CAPITAL DIVIDENDS

report of the
Property Law
and Equity Reform
Committee

NEW ZEALAND

REPORT

OF THE

PROPERTY LAW AND EQUITY REFORM COMMITTEE

Presented to the Minister of Justice

in November 1984

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REPORT ON

CAPITAL DIVIDENDS

To: The Hon. Geoffrey Palmer
Minister of Justice

Introduction

1. Where under a trust the destination of the proceeds of a share investment depends upon whether they are treated as capital or income, difficult questions can arise in determining their character. The return to shareholders may take a variety of different forms, and be derived either from trading profits or from the appreciation of capital assets. The particular forms of distribution dealt with in this report are the "capital profit dividend" and the "capital reserve dividend", both of which are derived from recognised improvements in the capital asset position of the company and made available as a cash distribution to the shareholder. By "capital profit" we mean a profit calculated on the basis of a sale or revaluation of the assets of a company. In the case of "capital reserve" we refer only to that part of the capital reserve which has been derived from profit so calculated, and set aside as a reserve in the accounts of the company. In either form, the profit may become available for distribution amongst the shareholders of the company. For convenience this Report will refer to both of these forms of distribution as "capital dividends".

2. Under the present law a capital dividend is prima facie income, and thus belongs to the life tenant. The capital of the trust investment is taken as being the shares themselves, so that any cash benefits accruing while the company is a going concern are regarded as income. This is so even though, if one looks beyond the shares to the corporate structure, they are made possible only because some capital asset owned by the company has increased in value, or been sold at a profit. In contrast, if the benefit comes to the trust in the form of additional bonus shares or share rights, or as dividend upon a winding up, it will be treated as capital and the life tenant will not be permitted to share in it. It may be a matter of chance, or business expediency totally unrelated to the interests of trustee shareholder, whether the directors recommend one form of distribution or the other. As was observed by Lord Russell of Killowen in the leading case of Hill v. Permanent Trustee Co. [1930] AC 720, at 729,

> "... moneys paid in respect of shares in a limited company may be income or corpus of a settled share according to the procedure adopted, i.e., according as the moneys are paid by way of dividend before liquidation or are paid by way of surplus assets in a winding up. Each process might appear to involve some injustice, the former to the remainderman, the latter to the tenant for life."

Terms of Reference

3. In August 1980 under your predecessor's authority, there was referred to us a suggestion by the Public Trustee that the present law be amended to remove difficulties and anomalies. Reference was made to the rule adopted in several states of the USA, and commonly known as the "Pennsylvania Rule" after the state where it was first adopted. This rule requires the trustee, and if necessary the court, to discriminate between various forms of distribution, according to whether it derives from capital or income within the structure of the company. It was suggested that this might offer a possible solution to the problem.

4. The question was first considered as part of our study of Share Premium Reserve Distributions, but as stated in our Report on that topic (page 7) we formed the view that more extensive investigation was needed and separate recommendations should be made. We accordingly asked Dr John Prebble, Senior Lecturer in Law, Victoria University of Wellington, to look into the Pennsylvania Rule and prepare a report. His very full and helpful paper is appended, and forms a basis for the recommendations we propose to make.

Juristic Basis of the Present Law

5. It is important to recognise that capital dividends are not consigned to income by some immutable rule of law, but simply as a process of construction of the trust instrument, where the settlor or testator, by using such words as "capital" and "income", has made a distinction for the purpose of the trusts he is establishing. As Lord Russell observed in Hill's case at 729,

> "... the point for decision is capable of statement thus: Is the sum.. 'net income or profits to be derived from such investment or investments', or is it 'capital of my said trust estate'?".

The legal ruling to which we have referred is no more than a prima facie rule of interpretation, capable of displacement if there are indications in the will or trust instrument that some other meaning is intended. Nevertheless the courts have consistently adopted this approach when interpreting the words "capital" and "income" or other similar terms frequently used in trust instruments. No doubt there are good reasons for this, not least the fact that it would be undesirable in the

great majority of cases to force the trustee to look behind the company's decision to the inner workings of the corporate structure. If the trust interests are sufficiently closely connected with the company to make such a course desirable, this would be known by testator or settlor and special provision could be made in the trust instrument for determining what is capital and what is income.

Should the Pennsylvania Rule be Introduced in New Zealand?

6. Dr Prebble's report brings out very forcibly the practical difficulties which would follow if a rule such as the Pennsylvania Rule were to be introduced in New Zealand. Among the considerations which weigh strongly with us are:

(a) The trustee will not be adequately equipped, or well enough informed, to make a proper decision where the trust is a small investor in a large institution;

(b) The trustee's concerns ('has the capital been maintained since the creation of the trust?') are quite different from those of the company, and the company accounts are therefore unlikely to yield the necessary information;

(c) The American courts themselves have been obliged to move from real values towards "notional values", which may prove just as artificial as the present law;

(d) In times of high inflation, the rule would be even more difficult to operate;

(e) In large public companies, where "asset-backing" may not be the primary factor in determining value, a policy of depleting capital reserves may have no adverse effect on the value of the shares themselves - indeed because of other factors, such as taxation consequences, it may make the shares more attractive to shareholders and thus more valuable.

We note that the Pennsylvania Rule is regarded as unworkable in modern conditions, and the current judicial and legislative trend is towards a rule more akin to the present law in New Zealand.

Cases Where the Present Law Causes Anomalies

7. It seems accepted on all hands, however, that cases can arise where the application of the present law might lead to apparently unreasonable and anomalous results. The following is a hypothetical example.

> The testator A leaves his shares in A Ltd to be held on trust for his second wife for life, then for his three children by his first marriage. A Ltd is a small private company in which the trustee has only minority voting

rights. A Ltd has been involved in the property letting business, acquiring no new properties since well before A's death. Shortly before the death of A's widow, the properties are sold and a capital dividend of 800 percent is declared, reducing the real value of the shares to little more than their nominal value. A's widow keeps the dividend for herself and her own family.

Should the law be amended to make special provision for cases such as this?

8. It is important to put this issue in proper perspective. The question is not whether it is fair or reasonable for Mrs A to deprive A's children of their inheritance. That (subject to the Family Protection Act 1955) is for A himself to decide. The question, as we have already observed, is whether A, having given Mrs A the "income" from "shares", is to be taken as having excluded from that term any distribution made prior to winding-up of the company which substantially eats into the present day value of the capital of the company. When the issue is put this way, any supposed anomaly or unreasonableness becomes much more speculative.

9. It would, after all, have been a simple matter for A, by using one of the well known and settled forms of discretionary trust, to have provided his trustees with a means of ensuring that the real value of the capital was not lost. Ought a decision by A to adopt instead, a simple form of income trust of the kind described in the example above, necessarily lead to an assumption he intended his widow to take the extraordinary "income" derived from capital dividends? Or should what might be the real truth of the matter be given some weight i.e. - that A may have been poorly advised, or perhaps more likely, that neither he nor his advisers ever contemplated the possibility that the company, the shares in which he had taken the trouble to specially mark out as ultimately passing to his children, might for all practical purposes although not in law virtually go out of the existence prior to the gift taking effect? Then from the viewpoint of the widow there may be other cogent factors which ought in fairness to be taken into account. Did the rents on the properties owned by the company represent an adequate return on the capital involved during the years of her life tenancy, even assuming, as is not always the case, that a reasonable proportion of the company's income was distributed to the widow by way of dividend? Could it not be the case that the one fat year in which the capital dividends were received no more than compensate the widow for the many preceding or succeeding locust years of poor earnings or inadequate dividends?

10. Looked at in the round, the approach adopted by the Courts in treating the destination, as between income and capital, of capital dividends as a question of construction, (which in practice almost assumes the proportion of a rule of law), probably achieves a just solution in the great majority of

cases. Nevertheless we consider that unusual circumstances can and do occur, which will, under the present law, produce anomalous results which the testator would neither have expected nor wanted. The problem as the Committee sees it is that unless special provision is made in the trust instrument there are no existing means by which either the trustees or the Court can lawfully make adjustments between income and capital to correct these anomalies. To illustrate this point:

- unless the trustees have authority given under the terms of the trust instrument to withhold or capitalise some or all of the "income" arising from the shares, they are usually powerless to effect an adjustment themselves. Currently there is no suitable statutory power generally available to trustees. The limited power to set aside capital reserves out of income conferred on trustees by the Trustee Amendment Act 1982 is not a complete answer as it is available only where trustees are carrying on a business. The Committee recognises there is a distinction to be drawn between trustees holding shares in a company which is the legal entity carrying on a business and trustees holding property which they themselves employ in a business they carry on.

- although some doubts on the point have been expressed in the past, it now appears to be accepted by the Courts that they do not have an inherent power to apportion dividends to correct these anomalies, except perhaps where the payment or receipt of the dividend can be shown to have resulted from some act or omission of the trustees which amounts to a breach of trust - see re Maclaren's Settlement Trusts [1951] 2 All E.R.414, Bakewell v. Holme (1944) 44 SRNSW 150 and the New Zealand cases of In re Bell [1940] NZLR 15 and In re Davis [1961] NZLR 597. Whilst the Courts do have jurisdiction in certain circumstances to vary trusts under s.64A Trustee Act 1956, the Committee is not satisfied that this jurisdiction is always appropriate or likely to be of practical utility when dealing with problems of this nature.

Recommendation for Reform

11. We consider there is a case for reform and recommend the Court be given limited jurisdiction to authorise trustees to depart from the ordinary rules about what is capital and what is income in their hands in relation to capital dividends. The alternative of giving authority to the trustees themselves to make adjustments has been considered but rejected. The reason is that we do not accept such an authority should be regarded as falling within the routine administrative activities of trustees for which general statutory provision ought properly be made, as it necessarily involves an alteration in the beneficial interests under the trust for which the settlor or testator has made no express provision. Furthermore, we think a call for apportionment of these

(1) Whether similar dividends have been declared with regularity in the past.

(2) Whether such dividends are regularly paid out of current earnings.

(3) The frequency with which such dividends are declared.

(4) The size of the dividend in relation to the market value of the shares at the time of the creation of the trust.

(5) The designation, if any, placed upon it by the directors of the corporation.

(6) The source of the earnings from which the distribution is made.

The distinction between ordinary and extraordinary dividends is, generally speaking, not important in jurisdictions operating under the Massachusetts rule. Rather, the distinction is between cash and stock dividends. All the former are allocated to income, and all the latter to principal. The source of the dividend is not important. The effect of the two rules may be compared by means of a table:

	Pennsylvania	Massachusetts
ordinary cash dividends	income	income
extraordinary cash dividends	apportioned	income
ordinary stock dividends	income	principal
extraordinary stock dividends	apportioned	principal

Thus, ordinary cash dividends are treated as income under both rules, whatever their source.

Merits of the two rules

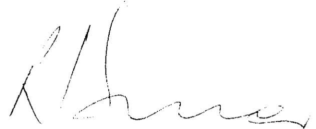
It is difficult to balance the relative merits of the Pennsylvania and Massachusetts rules as the reasons in favour of each are not strictly comparable. The strongest argument for the Pennsylvania rule is that it is fair, or at least purports to be so: whatever earnings accrue to the corporation during the term of the trust should be treated as income under the trust, at least if the earnings are distributed to the shareholders during the life of the trust. On the other hand, accretions to capital and distributions of earnings that accrued before creation of the trust should be treated as principal. In the language used by the rule, the "intact value" of the trust principal should be preserved. In contrast, the principal merit of the Massachusetts rule is its simplicity. This simplicity is highlighted when the difficulty and indeed, frequent impossibility, of correctly and logically applying the Pennsylvania rule is borne in mind.

No court has been willing to follow the Pennsylvania rule to its logical conclusion, which is to treat the revenue earnings of a corporation as for all purposes income of the shareholders and

advise those interested in capital of the receipt of the dividend or their intention to distribute. Another matter we have taken into account in considering this alternative is that trustees could be faced with serious practical difficulties in complying with a duty to give notice. Presumably they should notify all of the capital beneficiaries who may be or may become interested in capital yet some of them may be infants or under other disabilities, others out of the country; some may only have a contingent interest, and others may be as yet unborn.

15. Our proposals have been framed on the basis that if the Court is to be given an effective opportunity to redress the balance between income and capital the new jurisdiction must permit applications being made subsequent to distribution of the capital dividends. However we recognise special provision will then also be necessary to protect trustees from the personal liability which might otherwise arise in such a situation. The essence of the problem, which we see as unique, is that distribution of these dividends by trustees in a manner which at the time was perfectly proper and lawful could later prove to be "wrong" should the Court approve some scheme of apportionment as a result of a subsequent application. Should there be any prospect that one result of this could be that trustees are exposed to possible personal liability, several undesirable consequences may follow. One is that the Courts may become reluctant in these instances to approve what, by all standards, may otherwise be reasonable and fair schemes for apportionment of capital dividends, for fear of possibly penalising innocent trustees. Another is that trustees themselves may tend to defer distributing any dividends derived from capital sources no matter how much or little is involved or what the circumstances are, unless either with the agreement of all the beneficiaries, assuming such agreement is possible, or with the protection of a Court order. That would be contrary to the purpose of the reform we propose, which is simply to provide the possiblity of remedy for those very few unusual cases which produce serious anomalies without unnecessarily interfering with existing law practice or procedures.

16. The solution which we recommend is to provide protection for trustees who distribute capital dividends without breach of trust and without knowledge of an application to the Court, whilst giving the Court power to disturb prior distributions if in its discretion that is appropriate. Some ancillary powers of "tracing" distributions will also be required. Clauses of the draft bill annexed to this report set out more precisely what we have in mind.



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APPENDIX I

THE TREATMENT BY TRUSTEES OF DISTRIBUTIONS BY COMPANIES OF CAPITAL PROFITS AND CAPITAL RESERVES

John Prebble, B.A. LL.B. (Hons) (Auckland); B.C.L. (Oxford);

J.S.D. (Cornell); Inner Temple

In New Zealand and English law, where a company pays a dividend out of capital profits that dividend is income: IRC v. Reid's Trustees [1949] AC 361; Thomas Perry & Son Ltd v. C of T [1949] NZLR 116. Consequently as between a life tenant and a remainderman, the dividend belongs to the former, unless, of course, the testator has expressed a contrary intention. This result may be unfair to the remainderman for serveral reasons:

(a) The fundamental principle of a life tenancy followed by a remainder interest is that the capital of the fund should remain intact, the life tenant enjoying only the income during his life. Ordinarily, remaindermen can look forward to taking the benefit of any accretions to the capital value of the fund. But, so long as it does not thereby effect a reduction of issued capital (which requires the sanction of the court) a company whose articles of association are in standard form is entitled to pay out capital profits to its shareholders. Where such a distribution represents accretions to the capital value of shares that have occurred since the shares were settled on trust, it may be thought that there is an element of unfairness to the remainderman. This unfairness is so much the greater in cases where the increase in capital value accrued before the trust was constituted.

(b) If a company makes its capital profits undistributable by issuing them as bonus shares, those shares are treated as part of trust capital. This appears to be a reasonable conclusion. Take a company with issued capital of 100 $1.00 shares, and capital profits of $100.00. Ignoring any retained revenue profits, this company has assets of $200.00. On an assets valuation a least, each $1.00 share is worth $2.00. Suppose the company issues 100 bonus shares to its shareholders pro rata. The result is that each shareholder now has twice as many shares as before, but each share is worth only $1.00, because the total value of the company's assets remains the same. The new shares are credited by the trustee to capital, which is a fair result, as it means that the value of the trust capital remains the same. On the other hand, if the company distributes $100.00 as a cash dividend, the dividend goes to the life tenant, and the value of the trust capital is halved. It might seen unjust that the rights of the remainderman should depend upon the way in which the company chooses to deal with its $100.00 of retained profits.

(c) The problems identified above are exacerbated in periods of high inflation, since apparent capital profits may not be profits at all in real terms, but simply an increase in nominal value of capital assets. Nevertheless, company law and accounting practice permit such profits to be distributed as dividends.

(d) In New Zealand, although dividends from capital profits are, in the abstract, correctly described as income, generally speaking they are not subject to income tax. This is a result of section 4(5) of the Income Tax Act 1976, which excludes such distributions from the definition of dividends for tax purposes. Consequently, for the sake of their shareholders, companies often prefer to pay dividends out of capital profits if they can. This has two results. First, companies will more readily debit capital accounts to service a dividend than they might otherwise, other things being equal. Secondly, companies are driven to a variety of expedients in order to contrive capital profits that may be distributed to shareholders free of tax. Both these tendencies may be thought to erode the worth of company shares held by trustees, by siphoning off part of their value to life tenants.

The question of fairness between life tenants and remaindermen is particularly clear in the case of dividends from capital profits. However, this is only part of a larger issue. The same question arises in connection with revenue profits that accrued to the company before its shares were settled on trust. Whether such profits have been credited to some capital reserve, or simply labelled in the accounts of the company "retained profits", the problem is the same, Suppose a testator leaves 1000 shares on trust for his widow for life, with remainder to his son. The shares have a par value of $1.00, and a market value of $10.00. In this particular case, the market value exactly reflects asset backing, which comprises $1.00: original capital; $4.00: retained capital profits; $5.00: retained revenue profits. The capital value of the trust at its constitution is $10,000. The company is equally able to declare dividends from capital or from revenue profits. Either course will have some effect of reducing the value of the capital of the trust, and either course might seem to treat the remainderman unfairly as compared with the life tenant.

The American approach : Introduction

The problem of allocating distributions of capital and pre-settlement revenue profits between life tenants and remaindermen is one that has come before the courts in the different jurisdictions of the United States of America on innumerable occasions. In point of fact, cases on pre-settlement revenue profits are the more numerous, but, the relevant considerations being similar, both types of case have tended to be governed by the same rules.

The problems and their solutions have been the subject of a good deal of scholarly comment. There is an excellent treatment in Scott on Trusts (3rd ed, 1967) (supplemented) 1975-2023, on which this paper relies heavily. The American Law Institute has dealt with the issue in both the first and second Restatements : Trusts. The National Conference of Commissioners on Uniform State Laws has promulgated a uniform law on the subject, and a revised law.

The major feature of the scholarly, legislative, and judicial history of the law in this area has been a competition between two irreconcilable approaches, known as the Pennsylvania Rule and the Massachusetts Rule. The Massachusetts Rule is fundamentally similar to the current New Zealand law. That is, all cash dividends are treated as income, and stock dividends, or bonus issues, are treated as capital. On the other hand, the Pennsylvania Rule looks to the source within the company declaring the dividend to determine whether it should be allocated to capital or to revenue. There is also a third approach, known as the Kentucky Rule, whereby all dividends, of cash or stock, go to the beneficiary currently entitled to income. This rule has received little support, and will not be considered further in this paper. Several states, in particular Rhode Island and Delaware, have from time to time adopted hybrid approaches.

History of the Pennsylvania and Massachusetts Rules

The Pennsylvania Rule, which goes back to Earp's Appeal 28 Pa 368 (1857), was the early favourite, and reached the apogee of its acceptance among the different jurisdictions in the earlier decades of this century. It was adopted by the American Law Institute in the First Restatement : Trusts, published in 1935. However, by that date its eclipse was already well under way, and the Massachusetts Rule was adopted in the Second Restatement, published only twelve years later in 1947. The Massachusetts Rule was also adopted in section 5 of the Uniform Principal and Income Act, promulgated in 1931 by the National Conference of Commissioners on Uniform State Laws. It has since been enacted in 24 states, including Pennsylvania (Stats Ann (Purdon) Tit 20 ss.3470.1 to 3470.13, as inserted by the Principal and Income Act of 1947). Other states that had adopted the Act are listed in Scott on Trusts (3rd ed, 2101). The Massachusetts Rule is also adopted in section 6 of the revised Uniform Principal and Income Act, which had been adopted by 18 states by 1980. The most recent are California, 1967, Indiana, 1971, Kansas, 1970, Minnesota, 1969, Mississippi, 1972, and North Dakota, 1973. A copy of the relevant portion of the revised Act appears as an appendix to this paper.

Numerically, case law has been about evenly divided between the two rules, but since at least the 1930's the strong trend has been towards the Massachusetts Rule.

Detailed statements of the rules

Pennsylvania Rule (Taken from In re Jones' Estate 377 Pa 473, 105 A 2d 353, 354, per Bell J (1954))

The Pennsylvania Rule of apportionment between a life tenant who was entitled to income and a remainderman who was entitled to principal was based on the equitable theory that profits and earnings of a corporation which were made, accumulated and undistributed since the testator's death (or since the acquisition of the stock when it was acquired subsequent to his death) were income to which the life tenant under certain circumstances and upon proper occasions was entitled. To achieve this equitable result the court preserved for principal the intact value of the stock at the testator's death plus all subsequent capital increases and gave to the life tenant (in certain instances hereinafter set forth) the earnings since the date of the testator's death. Such an apportionment can and should be made upon the happening of any one of four events, namely:

(1) the distribution by the corporation of an extraordinary cash or stock dividend;

(2) the liquidation of the corporation;

(3) a sale of the stock by the trustees;

(4) the issuance of stock rights.

The Massachusetts Rule (taken from Restatement Second : Trusts, section 236, 2 ed 1959)

Except as otherwise provided by the terms of the trust, if shares of stock of a corporation are held in trust to pay the income to a beneficiary for a designated period and thereafter to pay the principal to another beneficiary, the following rules are applicable:

(a) Except as stated in clauses (e) and (f), dividends payable in cash or in property other than in shares of the declaring corporation, including ordinary and extraordinary dividends, are income, if payable to shareholders of record on a designated date which is within the period; or, if no such date is designated, if declared at a date within the period.

(b) Dividends payable in shares of the declaring corporation are principal.

(c) If the trustee has the option of receiving a dividend either in cash or in shares of the declaring corporation, the dividend is income irrespective of the choice made by the trustee.

(d) Rights to subscribe to the shares or other securities of the declaring corporation and the proceeds of any sale of such rights are principal, but rights to subscribe to the shares of other corporations are income.

(e) Upon the total or partial liquidation of the corporation during the period, amounts paid as cash dividends declared before such liquidation occurred or as arrears of preferred or guaranteed dividends are income; all other amounts paid upon corporate shares on distribution of the corporate assets to shareholders are principal.

(f) A distribution by a corporation which is a return of capital and not a distribution of earnings is principal.

(g) The earnings of a corporation not distributed by the corporation during the period are not income.

Note: Clauses (f) and (g), and the second part of clause (e) have always been accepted by American courts, even if they otherwise follow the Pennsylvania Rule.

Ordinary and extraordinary dividends

It is implicit in the language of the passage quoted from In Re Jones' Estate that the Pennsylvania Rule never applied to ordinary, regular dividends paid out in the usual course of business, whether in cash or stock. This was emphasised by Bell J in In re Catherwood's Trust 405 Pa 61, 173 A 2d 86, 94 (1961) where, quoting from his judgment in Cunningham Estate 395 Pa 1, 34, 149 A 2d 72, 89, the learned justice said:

> An ordinary cash dividend and an ordinary stock dividend belong to the life tenant, irrespective of when earned and irrespective of whether the intact value is or is not thereby impaired. Ordinary cash dividends include small extra cash dividends which are paid currently or irregularly (usually at the year's end). Ordinary stock dividends will include stock dividends [of any class] which are paid quarterly, semi-annually, or annually, currently or irreguarly, and do not exceed six per cent in any one year.

Bell J went on to explain the reason for this treatment of ordinary dividends. First, ordinary dividends should go to the "primary object of the testator's bounty", that is his widow or occasionally his children, rather than to remaindermen. They are part of income. Secondly, if small dividends had to be apportioned between the life tenant and the remainderman there would be a multiplicity of costly, vexatious, and wateful litigation. That would be impractical, unrealistic, and unwise.

Whether a dividend is "ordinary" or "extraordinary" depends on all the circumstances of the case. Among the factors which may be of importance, the Restatement Second lists the following at page 573:

(1) Whether similar dividends have been declared with regularity in the past.

(2) Whether such dividends are regularly paid out of current earnings.

(3) The frequency with which such dividends are declared.

(4) The size of the dividend in relation to the market value of the shares at the time of the creation of the trust.

(5) The designation, if any, placed upon it by the directors of the corporation.

(6) The source of the earnings from which the distribution is made.

The distinction between ordinary and extraordinary dividends is, generally speaking, not important in jurisdictions operating under the Massachusetts rule. Rather, the distinction is between cash and stock dividends. All the former are allocated to income, and all the latter to principal. The source of the dividend is not important. The effect of the two rules may be compared by means of a table:

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Thus, ordinary cash dividends are treated as income under both rules, whatever their source.

Merits of the two rules

It is difficult to balance the relative merits of the Pennsylvania and Massachusetts rules as the reasons in favour of each are not strictly comparable. The strongest argument for the Pennsylvania rule is that it is fair, or at least purports to be so: whatever earnings accrue to the corporation during the term of the trust should be treated as income under the trust, at least if the earnings are distributed to the shareholders during the life of the trust. On the other hand, accretions to capital and distributions of earnings that accrued before creation of the trust should be treated as principal. In the language used by the rule, the "intact value" of the trust principal should be preserved. In contrast, the principal merit of the Massachusetts rule is its simplicity. This simplicity is highlighted when the difficulty and indeed, frequent impossibility, of correctly and logically applying the Pennsylvania rule is borne in mind.

No court has been willing to follow the Pennsylvania rule to its logical conclusion, which is to treat the revenue earnings of a corporation as for all purposes income of the shareholders and

therefore belonging to the life tenant of the trust. See Scott on Trusts 3rd ed 1967, 1983. The Pennsylvania rule is applied only when there has occurred one of the four "apportionable events" listed in the passage taken from In re Jones. The most common is, of course, the payment of an extraordinary dividend.

Deciding whether to apply the Pennsylvania rule is only the start of the problem. The difficulty is then to ascertain the facts on which to base an apportionment between income and principal. The object of courts in applying the rule has been to preserve the "intact value" of the trust fund at the time of its creation. To discover just what this value was may be difficult enough. But when it is borne in mind that allowance must be made for capital fluctuations between the time of the creation of the trust and the distribution of the extraordinary dividend, the difficulty of the task becomes apparent. Even if the records of the company concerned are available to the trustee, which may not be the case, these records are almost certain to have been kept on an historical cost basis. Of course, serious inflation makes the problem just that much worse. By and large, it seems that United States courts never managed to resolve these difficulties, and anomalies grew up in the application of the Pennsylvania rule. For example, the courts have generally held that the intact value of shares bequeathed by the deceased are their book value to the deceased, whereas shares purchased by the trustee are valued at cost. See Cohan and Dean, "Legal and accounting aspects of fiduciary apportionment of stock proceeds : the non-statutory Pennsylvania rules," 106 U Pa L Rev 157, 160-162 and cases cited there (1957).

Assuming that an apportionment is going to be attempted, the fairest approach would obviously be an apportionment based upon the true, that is market, value of the principal of the trust. However, the American courts have not adopted that approach, and application of the Pennsylvania rule has been on the basis of more or less notional values. The calculation of intact value is explained in the following passage from Scott on Trusts 3rd ed 1967, 1995:

> In determining the intact value the market value of the shares is immaterial, since the market value to a large extent depends upon the expectation of future earnings. Ordinarily the intact value is determined by ascertaining the book value of the shares at the time of the creation of the trust, the book value of each share being obtained by adding the capital and surplus and dividing the result by the number of shares then outstanding. This value may be decreased by subsequent capital losses or increased by subsequent capital gains or surplus which is contributed and does not result from earnings of the corporation. Where the dividend declared is a stock dividend it is necessary to ascertain the book value of the stock after the dividend has been paid, and such proportion of the new shares is awarded to principal as necessary to preserve the intact value.
>
> ...

> Fortunately, as far as the courts of Pennsylvania are concerned, these matters are now only of academic interest, since the Pennsylvania Principal and Income Act is applicable to trusts whether created before or after its enactment.

At page 1986, Scott identifies two further problems in the application of the Pennsylvania rule in the case of stock dividends, or bonus shares. The rule requires that such distributions should be apportioned between life tenant and remainderman according to the source of the funds capitalised. It may be that an apportionment can be achieved without impairment of the intact value of the principal, particularly if any profits capitalised have accrued since the constitution of the trust. But if the part of the new shares goes to the life tenant, the effect may be to dilute a controlling or other strategic interest that the trust previously held in the corporation concerned, a result which probably would not have been intended by the testator.

Scott's second objection to allocating a portion of a stock dividend to a life tenant is that this action may eventually threaten the principal of the trust. He points out that bonus issues are often made in times of prosperity, when values are inflated. Thus, an apportionment to the life tenant might not at the time seem to impair the intact value of the fund. However, such impairment might follow if share values were to fall in a subsequent period of recession. One might reply that, since bonus shares allotted to a life tenant pursuant to the Pennsylvania rule represent only revenue profits, a remainderman has no cause for complaint, and the intact value of the trust principal would have fallen anyway. On the other hand, presuming that the testator envisages that the company in which he has shares will follow ordinarily prudent policies, he might well expect that the directors would recommend the capitalisation of some profits from time to time, whereby the capital of both the company, and consequently the trust, can be preserved and, possibly, enhanced. Of course, it is not necessary that the Pennsylvania rule should be applied to dividends of both cash and stock. One could decide to allocate all stock dividends to trust principal, which would satisfy the objections just canvassed. At the same time, cash dividends could be apportioned according to source, albeit that this still leaves the difficult problem of calculating the intact value of trust capital.

Although the reasons for the adoption of one or other of the rules are not strictly comparable, the American courts have, generally speaking, come to the conclusion that the Pennsylvania rule is simply unworkable in modern conditions. In In re Catherwood's Trust B J Jones J quoted at 173 A 2d 93 from the judgment in the court below:

> The apportionment picture in Pennsylvania has, indeed, degenerated into a sorry state, in spite of the lofty ideals of the many sincere and scholarly jurists who contributed to its develoment over the years. The fantastic growth of business structures in this country in the past one hundred

> years, with its myriads of corporate complexities and resulting astronomical apportionment calculations, has made the Pennsylvania apportionment rule practically unworkable today. It is described as an equitable doctrine, but it frequently produces results which are not only completely unforeseen and unpredictable, but actually harsh, inequitble and often contrary to the intentions of the creator of the trust .... Because [of] recent amendments to our laws permitting fiduciaries to invest in common stocks, most estates, even smaller ones, now have shares of the nation's largest corporations in their portfolios. The apportionment problems which confront trustees today, as the result of such holdings, create administrative problems of such complexity as to make the management of trust estates a truly nightmarish experience. It is utterly unrealistic to expect trustees to be compelled to analyse the intricate financial statements of mammoth multi-million dollar corporations, every time a stock dividend is declared, or a share of stock sold. The entire subject of apportionment should be carefully reviewed and the rule simplified by the courts which created the existing burdensome situation.

The considerations that weighed with Jones J will not always be present in cases where New Zealand trustees receive cash dividends paid from capital sources within the declaring company. In cases where the objective of the company is to enable the shareholders to take advantage of the tax-free status of capital-source dividends, the source of the dividend will be clearly and accurately indicated by the company concerned. Thus, the trustee would be relieved of the duty to make apportionment calculations. However, where a dividend is debited to a reserve account made up partly or wholly of retained profits, the task of the New Zealand trustee would be no easier than that of his counterpart in the United States of America. Over and above these considerations, there is also the factor that the accounts upon which the trustee would have to rely are those prepared by the company concerned. There is so much flexibility in the way in which accounts can be drawn up, particularly where it is a question of debiting payments to a mixed fund, that one might question whether the trustee would be doing his duty as between the life tenant and the remainderman if he simply accepted the accounts as presented by the company. This question is dealt with further below, under the heading "Fundamental difficulties of apportionment".

<u>General comments on the merits of adopting the Pennsylvania rule in New Zealand</u>

It was noted above under the heading "Ordinary and extraordinary dividends" that the Pennsylvania rule never applied to ordinary dividends, whether in cash or in stock. However, the major classes of dividends to which it has been suggested that the Pennsylvania rule might be applied in New Zealand are probably correctly described as "ordinary". These are of two types: first, dividends paid out of capital profits in order to obtain

income tax advantages for shareholders; secondly, dividends paid out of reserves when there is insufficient current profit to cover a dividend. In each case, what is contemplated is a series of payments of a regular nature, of a relatively modest amount relative to the total value of the company concerned. Such dividends are, in fact, in substitution for the ordinary cash dividends that would normally be paid by a company out of current profits.

Were the Pennsylvania rule to be adopted in New Zealand in its original form, it would in fact have no effect upon such dividends, as its terms expressly have no application. Be that as it may, practically speaking the rule could be applied to dividends specifically attributed to capital, as explained in the previous section. On the other hand, to try to apply the rule to dividends debited to reserves would raise the same problems of apportionment as in America, except in cases where the total reserve was built up either exclusively before or exclusively after the shares were settled on trust, in which event no apportionment would be necessary.

Fundamental difficulties of apportionment

Hitherto in this paper it has generally speaking been assumed that a company's capital and revenue accounts, so long as they are prepared honestly and competently, can safely be regarded as correctly reflecting the true balance of capital and revenue within that company. Such an assumption is, of course, necessary if one is to set any store at all by an apportionment pursuant to the Pennsylvania rule of a dividend from sources that are labelled as partly capital and partly revenue. However, there are fundamental difficulties in this assumption, as there are conceptual problems in determining just what is a source of any particular company dividend. This can be illustrated by a particular example.

Many companies have dividend policies that are only indirectly related to their annual earnings. Take, for instance, Conglomerate Ltd, a company that for 20 years earns 20 per cent on the par value of its shares, and regularly pays a dividend of 10 per cent. In 1981, its current operations make a loss, but it makes a capital profit on the sale of a building. Conglomerate maintains its 10 per cent dividend, in fact using a banker's overdraft to pay the money, as all its funds are tied up in trading stock. What is the source of this 10 per cent dividend in 1981? There are several possibilities, which include: accrued profits from 1980; accrued profits from 1960; the capital profit. Of course, Conglomerate Ltd can, and will, debit whichever account it chooses. But such action cannot determine the facts, whatever they may be; rather, the accounting entry simply acts as a statement of what the position is to be taken as being between the company and its members. If there is in truth a source of the money that is paid out as the dividend, logically the record-keeping by the company can only disclose or obscure it; it cannot determine it. In fact, the truth of the matter is

that it is impossible to identify the source. All one can say is that, pursuant to company law and to certain accounting conventions which it has followed, Conglomerate Ltd is permitted to pay a dividend, and has done so.

In practice, it appears that courts that have applied the Pennsylvania rule and have sought out the source of funds paid out by a company have relied on the accounting decisions made by that company. But if the true enquiry is to discover whether the trust principal will be left intact if the distribution goes to the life tenant, this procedure can only be justified in the absence of anything more satisfactory.

Practical necessity of changing the current rules

Doubts as to the merits of the current New Zealand rules arise from a concern that the interest of a remainderman is eroded by dividends paid to the life tenant. It may be that this concern is not well founded, for the following reasons.

One starts with three considerations. First, the whole problem relates to the asset backing of shares held by trustees. In so far as the value of shares is affected by factors other than their asset backing, it makes no difference to the remainderman whether or not the Pennsylvania rule is adopted. The object of the rule is to preserve the principal of the trust. From the point of view of the remainderman, the rule operates by ensuring that if a company distributes property which, from the point of view of either the trust or the company is a capital asset, then that property is retained as principal of the trust. Secondly, insofar as the value of shares in a company is influenced by their asset backing, this valuation depends on the value of shareholders' funds. These funds include not only capital and capital profits, but also retained revenue profits. In fact, in a mature company this last element is often the most significant. When a remainderman succeeds to company shares, it is immaterial to him how their value is made up. Thirdly, dividend policy of most companies is dictated by what the company can afford to pay and what the shareholders demand, and only indirectly by its current profit.

Taking these three considerations into account, one may examine, for example, company shares that have been held on trust for a life tenant for ten years. Suppose the company has been trading reasonably profitably over this period, and has paid regular dividends. The life tenancy has terminated and the issue arises as to whether the value of the share in the hands of the remainderman has been eroded by the dividend policy of the company. It is suggested that in such circumstances it would make no difference whether the dividends had been paid wholly from revenue profits, or from a mixture of capital and revenue. The company has simply paid out what it can afford in response to the demands of its shareholders. Whether these payments have been debited to capital or to revenue is unlikely to make much difference to the value of the shares as received by the

remainderman. Indeed, if the company had had a policy of paying dividends from capital, and were the company able to continue to do so, the value of its shares would probably go up, so as to reflect the favourable tax regime applicable to the dividends. Moreover, if the company has been able to pay dividends out of capital profits, it may well be that the actual amounts paid have been kept lower than would otherwise have been the case, since a less generous dividend, if paid from capital, will leave the shareholders in as good an after-tax position as a larger dividend met wholly from revenue profits. Thus, the total value of shareholders' funds retained within the company at the end of the life tenancy could well be greater after a period of dividends debited to capital sources. It is no reply to this argument to suggest that a company not making any revenue profits might entrench upon its capital and therefore on the capital of the trust, to the detriment of the remainderman. Theoretically, that can happen. In practice, such a company is unlikely to pay out dividends unless it can reasonably afford to do so. The fact that for a period the dividends are taken from capital profits would be unlikely to make a significant difference to the value of the shares of the company in the long term. The analysis and arguments set out above are applicable to companies in ordinary cirucmstances, whether public or private. Of course, they do not apply where the company were, for example, to realise a capital profit on half its undertaking and simply to pay this out in cash. Such a transaction would certainly entrench upon the principal of a trust holding shares in the company.

Conclusion

In the United States of America, the Pennsylvania rule never applied to ordinary dividends, and even for extraordinary dividends it has been found unworkable and abandoned in most jurisdictions. Be that as it may, the rule could be applied without excessive difficulty in certain limited circumstances in New Zealand. The clearest example is where a company pays dividends out of capital profits and, in making the distribution, specifically identifies the fraction of the dividend that is attributable to that source. On the other hand, the rule would be difficult to apply in cases where dividends are debited to reserve funds built up over many years. Detailed sub-rules would be necessary in order to guide trustees in making their apportionments between life tenants and remaindermen. Moreover, it may be doubted whether resort to the Pennsylvania rule is really necessary in the case of ordinary dividends, even where these are paid from capital profits. In the case of extraordinary dividends, where a large portion of the value of the company is distributed to shareholders, there is no problem if the dividend is a stock dividend, or bonus issue. The new shares are attributed to principal in the accounts of the trust. The difficult case appears to be that where an extraordinary dividend, representing a large portion of the value of the company, takes the form of cash. If the source of this cash is capital profits, or if it is revenue profits that accrued before the shares were settled on trust, the remainderman has a real grievance when the

cash is distributed to the life tenant. In these circumstances, there is a case for application of the Pennsylvania rule. However, the view of the present author is that the apportionment calculations that would have to be undertaken in order to apply the Pennsylvania rule are so complex and uncertain that the adoption of the rule is not really practical. This is, of course, the reason why the rule has been abandoned in American jurisdictions. At least, in New Zealand, the instances where there may be a real case for the application of the Pennsylvania rule are rare.

APPENDIX

Revised Uniform Principal and Income Act, section 6

(Reproduced from Scott on Trusts 3rd ed 1967, 2022)

"(a) Corporate distributions of shares of the distributing corporation, including distributions in the form of a stock split or stock dividend, are principal. A right to subscribe to shares or other securities issued by the distributing corporation accruing to stockholders on account of their stock ownership and the proceeds of any sale of the right are principal.

"(b) Except to the extent that the corporation indicates that some part of a corporate distribution is a settlement of preferred or guaranteed dividends accrued since the trustee became a stockholder or is in lieu of an ordinary cash dividend, a corporate distribution is principal if the distribution is pursuant to (1) a call of shares: (2) a merger, consolidation, reorganisation, or other plan by which assets of the corporation are acquired by another corporation; or (3) a total or partial liquidation of the corporation, including any distribution which the corporation indicates is a distribution in total or partial liquidation or any distribution of assets, other than cash, pursuant to a court decree or final administrative order by a government agency ordering distribution of the particular assets.

"(c) Distributions made from ordinary income by a regulated investment company or by a trust qualifying and electing to be taxed under federal law as a real estate investment trust are income. All other distributions made by the company or trust, including distributions from capital gains, depreciation, or depletion, whether in the form of cash or an option to take new stock or cash or an option to purchase additional shares, are principal.

"(d) Except as provided in subsections (a), (b), and (c), all corporate distributions are income, including cash dividends, distributions of or rights to subscribe to shares or securities or obligations of corporations other than the distributing corporation, and the proceeds of the rights or property distributions. Except as provided in subsections (b) and (c), if the distributing corporation gives a stockholder an option to receive a distribution either in cash or in its own shares, the distribution chosen is income.

(e) The trustee may relay upon any statement of the distributing corporation as to any fact relevant under any provision of this Act concerning the source or character of dividends or distributions of corporate assets."

APPENDIX II

TRUSTEE AMENDMENT

Analysis

A BILL INTITULED

An Act to amend the Trustee Act 1956 relating to the treatment in the hands of trustees of capital dividends.

BE IT ENACTED by the General Assembly of New Zealand in Parliament assembled, and by the authority of the same, as follows:

1. Short Title and commencement - (1) This Act may be cited as the Trustee Amendment Act 1984, and shall be read together with and deemed part of the Trustee Act 1956* (hereinafter referred to as the principal Act).

   (2) This Act shall come into force on the 28th day after the date on which it receives the Governor-General's assent.

   * Reprinted 1977, Vol. 4, p.3607
   Amendments: 1982, No.50; 1982, No.106; 1983, No.31; 1983, No. 116

2. Powers of the Court in respect of capital dividends - The principal Act is hereby amended by inserting, after section 64A (as inserted by section 9(1) of the Trustee Amendment Act 1960), the following section:

   "64B (1) In this section -

   "'Capital profit', in relation to a company, means a profit calculated on the basis of a sale or revaluation of the capital assets of the Company or any of them:

   "'Capital reserve', in relation to a company, means a sum derived from a capital profit made by the company and set aside in the books of the company as a capital reserve:

   "'Capital dividend", in relation to a company, means a sum distributed by the company by way of dividend to its shareholders out of a capital profit or a capital reserve.

   "(2) Where any sum is paid to the trustee by a company by way of a capital dividend, the Court may if it thinks fit, by order, empower or direct the trustee to treat the whole or any part of that sum as capital for the purposes of the trust.

"(3) In considering any application for an order under this section, the Court shall not be limited to a determination of the intentions of the testator or settlor in regard to the matter, but may be guided by what is fair and just as between those persons who are entitled to the income and those who are entitled to the capital of the trust, having particular regard to the present and likely future needs of those persons, the history of the administration of the trust to date, and all such other circumstances of the case as the Court considers relevant.

"(4) No action shall lie against the trustee by reason of his having distributed as income the whole or any part of the amount received by him by way of capital dividend if the distribution was properly made by the trustee before service on him of any application under this section that could affect that amount and without notice in writing of any such application or intention to make such an application; but nothing in this subsection shall prevent the Court from making an order pursuant to subsection (6) of this section disturbing the distribution made by the trustee.

"(5) For the purposes of subsection (4) of this section, section 48 of the Administration Act 1969 shall apply with all necessary modifications.

"(6) Where the Court makes an order under subsection (2) of this section after the trustee has distributed as income the whole or any part of the amount received by him by way of capital dividend, the Court may also make any order of a kind authorised by subsection (1) of section 49 of the Administration Act 1969 (which relates to the following of assets); and the provisions of that section and sections 50 and 51 of that Act shall apply with any necessary modifications."

P. D. HASSELBERG, GOVERNMENT PRINTER,
WELLINGTON, NEW ZEALAND—1985