registered under the Federal Investment Company Act of 1940, as from time to time amended. . . ."<sup>9</sup>

For a small trust or a will in which the testator or grantor expects and wants shares of an investment company as the major investment medium, the writer's preference would be to adapt the proposed statute just quoted and in addition to the grant of broad general investment powers use language somewhat as follows:

". . . and may invest without further diversification any part or all of the trust, including accumulations if any, in any one or more open-end or closed-end manage-

7. Trachtman, *Administrative Provisions for Wills*, 89 TRUSTS AND ESTATES 661 (Oct. 1950) (italics supplied).

8. TWEED AND PARSONS, *LIFETIME AND TESTAMENTARY ESTATE PLANNING* 98 (Am. Law Inst. 1950) (italics supplied). See also, *id.* at 87, 119, 129.

9. A PROPOSED AMENDMENT TO THE PRUDENT MAN RULE FOR TRUST INVESTMENT (1950), sponsored by the Committee on Arrangement, Roy C. Osgood (Boston) Chairman.

ment type investment companies or investment trusts, or in any discretionary common trust fund."

## II.

The second point has had less attention from draftsmen, although it may be even more important to the trustee. The purpose is to simplify the administration of the trust, clarify its purposes and forestall disputes and litigation. If shares of regulated investment companies have been purchased or are held, a clause such as the following is certain to be most welcome to the trustee when and if the question of disposition of a capital gain distribution eventually overtakes him.

CLAUSE.....(..) Capital gain dividends, as defined by Section 362 of the Internal Revenue Code, shall constitute principal, but the trustee, in his discretion, may at any time distribute all or any part thereof to the beneficiary or beneficiaries entitled to receive the income at the time of such distribution if, in the uncontrolled judgment and discretion of the trustee, such distribution would be in the best interests of such beneficiary or beneficiaries.

If in the dispositive provisions of the trust agreement the trustee has discretion to pay (or apply) principal to the income beneficiary, the matter can be handled simply in the section dealing with principal and income in a variety of ways to suit the circumstances of the individual trust.

CLAUSE.....: Capital gain dividends shall constitute principal;

or

CLAUSE.....: Realized capital gains, including capital gain dividends, shall constitute principal;  
or if the grantor or testator so desires

CLAUSE.....: Realized capital gains shall constitute principal but all capital gain dividends shall be distributed as income;

Some draftsmen might prefer to let the matter rest with a conventional clause permitting the trustee to use his discretion in allocating receipts between principal and income. For example, the Trachtman Committee draft suggests giving the trustees power to:

". . . (4) determine whether or to what extent receipts should be deemed income or principal, whether or to what extent expenditures should be charged against principal or income, and what other adjustments should be made between principal and income. . . ." <sup>10</sup>

Tweed and Parsons on the other hand provide that:

". . . Rents, royalties and cash dividends received from wasting assets (including without limitation cash dividends paid by oil, coal, lumber or mining companies), extraordinary cash dividends other than liquidating dividends, and dividends payable in the stock of a corporation other than the corporation declaring or authorizing the same shall be income.

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10. Trachtman, *supra* note 6, at 661. See also the clause entitled "ENCOURAGING DETERMINATIONS IN FAVOR OF CURRENT INCOME BENEFICIARY" and especially the commentary on "Power (4)." *Id.* at 662, 663.

"The proceeds of the sale of unproductive or underproductive property, liquidating dividends, and rights to subscribe to stock shall be principal. . . ."<sup>11</sup>

Because of the unique character of the capital gain dividend, this latter, also a conventional type of clause, appears to leave the trustee with the problem of whether the capital gain dividend is a dividend on a wasting asset, or perhaps a liquidating dividend, or merely a *Byrne*<sup>12</sup> dividend.

In the present state of the law on the subject it is submitted that in a small trust designed for the use of investment company shares as a major investment medium, or where they seem a logical choice, more specific guidance to the trustee will be helpful to him.

To hold that capital gain dividends as principal constitute an unlawful accumulation of income, even where, as in New York, severe restrictions are imposed on such accumulation, would require an aggressive extension of the doctrine of the *Byrne* case, which seems merely to have gone off on the point that in the absence of specific provisions in the instrument such dividends should be treated as income.

### III.

The third point, that revocable and amendable trusts be reviewed and appropriate language inserted while there is yet time, follows naturally from the discussion but is easy to overlook. The opportunity for constructive action is great. There are doubtless thousands of revocable living trusts in existence established before investment company shares were seriously considered as major media for small trusts. Many are settlor-controlled and presumably many of these now hold investment company shares. Many other settlors might wish to empower their trustees to acquire shares if the matter were brought to their attention. After the death of the settlors the trustees of these trusts, too, will need and appreciate guidance on the disposition of capital gain dividends even if no practical problem exists now.

### SUMMARY

Armed with one clause permitting the investment of the entire trust fund in shares of a single investment company, and a second giving him directions as to the treatment of capital gain dividends, many a man who would otherwise shrink from accepting the responsibilities of trusteeship of a moderate-sized or small fund can face the prospect with equanimity and many a trust company which for one reason or another does not find a common trust fund practicable can accept small trusts, and what is more, make them a profitable part of its business.

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11. TWEED AND PARSONS, *supra* note 7, at 100.

12. See note 1 *supra*.