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## Trusts - Principal and Income Act - Mutual Funds

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## RECENT DECISIONS

TRUSTS—Principal and Income Act—Mutual Funds—The Pennsylvania Supreme Court in interpreting sections 5(1) and 5(3) of the Principal and Income Act of 1947<sup>1</sup> has held that mutual fund distributions designated as realized capital gains are allocable to principal.

*In Re Estate of Brock*, 420 Pa. 454, 218 A.2d 281 (1966).

In *In Re Estate of Brock*<sup>2</sup> a trust was created with gifts of income totaling \$18,700 payable to seven primary beneficiaries. Any income in excess of that amount was to be paid to two secondary beneficiaries and upon the death of any beneficiary, that portion of income released by such death was to be divided between Bryn Mawr College and the Pennsylvania Academy of Fine Arts. At the time of the trial three of the primary beneficiaries and one secondary beneficiary, the appellant, were alive. The trustees invested in seven shares of the Philadelphia Fund, Inc., a mutual fund registered as a regulated investment company. In 1964 the trustees received a distribution of one dollar and five cents from the fund designated as seven cents a share from ordinary income and eight cents a share from realized capital gains. The dividend was payable in cash or additional shares of the fund. The trustees elected to take the dividend in cash and filed an account crediting the entire distribution to income. Bryn Mawr objected to the allocation of the fifty-six cents designated as realized capital gains to income.<sup>3</sup> Its position was upheld by the lower court; the life beneficiary appealed.<sup>4</sup>

The proper allocation of the distribution is uncertain primarily because of the nature of a mutual fund. Investment companies or mutual funds were created to fill the needs of the small investor for a diversified portfolio and for expert management of his securities. By combining the resources of many small investors for the purchase, holding, and sale of corporate stocks and securities both of these objectives are achieved. Income is derived in the form of cash, received as interest or dividends on the securities held, or capital gains, which result from the sale or exchange of securities at a profit. According to federal law, the mutual

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1. PA. STAT. ANN. tit. 20, § 3470.5 (1947).

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

3. All parties agreed that forty-nine cents was properly allocated to income.

4. REV. RUL. 60-385, 1960-2 CUM. BULL. 170; provides that where a will creates a trust with income payable to someone for life and the principal thereafter to charity and the trustee is empowered to invest in mutual or regulated investment company funds, the remainder to charity will not qualify for the charitable deduction under federal estate tax law if, *under the applicable state law*, any capital gains distribution on the shares of the mutual or regulated investment company would be allocated to income and distributed to the income beneficiary. Fifty-nine estates in the Philadelphia area alone are affected by this decision involving taxes in excess of \$3,600,000.

fund in declaring a dividend must designate the source thereof as ordinary income or capital gains.<sup>5</sup> This dual aspect of dividends has created problems concerning the proper allocation of mutual fund distributions between principal and income.<sup>6</sup>

Prior to this decision three Pennsylvania county courts,<sup>7</sup> in line with several other jurisdictions,<sup>8</sup> had held that mutual fund distributions were allocable to income. This result was reached through the use of the stock-in-trade theory,<sup>9</sup> which characterizes the securities held by the mutual fund as inventory items. Since the securities are treated as an inventory item, the sale of such securities gives rise to ordinary income. The Pennsylvania Supreme Court rejected this analysis and adopted the *conduit theory*<sup>10</sup> previously followed by only the Massachusetts Supreme Court.<sup>11</sup> Under the *conduit theory* the mutual fund is not considered an entity but merely a *conduit* between the investor and the investments made by the fund. An analogy is drawn between the mutual fund in-

5. Investment Company Act of 1940, 15 U.S.C. § 80a-19 (1940).

6. For a more complete discussion of mutual funds and the theories concerning them, see 98 A.L.R.2d 511 and 18 Sw. L.J. 508 (1964).

7. Summerfield Estate, 26 Pa. D. & C.2d 526 (1962); Cohen Estate, 13 Fid. Repr. 209 (1963); Lovett Estate, 78 Pa. D. & C. 21 (1951). These cases are distinguishable from the present case either because they did not involve the Principal and Income Act or because they interpreted a different section of the Act.

8. Bryne's Estate, 192 Misc. 451, 81 N.Y.S.2d 23 (1948); Briel v. Moody, 77 N.J. Super. 306, 186 A.2d 314 (1962); Rosenberg v. Lombardi, 222 Md. 346, 160 A.2d 601 (1960); Gardner's Trust, 266 Minn. 127, 123 N.W.2d 69 (1963); Coates v. Coates, 304 S.W.2d 874 (Mo. 1957); cases collected in 98 A.L.R.2d 511 (1964). The holding of three of these courts has been changed by statute. MD. CODE ANN. art. 75B, 6(c) (1957); N.J. STAT. ANN. 3A:14A-5 (1953); MCK PERSONAL PROPERTY LAW, 27(e) (1962).

In all, fifteen states allocate realized capital gains to principal. Seven states have accomplished the allocation to principle by the adoption of the Uniform Principal and Income Act of 1962. IDAHO CODE, 68-1006(c) (1948); KAN. STAT. ANN. 58-905(c) (1964); LA. REV. STAT. tit. 9:2148(c) (1950); MICH. STAT. ANN. 2679(6)(c) (1957); MD. CODE ANN. art. 75B, 6(c) (1957); CODE OF LAWS OF S.C. tit. 67-509(c) (1962); WYO. STAT. 34-379(c) (1957). Eight states have enacted separate legislation to achieve this result. CONN. GEN. STAT. 45-113(1) (1958); FLA. STAT. ch. 690.06(1) (1965); 18 ME. REV. STAT. ANN. 4054 (1965); N.J. STAT. ANN. 3A:14A-5 (1953); MCK PERSONAL PROPERTY LAW, 27(e) (1962); N.C. GEN. STAT. 37-5(e) (1950); TENN. CODE ANN. 35-706(1) (1950); WIS. STAT. 231.40(5)(a) (1963). Three states allocate capital gains to income unless stated to be otherwise by the declaring corporation. ILL. REV. STAT. ch. 30, § 164 (1965); 60 OKLA. STAT. 1961, 175.29(a); TEX. CIV. STAT. ANN. art. 7425b-29 (1960). Two other states make the allocation to income by judicial decision. Gardner's Trust, 266 Minn. 127, 123 N.W.2d 69 (1963); Coates v. Coates, 304 S.W.2d 874 (Mo. 1957).

9. BOGERT, TRUSTS AND TRUSTEES § 858 (2d ed. 1955).

10. In a direct investment and common trust fund participation, capital gains are credited to principal. By analogy, the proponents of this view conclude that the fund as a mere conduit should reach the same result. Scott takes the position that allocating capital gains to income is unsatisfactory, but does not specifically mention the conduit theory. 3 SCOTT, TRUSTS § 236.14 (2d ed. 1956).

11. Tait v. Peck, 346 Mass. 521, 194 N.E.2d 707 (1964).

vestor and a direct investor or common trust fund participant. The Massachusetts Supreme Court, acting without a Principal and Income Act,<sup>12</sup> utilized common law principles in applying capital gain dividends to principal. The Pennsylvania Supreme Court was able to achieve the same result by applying sections 5(1) and 5(3) of the Principal and Income Act of 1947 which provide:

Section 5(1). Corporate distributions made to a trustee in the shares of the distributing corporation, however described or designated by the distributing corporation, shall be deemed principal but if the number of shares of any class distributed to shareholders of such class is six per cent (6%) or less of the number of shares of that class outstanding on the record date for such distribution, the shares so distributed shall be deemed income. *Except as provided above and in other subsections of this section* all dividends payable otherwise than in shares of the distributing corporation, including ordinary and extraordinary cash dividends and dividends payable in shares or other securities or obligations of corporations other than the distributing corporation, shall be deemed income. *Where the trustee shall have the option of receiving a dividend, either in cash or in the shares of the distributing corporation, it shall be considered as a cash dividend and deemed income, irrespective of the choice made by the trustee.* [Emphasis supplied.]

Section 5(3). Where the assets of a corporation are liquidated, wholly or partially, amounts paid upon corporate shares as cash dividends, declared before such liquidation began, or as arrears of cumulative preferred, or guaranteed dividends shall be deemed income, all other amounts paid upon corporate shares on disbursement of the corporate assets to the stockholders shall be deemed principal. *All disbursements of corporate assets to the stockholders, whenever made, which are designated by the corporation as a return of capital or division of corporate property, shall be deemed principal.* Any profit or loss resulting from the sale or liquidation of corporate shares shall enure to or fall upon principal. [Emphasis supplied.]<sup>13</sup>

The court found itself in the anomalous position of reaching the same

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12. Massachusetts does not have a Principal and Income Act. *Tait v. Peck*, *supra* note 11.

13. PA. STAT. ANN. tit. 20, § 3470.5(1)(3) (1947).

result as the lower courts unless some subsection of section 5 provided to the contrary. The second sentence of subsection 5(3) seemed to provide the answer sought by the court since the fund had designated the return as a "capital gain." The court relying on the word "capital" stated: "Clearly, the fund has 'designated' this 'disbursement of its corporate assets' as a return of 'capital' and, clearly, this distribution falls within the second rule of section 5(3) and, therefore, must be 'deemed principal'."<sup>14</sup>

Thus, the Pennsylvania Supreme Court, using the *conduit theory* as a guide to the desired economic result, interpreted its statute to allocate capital gains dividends to principal. Whether such an interpretation is as clear as the majority<sup>15</sup> would believe is at least open to question. Sentence two of section 5(3) could very well pertain to the return of paid-in or surplus-capital or capitalized earnings. Perhaps the fund's designation of the return as "capital" can be explained by the fact that such designation is required by federal law.<sup>16</sup> Another persuasive factor to be considered is that three states which have a provision identical to sentence two of section 5(3) have made separate provision for the distributions from mutual funds.<sup>17</sup> The Pennsylvania court also relies on the Revised Uniform Principal and Income Act of 1962.<sup>18</sup> Although this Act has not been adopted in Pennsylvania, the court noted that the revision allocating capital gains to principal must have been necessary to remove the confusion which had arisen over the language of subsection 5(3). Whether such reliance is valid depends on whether this provision was intended as a revision or as an addition. In the commissioners' prefatory notes to the 1962 Act it is stated: "Provision is also made for treatment of the distributions of a regulated investment company or real estate investment trust."<sup>19</sup> This statement indicates that an addition, not a revision, was intended.

The crux of the problem seems to be in the court's adoption of the *conduit theory* to reach the desired result. The use of the *conduit theory* or the stock-in-trade theory is nothing more than the utilization of a fiction. The *conduit theory* disregards the very entity of the fund, a fact

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14. 420 Pa. 454, 473, 218 A.2d 281, 290 (1966).

15. Justice Roberts disagreed that the conduit theory expressed an accurate characterization of a mutual fund because it disregards the entity of the fund thus distorting the true economic consequences. He concluded that a more accurate picture was presented by the stock-in-trade theory advocated by Professor Bogert. BOGERT, TRUSTS AND TRUSTEES § 858 (2d ed. 1955).

16. Investment Company Act of 1940, 15 U.S.C. § 80a-19 (1940).

17. N.C. GEN. STAT. § 37-5(c)(2) (1950); TENN. CODE ANN. § 35-706(1) (1955); WIS. STAT. § 231.40(5)(c) (1963).

18. Uniform Laws Annotated, 9B Miscellaneous Acts, Revised Uniform Principal and Income Act at 190 (Supp. 1962).

19. Uniform Laws Annotated, 9B Miscellaneous Acts, *supra* note 18 at 191.

seemingly as indisputable as taxes. On the other hand, the stock-in-trade theory, in classifying the securities as an inventory item, disregards the character of the asset being sold. Stocks and bonds have traditionally been considered as capital assets and to treat them differently serves no purpose except to permit the return to be credited to income. The business of the mutual fund, as the court emphasized, is a "unique business";<sup>20</sup> a business so identified should, like the banking and insurance businesses, be the subject of exact and comprehensive legislative regulation. This suggestion is not intended to mean that the court should become a super-legislature. The court should interpret the Act and, if a situation is not provided for in the Act, the case should be decided according to other principles. It is paradoxical that the court must disregard the *entity* of the fund to reach the desired economic result; then rely on that *entity's* designation of the distribution as a capital gain to interpret its statute.

One troublesome question left unanswered by the court is the retroactive application of *Brock*. If a trustee has paid capital gain distributions to the life beneficiary, the beneficiary may be liable for the return of such funds. The Restatement of Trusts First and Second provides:

If the trustee has made a payment out of trust property to one of several beneficiaries to which the beneficiary was not entitled, such beneficiary is personally liable for the amount of such overpayment, and his beneficial interest is subject to a charge for the repayment thereof, unless he has so changed his position that it is inequitable to compel him to make repayment.<sup>21</sup>

The Restatement position has been accepted by the Pennsylvania courts in at least two lower court decisions.<sup>22</sup> In a case<sup>23</sup> decided prior to the publication of the Restatement of Trusts, the Pennsylvania Supreme Court adopted a position later followed by the drafters of the Restatement. In an action by a trustee to recover funds wrongfully paid, the court quoted with approval from the case of *Northrop v. Graves*:<sup>24</sup>

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20. 420 Pa. 454, 463, 218 A.2d 281, 285 (1966).

21. Restatement, Second, Trusts § 254. This provision is identical to § 254 of the first Restatement of Trusts.

22. In *Dougherty Estate*, 7 Fid. Repr. 138 (1957), the trustee brought suit against decedent's estate to recover money paid by mistake. Instead of paying a one-fifth interest as provided by the will the trustee had paid a one-half interest. The court quoted the Restatement view with approval, but limited recovery to a six year period in accordance with the statute of limitations. Likewise, in *Weaver's Estate*, 15 Pa. D. & C.2d 57 (1958), the trustee through an improper interpretation of the will had overpaid one beneficiary. The court permitted recovery against the beneficial interest even though the will contained a spendthrift provision.

23. *Union Trust Company of N.Y. v. Gilpin*, 235 Pa. 524 (1912).

24. 19 Conn. 548 (1849).

We mean distinctly to assert that where money is paid by one under a mistake of his rights and his duty, and which he was under no legal or moral obligation to pay, and which the recipient has no right in good conscience to retain, it may be recovered back in an action of indebitatus assumpsit whether such mistake be one of fact or law; and this we insist may be done both upon principle of Christian morals and the common law.<sup>25</sup>

Even though the result reached by the court is in accord with the majority of jurisdictions today, its adoption of the *conduit theory* and its interpretation of section 5(3) to allocate capital gains dividends to principal has created more problems than it has solved. It is apparent that the only solution rests with the legislature. A bill<sup>26</sup> providing for the allocation of capital gains dividends to income was introduced in 1961; the bill died in committee. But the confusion in this area today indicates it is time for the legislature to act to resolve the problems which have arisen out of mutual fund distributions.

*Richard E. Myers*

**CRIMINAL LAW—Criminal Procedure—Accused's loss of memory surrounding events of alleged criminal act held not to entitle him to a discharge from the indictment or stay of proceedings.**

*Commonwealth ex rel. Cummins v. Price*, 421 Pa. 396, 218 A.2d 758 (1966).

Relator was indicted for first degree murder. The only evidence presented of the alleged murder was circumstantial and, at best, inconclusive.<sup>1</sup> A pretrial petition for a writ of habeas corpus was filed requesting that (1) the murder indictment be dismissed and relator be discharged from custody, or (2) the trial on the indictment be postponed. The petition averred that while the relator was at no time insane or incompetent, he was suffering from a permanent loss of memory of the events and circumstances implicating him in the alleged murder. In dismissing the petition the lower court found that relator was not feigning the amnesia but did not determine its expected duration. On appeal the supreme court held, with two Justices dissenting, “. . . that defendant is not entitled at this time (1) to a discharge from the indictment, or (2) to a stay of proceedings. . . .”<sup>2</sup>

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25. *Union Trust Company of N.Y. v. Gilpin*, 235 Pa. 524, 530 (1912).

26. House Bill 592, Session of 1961.

1. The ballistics report stated only that the bullets taken from the victim were of the same general class characteristics as bullets test-fired from the revolver which police had found in relator's car. A more positive identification was not made.

2. *Commonwealth ex rel. Cummins v. Price*, 421 Pa. 396, 406, 218 A.2d 758, 763 (1966).