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# Discounts in Trust Investments

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## DISCOUNTS IN TRUST INVESTMENTS

By JOSEPH FORER\*

A TRUSTEE purchases a bond selling below par. Before maturity or call he sells the bond for more than the purchase price, or at maturity or call he is paid par. Must he credit the gain to income or to principal, and whichever the case, how and when shall the credit be made available?<sup>1</sup>

If the volume of litigation these questions have provoked is an adequate criterion of their importance, one must conclude that they have occupied the attention of writers<sup>2</sup> to an extent disproportionate to their significance. There is reason to believe, however, that for once at least academic concern is an accurate index to practical consequence. Since bonds are often bought below or above par, a great many trustees must frequently resolve these or related issues. That the resolution is customarily made with an insouciance springing from confidence in the habitual only enhances the desirability of full discussion. If you catch a glimpse of the beast, there is merit in crying wolf to the unwary. In addi-

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<sup>1</sup>If an intention on the subject is manifested in the trust instrument, that, of course, will govern. Just when an intention is to be implied from the use of particular language is itself something of a problem. See (1936) 34 Mich. L. Rev. 448. Where securities are received from the settlor, as distinguished from those purchased by the trustee, the income beneficiary is held entitled to all the interest on bonds inventoried above par, on the theory that such a course serves the settlor's intention. *Boston Safe Deposit & Trust Co. v. Williams*, (1935) 290 Mass. 385, 195 N. E. 393; *Ballantine v. Young*, (1908) 74 N. J. Eq. 572, 70 Atl. 668; aff'd on other points in (1910) 76 N. J. Eq. 613, 75 Atl. 1100. But cf. *In re Wells' Estate*, (1913) 156 Wis. 294, 144 N. W. 174. It seems clear, accordingly, that where the bonds are inventoried below par the income beneficiary will receive only the interest, and will not receive any part of the difference between par and the inventory value.

<sup>2</sup>*Edgerton, Premiums and Discounts in Trust Accounts*, (1918) 31 Harv. L. Rev. 447; 4 *Bogert, Trusts and Trustees* (1935) sec. 830; *Black, Amortization—An Unsettled Question in Trust Accounting*, (1932) 17 Mass. L. Q. 81; *Vierling, Amortization of Premiums and Accumulation of Discounts on Trust Investments*, (1923) 36 Trust Cos. 177; *Vierling, Pros and Cons in Regard to Amortization of Premiums and Accumulation of Discounts on Trust Investments*, (1923) Trust Cos. 489; *Vierling, Accumulation of Discounts*, (1926) 11 St. Louis L. Rev. 266; *Kinnear, The Administration of Trust Funds*, (1936) 6 Fortnightly L. J. 87; *Notes*, (1927) 48 A. L. R. 684, 689; (1936) 101 A. L. R. 7; *Developments in the Law, Trusts—1934*, (1935) 48 Harv. L. Rev. 1162, 1194, 1195; *Note*, (1935) 45 Yale L. J. 156; *Note*, (1936) 20 MINNESOTA LAW REVIEW 203; (1933) 47 Harv. L. Rev. 143; (1936) 34 Mich. L. Rev. 448.

tion, recent developments in the bond market have produced new wine, and it is doubtful that the old bottles will suffice.

## I

There is a handful of cases in which the income beneficiary<sup>3</sup> has sought to obtain the gain, which will hereafter be referred to as "discount." In every instance but one<sup>4</sup> he has been unsuccessful. He has been refused where he asked that the discount be made available to him prior to realization in the form of periodic installments.<sup>5</sup> He has met with no greater success where he has claimed the discount in a lump sum after it was realized.<sup>6</sup> The first type of refusal, of course, is not altogether conclusive. A court might deny the life tenant the discount before realization, but allow it to him afterwards. On the other hand, courts which deny the life tenant the lump sum after realization necessarily hold that he has no right to the discount at all. As it happens, most of the cases have involved realized discounts, but the courts generally have assumed that such a situation was identical with that in which the discount had not yet been realized. Thus in *In re Houston's Will*<sup>7</sup> a life tenant objected to an accounting by trustees which credited to principal a realized discount. Yet the court said:

"The question which is presented for decision therefore is whether or not, where trust funds are invested in bonds at a discount, the discount is to *be accumulated* in favor of a life beneficiary, rather than treated as an accretion to the principal in favor of the remaindermen."<sup>8</sup>

<sup>3</sup>The income beneficiary will hereafter be referred to as the "life tenant," the remainder beneficiary as the "remainderman."

<sup>4</sup>Re Armstrong, (1934) 55 Ont. L. Rep. 639.

<sup>5</sup>In re Gartenlaub's Estate, (1926) 198 Cal. 204, 244 Pac. 348, discussed *infra*, note 6.

<sup>6</sup>Townsend v. United States Trust Co., (N.Y. 1877) 3 Redf. Surr. 220 (semble); In re Houston's Will, (1933) 19 Del. Ch. 207, 165 Atl. 132; Wood v. Davis, (1929) 168 Ga. 504, 148 S. E. 330; Old Colony Trust Co. v. Comstock, (1935) 290 Mass. 377, 195 N. E. 389. Cf. In re Gerry, (1886) 103 N. Y. 445, 9 N. E. 235. In Gartenlaub's Estate, (1926) 198 Cal. 204, 244 Pac. 348 cited *supra* note 5, the life tenant asked to have the discount periodically accumulated for his benefit. It is clear, however, that he did not seek accumulation for future distribution, but wished to have periodic credits to offset amortization of premiums for the remainderman's benefit. The purpose of the action, therefore, was to have released periodically that portion of the interest paid by the debtor which would otherwise be held to compensate corpus for the premiums in accordance with the holding of In re Gartenlaub's Estate, (1921) 185 Cal. 648, 198 Pac. 209. The court's holding, therefore, was a refusal to compel the trustee to make the discount available in periodic installments prior to realization.

<sup>7</sup>(1933) 19 Del. Ch. 207, 165 Atl. 132.

<sup>8</sup>(1933) 19 Del. Ch. 207, 208, 165 Atl. 132, 133. Italics added.

Now a trustee may purchase a bond at a price above par and subsequently liquidate it at less than the purchase price. If the discount authority is accepted, it is only logical to conclude that in this situation the premium should be paid out of principal rather than income.<sup>9</sup> If income is not to get the advantage of a discount, it should not be burdened with a premium; if corpus is inflated by discounts, it should be deflated by premiums. However, while some courts have charged principal with the premium,<sup>10</sup> the present trend and majority view are to the effect that corpus should be reimbursed out of income for the premium,<sup>11</sup> reimbursement being customarily accomplished by withholding part of each interest coupon and crediting the withheld sum to principal.<sup>12</sup>

The usual rationalization for the majority premium view is that in order to preserve corpus it is essential that the life tenant should receive only the true income yield, and that in business understanding the interest payable on premium bonds is in part income, in part a return of principal.<sup>13</sup> This reasoning may be sound enough,

<sup>9</sup>The purchaser of a bond customarily pays, in addition to the quoted price, an amount representing accumulated interest, which must be restored to principal on collection of the first interest payment. *Hemenway v. Hemenway*, (1883) 134 Mass. 446; 4 *Bogert, Trusts and Trustees* (1935) 2434. The premium referred to herein, however, is the payment of an amount above par without reference to any payment on account of accumulated interest.

<sup>10</sup>*Whitridge v. Williams*, (1889) 71 Md. 105, 17 Atl. 938; *In re Penn-Gaskell's Estate*, (1904) 208 Pa. St. 346, 57 Atl. 715; *Hite's Devises v. Hite's Executor*, (1892) 93 Ky. 257, 20 S. W. 778. On the English view, which is in accord, see *Edgerton, Premiums and Discounts in Trust Accounts*, (1918) 31 Harv. L. Rev. 447, 448, n. 2.

<sup>11</sup>*Curtis v. Osborn*, (1907) 79 Conn. 555, 65 Atl. 968; *In re Gartenlaub's Estate*, (1921) 185 Cal. 648, 198 Pac. 209; *Ballantine v. Young*, (1908) 74 N. J. Eq. 572, 70 Atl. 668, aff'd on other points in (1910) 76 N. J. Eq. 613, 75 Atl. 1100; *New York Life Ins. & Trust Co. v. Baker*, (1901) 165 N. Y. 484, 59 N. E. 257; *In re Stevens*, (1907) 187 N. Y. 471, 80 N. E. 358; *Dexter v. Watson*, (1907) 54 Misc. Rep. 484, 106 N. Y. S. 80; *In re Brewster's Estate*, (1937) 163 Misc. Rep. 820, 298 N. Y. S. 761; *Gould v. Gould*, (1925) 126 Misc. Rep. 54, 213 N. Y. S. 286; *New England Trust Co. v. Eaton*, (1886) 140 Mass. 532, 4 N. E. 69; *Old Colony Trust Co. v. Comstock*, (1935) 290 Mass. 377, 195 N. E. 389; *In re Allis' Estate*, (1904) 123 Wis. 223, 101 N. W. 365; *In re Wells' Estate*, (1913) 156 Wis. 294, 144 N. W. 174.

<sup>12</sup>On the methods of amortization see *Vierling, Amortization of Premiums and Accumulation of Discounts on Trust Investments*, (1923) 36 *Trust Cos.* 177; *Edgerton, Premiums and Discounts in Trust Accounts*, (1918) 31 Harv. L. Rev. 447, 455 et seq.; 4 *Bogert, Trusts and Trustees* (1935) sec. 831, pp. 2433, 2434. As to whether amortization should be till call or to maturity cf. *Old Colony Trust v. Comstock*, (1935) 290 Mass. 377, 195 N. E. 389, with *In re Brewster's Estate*, (1937) 163 Misc. Rep. 820, 298 N. Y. S. 761.

<sup>13</sup>*In re Gartenlaub's Estate*, (1921) 185 Cal. 648, 652, 198 Pac. 209, 210, 211; *Ballantine v. Young*, (1908) 74 N. J. Eq. 572, 574, 575, 70 Atl. 668, 669, aff'd on other points in (1910) 76 N. J. Eq. 613, 75 Atl. 1100;

but it cuts two ways. If the true income yield of premium purchases is to be calculated by taking into account the price paid, why should not the yield of discount purchases be similarly calculated?

If the interest paid on a premium investment represents in part principal, why does not the face amount of a discount investment represent in part income? If it is necessary to preserve corpus by limiting the life tenant to the true income yield, is it not equally necessary to preserve income by allowing it at least the true income yield?

Despite the apparent inconsistency between the discount and majority premium views, the discount authority has been established in the very jurisdictions which apply the majority premium rule. What is more, both rules have been applied to the same trust. Thus in *Old Colony Trust Co. v. Comstock*,<sup>14</sup> the Massachusetts court held, as to the same trust, that (1) premiums must be amortized for the remainderman's benefit; (2) realized discounts may not be paid to the life tenant. In 1921, the California court held that premiums should be amortized,<sup>15</sup> but five years later, in connection with the same trust, it held that discounts ought not to be accumulated as set-offs against amortizations of premiums.<sup>16</sup>

The cases which first established the discount rule were decided before the premium doctrine had crystallized, and their logic was simple to the point of naiveté: the remainderman had always been held entitled to profits realized on a purchase and sale, and here was a purchase and a sale and a profit.<sup>17</sup> After the development of the majority premium rule, however, the courts, with one exception,<sup>18</sup> felt compelled to justify the discount rule on other bases.

The principal justifications are three in number. First, it is pointed out that the discount is not realized until the bond is sold

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New England Trust Co. v. Eaton, (1886) 140 Mass. 532, 536, 4 N. E. 69, 71, 72; In re Stevens, (1907) 187 N. Y. 471, 476, 477, 80 N. E. 358, 359; In re Allis' Estate, (1904) 123 Wis. 223, 231, 232, 101 N. W. 365, 368; In re Wells' Estate, (1913) 156 Wis. 294, 309, 310, 144 N. W. 174; 179, 180; Old Colony Trust Co. v. Comstock, (1935) 290 Mass. 377, 380, 195 N. E. 389, 391.

<sup>14</sup>(1935) 290 Mass. 377, 195 N. E. 389.

<sup>15</sup>In re Gartenlaub's Estate, (1921) 185 Cal. 648, 198 Pac. 209.

<sup>16</sup>In re Gartenlaub's Estate, (1926) 198 Cal. 204, 244 Pac. 638, discussed supra, note 6.

<sup>17</sup>Townsend v. United States Trust Co., (N.Y. 1877) 3 Redf. Surr. 220 (semble). Cf. In re Gerry, (1886) 103 N. Y. 445, 9 N. E. 235.

<sup>18</sup>(1929) Wood v. Davis, 168 Ga. 504, 148 S. E. 330.

or paid. Hence, it is said, if the discount is paid to the life tenant in installments during the life of the bond, the remainderman is subjected to an extraordinary risk, since in the event of dishonor or a sale at a price below the purchase price, he loses not only all or part of the amount paid for the bond but also the amount paid to the life tenant; that he may lose the first sum is a risk he customarily runs, but that he should run the risk of losing the second sum is a hazard beyond common experience.<sup>19</sup>

Assuming, for the present only and generously enough, that this argument is sound so far as it goes, obviously it does not go far enough. At most it is a reason for not paying the life tenant the discount before it is realized, but it cannot conceivably be a valid reason for refusing him the discount after it has been realized. There is no sense in protecting corpus against the potential dishonor of a paid security. But so comes home to roost the fallacy in approach already pointed out, that is, the assumption by the courts that disposition of a discount after realization must be identical with disposition before realization.

The second principal argument advanced for refusing the life tenant the benefit of the discount has been that bonds sell below par not only on account of the comparatively low interest rate, but very frequently because of factors of risk, speculation, market whims, etc., all of which normally run to the benefit or detriment of corpus.<sup>20</sup> Any informed person will freely concede that a discount does not necessarily reflect a comparatively low interest rate, but once the concession is made, how is it pertinent? The rule that premiums must be amortized is not traditionally supported by the contention that the premium reflects a comparatively high interest rate. If it were, the contention that price depends only on interest rate would be just as erroneous as when advanced in connection with a below-par instead of above-par security. The rationale of the premium cases has been that of "true yield," and on this score the cause of the price is irrelevant. For the setting up of this man of straw Mr. Justice Holmes is perhaps chiefly to blame. He assumed that the only possible rationale for compensating corpus for premiums was a theory that a premium

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<sup>19</sup>In *re Gartenlaub's Estate*, (1926) 198 Cal. 204, 214, 215, 244 Pac. 348, 352; In *re Houston's Will*, (1933) 19 Del. Ch. 207, 212, 213, 165 Atl. 132, 134; *Old Colony Trust Co. v. Comstock*, (1935) 290 Mass. 377, 382, 383, 195 N. E. 389, 392.

<sup>20</sup>In *re Gartenlaub's Estate*, (1926) 198 Cal. 204, 209, 210, 211, 244 Pac. 348, 350; In *re Houston's Will*, (1933) 19 Del. Ch. 207, 211, 212, 165 Atl. 132, 134, 135; *Old Colony Trust Co. v. Comstock*, (1935) 290 Mass. 377, 383, 384, 195 N. E. 389, 392, 393.

was caused only by a relatively high interest rate, and refused to adopt the obvious fiction.<sup>21</sup> But the assumption is, of course, unwarranted. The justification for amortizing premiums or accumulating discounts is that in an economic and business sense the true yield of a security is ascertainable by reference to both the price and the contract rate of interest, and not by reference to the latter factor alone.

The third argument has been that a system of accumulating discounts would encounter various practical difficulties.<sup>22</sup> Just what these difficulties may be has not been enunciated otherwise than vaguely, although half-hearted references have been made to possible complications in case the bond is sold or the life tenant dies before redemption. But any such troublesome contingencies are also inherent in the premium situation, if, as the authorities seem to indicate, the periodic crediting to principal of the withheld portion of the coupons is final, not conditional. Moreover, this argument has been made even when the discount had already been realized, so that again the courts have indulged in a solicitude to avoid what can no longer occur.

The Restatement of Trusts adopts the prevailing rules as to premiums and discounts, subject to some qualifications.<sup>23</sup> The Uniform Principal and Income Act,<sup>24</sup> however, has adopted the rule intended best to promote expedient trust administration,<sup>25</sup> that is, the minority rule to the effect that premiums are not to be amortized and discounts are not to be accumulated. Still another doctrine was proposed by Mr. Justice Holmes, who urged that no fixed rule should be applied, but that the matter should be left to the discretion of each individual trustee, subject to court review of his accounting to insure his having used "reason-

<sup>21</sup>*Hemenway v. Hemenway*, (1883) 134 Mass. 446; dissenting in *New England Trust Co. v. Eaton*, (1886) 140 Mass. 532, 544, 4 N. E. 69, 77.

<sup>22</sup>*In re Gartenlaub's Estate*, (1926) 198 Cal. 204, 215, 244 Pac. 348, 352; *Old Colony Trust Co. v. Comstock*, (1935) 290 Mass. 377, 384, 195 N. E. 389, 393.

<sup>23</sup>Section 239, Comment *f*; Section 240, Comment *h*.

<sup>24</sup>Section 6 of the Act provides: "Where any part of the principal consists of bonds or other obligations for the payment of money, they shall be deemed principal at their inventory value or in default thereof at their market value at the time the principal was established, or at their cost where purchased later, regardless of their par or maturity value; and upon their respective maturities or upon their sale any loss or gain realized thereon shall fall upon or enure to the principal." Cf. *Oregon*, Code (1935 Supp.) secs. 63-1201 ff.; *Hawaii*, Rev. L. (1935) sec. 4714.

<sup>25</sup>See *Handbook of the National Conference of Commissioners on Uniform State Laws and Proceedings* (1931) 327; (1936) 34 Mich. L. Rev. 448, 451, n. 12.

able care to hold the balance even between opposing interests."<sup>26</sup> Finally, it has been suggested that as a discount may in part reflect a low interest rate, in part other factors, the life tenant should be allowed the prevailing investment yield, and the remainderman should be allowed the balance.<sup>27</sup> It would follow that in a premium case the life tenant should be charged with a sufficient amount of the premium to bring the income yield down to the prevailing yield, and the remainderman should bear the balance. Under this system, if the prevailing yield is 4 per cent and a 20-year 3 per cent bond is bought at 65, \$20 of the discount will be allocated to income, \$15 to principal. If the prevailing yield is 4 per cent and a 5 per cent 20-year bond is bought at 130, \$20 of the premium and no more will be amortized out of coupons.

As is so often the case, the reasoned adoption of any one of the several possible rules will depend primarily on the fundamental approach of the person who must choose between the alternatives. In this instance there is simply a choice between the postulates with which one may begin. If the approach is from the viewpoint of a trustee anxious to promote a facile administration of the trust, the best rule may seem to be that of the Uniform Act, namely, neither to amortize premiums nor to accumulate discounts. This rule is the simplest and saves accounting expenses, and under it a trustee can still adjust the equities to some extent by striking a rough balance between premium and discount purchases. If the approach is that one should merely apply logically the general rule that the life tenant is entitled to economic income, the remainderman to economic principal, the rule to apply is that of amortizing premiums and accumulating discounts. As has been most ably pointed out,<sup>28</sup> a discount is not a capital gain but an "income" gain, although the difference be-

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<sup>26</sup>Cases cited in note 21, *supra*. The rule is not altogether without other support. Cf. *In re Houston's Will*, (1933) 19 Del. Ch. 207, 165 Atl. 132. Furthermore, in most cases the courts have merely approved the action of a trustee in amortizing premiums or in refraining from accumulating discounts. But cf. *New York Life Ins. & Trust Co. v. Baker*, (1901) 165 N. Y. 484, 59 N. E. 257, charging the account of a trustee who had failed to amortize premiums.

<sup>27</sup>(1933) 47 Harv. L. Rev. 143; *Developments in the Law, Trusts*—1934, (1935) 48 Harv. L. Rev. 1162, 1194, 1195.

<sup>28</sup>Black, *Amortization—An Unsettled Question in Trust Accounting*, (1932) 17 Mass. L. Q. 81, 84; Edgerton, *Premiums and Discounts in Trust Accounts*, (1918) 31 Harv. L. Rev. 447, 460, 461, and see also at 451, 452; Vierling, *Pros and Cons in Regard to Amortization of Premiums and Accumulation of Discounts on Trust Investments*, (1923) 36 Trust Cos. 489, 493; Vierling, *Amortization of Premiums and Accumulation of Discounts on Trust Investments*, (1923) 36 Trust Cos. 177, 180.

tween such a gain and that accomplished by the mere selling of an asset at a better price than cost has not always been perceived.<sup>29</sup> The distinction is, of course, that in a discount purchase the future appreciation is inherent in the investment at the time it is made; it is calculable at the time of purchase. In a sense, it is a contracted gain.

The approach to the problem may be from the viewpoint of one anxious to maintain a sort of equitable status quo. Such an approach may result in a deliberate abandonment of strict theory and the adoption of the rule allowing the life tenant no less and no more than the prevailing interest yield.

The only rules which lack justification no matter what the approach are those now applied in most states, and those urged by Mr. Justice Holmes. To amortize premiums without accumulating discounts has no basis in either administrative convenience or theory, and results in gross injustice to the life tenant. Mr. Justice Holmes' rule of discretion, advocated because of a mistaken notion of the basis for amortizing premiums, is unsound because in almost all cases the trustee will have no relevant facts to influence the discretion he is supposed to exercise. He will have to make his choice on the basis of approach, rather than on the basis of factual circumstances. He will therefore have to do what the courts should do—choose a rule of law, and there is no reason to govern his choice by a fictitious standard of impartiality.

There cannot be much hope that the courts which now apply the prevailing rules will change them by the decisional process, or even that other courts will arrive at other results. A change in the prevailing authority would involve the possible surcharging of thousands of trustees who in good faith and in reliance on court decisions for years have amortized premiums without accumulating discounts. However, a change may, of course, be accomplished by legislation, possibly by widespread adoption of the Uniform Act.

There is, however, one application of the majority rules which is not yet so fixed that it may not be open to reconsideration. A bond may be bought at a premium and subsequently sold at an even higher premium or at a loss smaller in amount than the sinking fund. It has been indicated that in this event the remainderman should be credited not only with the gain made from the sale

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<sup>29</sup>See cases cited *supra* note 17. A Canadian commentator has fallen into the same error. Kinneer, *The Administration of Trust Funds*, (1936) 6 *Fortnightly L. J.* 87.

(to which he is clearly entitled), but also with the whole of the sinking fund built up during the time the bond was held.<sup>30</sup> The justification for this rule is that the approach of maturity has an inevitable tendency to force premiums down toward par. Hence, the maintenance or increase in price must have been caused by economic changes of which principal is the traditional beneficiary; and "that the remainderman has gained on the sale because of accidental reasons to the benefit of which he is entitled should not prevent him from recouping from the life cestui a loss actually suffered due to the wasting of the bond."<sup>31</sup>

It would appear, however, that a reexamination of the situation is in order. It is true, of course, that *in the long run* the passage of time will force down premiums. But this does not mean that in the absence of other changes in circumstances a premium will *consistently* drop as the bond approaches maturity. The passage of time alone, even of a number of years, will frequently have the effect of forcing the premium up rather than down. If the bond is bought and sold during one of these periods, the gain is partly or wholly due to the lapse of time. In such a case it is unfair to income to allot to corpus a fund built up to protect it against an expected attrition of time which has not materialized. The passage of time has caused a gain, not a wasting.

The reason why premiums may within certain periods increase with the passage of time is clear. It is a truism that as bonds approach maturity their net yield tends to drop because of the attractiveness of the increased liquidity inherent in the shorter term of the investment. Although the yield grows less as time advances, nevertheless the price of a bond bought at a premium will tend to fall, though not at so rapid a rate as would be the case if the factor of increasing liquidity were absent. Between certain periods, however, the pull of the liquidity factor may

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<sup>30</sup>In *re Wells' Estate*, (1913) 156 Wis. 294, 144 N. W. 174; see *New England Trust Co. v. Eaton*, (1886) 140 Mass. 532, 537-539, 9 N. E. 69, 72-74.

<sup>31</sup>4 Bogert, *Trusts and Trustees* (1935) sec. 831, p. 2433. The cases cited *supra*, note 30, have reasoned that corpus is entitled to the gain because it would have borne any loss in case of a sale at a price below that of purchase. If this language be taken literally, obviously it has no bearing on the question of what disposition should be made of the sinking fund, not of the gain on the sale. If what is meant is that corpus should get the sinking fund despite sale at a price above purchase price because the sale might have been at a price so far below purchase price that the sinking fund would not compensate for the entire loss, the argument is unsound. The possibility of gain on a sale is balanced by the possibility of loss without reference to the sinking fund.

be so great that the yield will fall steeply, and so much so that the price, a function of the yield, may tend to go up during those periods rather than down. An illustration of the operation of this process may be found by glancing at the quotations on government bonds. At the present writing two issues of three per cent Treasury bonds are quoted on the New York bond market. The bonds of both issues are identical in every respect, with the exception that those of one issue are callable in 1946 and mature in 1948, while the others are callable in 1951 and mature in 1955. If it is a correct assumption that the passage of time inevitably forces premiums down in the absence of changing economic conditions, it follows that *on the same day* the 1946-48 bonds will sell at less of a premium than the 1951-55 bonds. But it is the contrary that is true. Thus on April 18, 1939, the 1946-48 bonds sold at 110.14 (dollars and thirty-seconds), whereas the 1951-55 bonds sold at 109.24. On April 20, 1939, there was trading on the New York exchange in five issues of Treasury  $2\frac{3}{4}$ 's, each issue being identical with the others except for differences in redemption and maturity dates. The following table of prices on April 20 shows that the issues with the earlier redemption and maturity dates sold at a higher premium than the issues with the later redemption and maturity dates (prices in dollars and thirty-seconds, high and low quotations through April 20) :

<i>Issue</i>	<i>Price</i>	<i>High for 1939</i>	<i>Low for 1939</i>
1945-47 .....	108.22	109	107
1948-51 .....	108	108.7	105.19
1951-54 .....	106.25	106.28	104
1956-59 .....	106.6	106.6	103.4
1960-65 .....	105.2	105.3	102.20

On the same date, too, the two earliest maturing issues of Treasury  $2\frac{3}{4}$ 's sold at a higher price than an issue of Treasury  $2\frac{7}{8}$ 's, which is callable in 1955 and matures in 1960, the  $2\frac{7}{8}$ 's closing at 107.8. The high for 1939 through April 20 for this issue was 107.11 and the low was 104.12.

The European war has, of course, had a considerable influence on the prices of government bonds. The following table of the closing prices for selected issues of Treasury bonds on October 6, 1939, illustrates that the change in market conditions has not reversed the principle that operated in April. (Prices in dollars and thirty-seconds.)

<i>Issue</i>	<i>Price</i>
2 $\frac{3}{4}$ 's, 1945-47 .....	104.23
2 $\frac{3}{4}$ 's, 1948-51 .....	103.6
2 $\frac{3}{4}$ 's, 1951-54 .....	101.20
2 $\frac{3}{4}$ 's, 1956-59 .....	100.24
2 $\frac{3}{4}$ 's, 1958-63 .....	100.23
2 $\frac{3}{4}$ 's, 1960-65 .....	100.24
2 $\frac{7}{8}$ 's, 1955-60 .....	101.22
3's, 1951-55 .....	104.4

## II

Up to now the discussion has been concerned with securities paying interest at periodic intervals, and necessarily the threshing has been largely of old straw. There are, however, no authorities and no writings dealing with what might be called "pure discount" securities; that is, securities on which the creditor does not undertake to pay interest periodically, but which are offered for purchase on original issue at a price below maturity value.

Until recently, there has been no need for trustees to be overly concerned with the disposition of the discount on such securities. As most of these are short term obligations, they probably have not been purchased in any considerable volume by trusts, and when purchased, it has no doubt been assumed that the discount belonged to income, as otherwise the investment would yield no income at all. Furthermore, in view of the extremely short term of the investment, there was no difficulty in waiting till liquidation before making the discount available to income.

In the last few years, however, the availability of United States Savings Bonds has greatly increased the amount of "pure discount" securities held in trust, and the fact that these bonds have a ten-year term gives rise to a definite problem.

United States Savings Bonds are issued under the act of February 4, 1935,<sup>32</sup> which authorizes the secretary of the treasury, with the approval of the president, to issue such bonds from time to time on a discount basis only, to mature not less than ten nor more than twenty years from date of issue. The secretary of the treasury is empowered to prescribe terms for redemption before maturity, and the issue price and terms of redemption must be such as to afford an investment yield not in excess of three per cent compounded semiannually. It is provided that "it shall not be lawful for any one person at any one time to hold Savings Bonds

<sup>32</sup>49 Stat. at L. 21, 31 U. S. C. A. sec. 757c.

issued during any one calendar year in an aggregate amount exceeding \$10,000 (maturity value)."<sup>33</sup>

Savings bonds are issued only in certain authorized registered forms, including registration in trust. The bonds are payable at or after maturity at full value, or, at the option of the owner, may be redeemed at any time prior to maturity (but not within 60 days after the issue date) at the redemption value of the bond as of that time. They may not be the subject of a voluntary transfer, but are not exempted from creditors' remedies. Savings bonds may be purchased for cash at post offices of the first, second, and third classes, and at selected post offices of the fourth class, and may also be purchased by mail upon application to the treasurer of the United States or to any Federal Reserve bank. The bonds

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<sup>33</sup>Under the regulations of the Treasury Department the savings bond holdings of a trust are chargeable to the beneficiaries having "present interests." A trust with more than one beneficiary may be able, therefore, to hold more than \$10,000 (maturity value) of savings bonds issued during any one calendar year. On the other hand, if a beneficiary with a present interest has individual holdings, the amount which can be held by the trust will thereby be diminished, with the result that a trust with one beneficiary may not be able to hold the full \$10,000. Even if there is more than one beneficiary with a present interest, if one of them holds in his individual right \$10,000 of savings bonds issued in one calendar year, the trust will be unable to hold any more savings bonds issued during the same year. Section III-1 of Treasury Department Circular No. 530, 2d Revision, Dec. 15, 1938 (regulations governing United States Savings Bonds), Federal Register Dec. 23, 1938, p. 3128, sets forth that in determining holdings for the purpose of the limitation on holdings, "there must be taken into account the aggregate present interest of that person in the maturity value of all savings bonds issued during any one calendar year, as shown by the issue dates thereon, including, but not limited to: (a) The entire maturity value of (1) bonds registered in the name of that person and (2) those registered in his name with another named as co-owner, and (b) The extent of his present interest in (1) those held for his benefit by a fiduciary . . . and (2) those in which he has acquired a present interest because of the death of another or on the happening of any other event. Bonds of which the person is merely the designated beneficiary in case of the death of the owner, bonds which are held by him in a fiduciary capacity only, or bonds in which he has only a future beneficial interest need not be included." Section III-2 of the same circular sets out the method by which a beneficiary's present interest in trust holdings may be computed, as follows: "The extent of a person's present interest in bonds held in trust is deemed to be determined by his relative share of the income from the trust, whether such share is payable periodically or is to be accumulated for future distribution, and may be calculated in accordance with the following general rules: (a) If his share does not exceed a certain fractional part of the entire income from the trust, he will be charged only with a corresponding fractional interest in the bonds; (b) If he is entitled to the entire income from the trust, or if he is entitled to a stipulated sum or other share which may exceed any definite fractional part of the entire income, he must be charged with the entire interest in the bonds. Where the identity of the beneficiaries of a trust cannot be presently determined, or where the trust is charitable in nature with indefinite beneficiaries, \$10,000 (maturity value), but no more, of bonds issued during any one calendar year may be held for the trust."

are issued in denominations (representing maturity values) of \$25, \$50, \$100, \$500, and \$1,000, for which the corresponding purchase prices are, respectively, \$18.75, \$37.50, \$75, \$375, and \$750. The bonds are dated as of the first day of the month in which the purchase price is received, and mature ten years after such issue date. No periodic interest is paid, and, as can be seen from the above figures, if a bond is held till maturity it affords an investment yield of about 2.9 per cent per annum compounded semiannually. The bond increases in redemption value at stated intervals, but not in regular amounts, so that a bond cashed before maturity yields a smaller percentage return than a bond cashed at maturity. The redemption values are shown in the following table:

MATURITY VALUE	\$25.00	\$50.00	\$100	\$500	\$1,000
ISSUE PRICE	\$18.75	\$37.50	\$75	\$375	\$750
Period after issue date	Redemption values during each period				
First year	\$18.75	\$37.50	\$ 75.00	\$375.00	\$ 750.00
1 to 1½ years	19.00	38.00	76.00	380.00	760.00
1½ to 2 years	19.25	38.50	77.00	385.00	770.00
2 to 2½ years	19.50	39.00	78.00	390.00	780.00
2½ to 3 years	19.75	39.50	79.00	395.00	790.00
3 to 3½ years	20.00	40.00	80.00	400.00	800.00
3½ to 4 years	20.25	40.50	81.00	405.00	810.00
4 to 4½ years	20.50	41.00	82.00	410.00	820.00
4½ to 5 years	20.75	41.50	83.00	415.00	830.00
5 to 5½ years	21.00	42.00	84.00	420.00	840.00
5½ to 6 years	21.25	42.50	85.00	425.00	850.00
6 to 6½ years	21.50	43.00	86.00	430.00	860.00
6½ to 7 years	21.75	43.50	87.00	435.00	870.00
7 to 7½ years	22.00	44.00	88.00	440.00	880.00
7½ to 8 years	22.50	45.00	90.00	450.00	900.00
8 to 8½ years	23.00	46.00	92.00	460.00	920.00
8½ to 9 years	23.50	47.00	94.00	470.00	940.00
9 to 9½ years	24.00	48.00	96.00	480.00	960.00
9½ to 10 years	24.50	49.00	98.00	490.00	980.00
AT MATURITY	\$25.00	\$50.00	\$100.00	\$500.00	\$1,000.00 <sup>34</sup>

This brief description of savings bonds shows certain features which make them attractive trust investments. If they are held till maturity, their return is greater than is now obtainable on other federal securities. Whenever necessary they may be cashed without loss of principal, and, after the first year, for an amount higher than the purchase price. Since trustees are not permitted to speculate, and must have as one of their primary purposes the maintenance of corpus intact, the advantage that the bonds cannot

<sup>34</sup>The substance of this paragraph is derived from Treasury Department circular No. 530, Second Revision, Dec. 15, 1938 (regulations governing United States Savings Bonds), and Treasury Department Circular No. 596, Dec. 15, 1938 (offer of United States Savings Bonds, Series D), Federal Register (Dec. 23, 1938) p. 3135.

fluctuate downward more than offsets the disadvantage that they cannot fluctuate upward beyond the fixed return.

It is not surprising, therefore, that a considerable amount of trust monies have been invested in savings bonds. No statistics are available as to the amount purchased by trustees alone, but the amount purchased by all fiduciaries (including trustees, guardians, executors, etc.) is known. From March 1, 1935 (the first issue date), through July, 1939, \$172,981,600 (maturity value) of savings bonds have been registered in a fiduciary form, representing a total purchase price of \$129,736,200.<sup>35</sup>

Despite the prevailing authority to the effect that discounts on securities paying interest periodically do not inure to the life tenant's benefit, it is clear that discounts on "pure discount" securities must be regarded as income, as they are obviously in lieu of interest, and as there is no other income from the investment. It is true, however, that the courts of jurisdictions which may adopt the Uniform Principal and Income Act will have to stretch the literal terms of the act to arrive at this result, as the section dealing with the disposition of discounts does not differentiate between "pure discount" and other securities.<sup>36</sup>

But if the accrual in value must belong, then, to the life tenant, how are the bonds to be administered for trusts in which no part of the income is to be accumulated, in view of the fact that the accrual is not realized until the bonds are cashed? There are several alternatives possible. First, the income represented by the accruing interest may be withheld and paid to the life tenant when realized at redemption. Such a procedure, however, would obviously be a breach of the duty owed to the life tenant, for he is entitled not merely to income but also to a steady flow of income.<sup>37</sup> The alternative, of course, is to pay the life tenant the interest accruing on the bond periodically, obtaining funds for the purpose by using uninvested cash, by borrowing, or by liquidating part of corpus, as by redeeming a savings bond of low denomination or selling another principal asset. In the one decision which held that the life tenant was entitled to the discount on bonds paying interest periodically, the court ruled that the discount should be paid out of uninvested capital. If there was no such capital, said the court, the trustees should not have invested in discount securi-

<sup>35</sup>The statistics have been obtained from the Division of Savings Bonds, United States Treasury Department.

<sup>36</sup>See note 24, *supra*.

<sup>37</sup>Re *Armstrong*, (1934) 55 Ont. L. Rep. 639, 641, 642; *Restatement, Trusts* (1935) sec. 227; 3 *Bogert, Trusts and Trustees* (1935) sec. 612, p. 1943; cf. *Graves v. Graves*, (1934) 115 N. J. Eq. 547, 171 Atl. 681, 684.

ties as they would be unable to make good the loss to the life tenant.<sup>38</sup> On the other hand, as we have already seen, the courts which denied the life tenant the discount on bonds paying interest periodically gave as one of their reasons the unavailability of a fund out of which to pay the life tenant. If the life tenant were paid out of capital before the discount was realized, then, said the courts, the remainderman would be subjected to the risk of losing, in case of dishonor, the amount paid out as well as the principal.<sup>39</sup>

It is clear, however, that the reason given for not making payment to the life tenant periodically, whether out of uninvested or invested capital, is without foundation, both as applied to "pure discount" and other bonds. Whatever additional risk of dishonor is created for the remainderman as to the discount security is offset by the fact that there is no longer any risk of dishonor of the capital which has been paid out. What has really happened has been that principal has changed its form from, on the one hand, a savings bond plus another capital asset into a savings bond plus accumulated interest on that bond. The amount of capital remains the same, and consequently the same amount as before, and no more, is subject to possible dishonor. Taking the viewpoint that principal is an amount, not a res, the principal is unchanged. Taking the viewpoint that principal is a res, then the nature of the res has been changed, as it always is in a change of investments, but without detriment to the remainderman.<sup>40</sup>

It is true that there may be other objections to paying the life tenant the discount in installments prior to realization in the case of a security whose price fluctuates. As the life tenant is paid each installment, the book value of the bond is, of course, written up a corresponding amount. However, the write-up will be ascribing a fictitious increase if the value of the bond has not risen *on the market* to a corresponding extent. So long as the fund being accumulated to equal the discount is not paid out, but is only credited to income conditionally, this objection is of no consequence. For that matter, if premium amortizations are to be credited to principal unconditionally, thereby ascribing to a premium bond a possibly fictitious decrease in value, there is no reason why the discount fund should not be either paid out or credited finally. Furthermore, if an unconditional write-up does not cor-

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<sup>38</sup>Re Armstrong, (1934) 55 Ont. L. Rep. 639.

<sup>39</sup>See note 19, *supra*. Cf. Restatement, Trusts (1935), sec. 240, Comment *h*; sec. 233, Comment *d*.

<sup>40</sup>See Isaacs, Principal—Quantum or Res?, (1933) 28 Harv. L. Rev. 725.

respond with the market the effect is merely to subject the remainderman to any loss (as he is subject to any gain) caused by market fluctuations—a result entirely justifiable. In the case of bonds which pay interest periodically, there is also the danger that the coupons may be dishonored, in which case the trustee will be pretty much at a loss as to how to proceed. On the whole, however, none of the possibilities mentioned appear sufficiently consequential to offset the desirability of fair treatment for the life tenant, especially if the premium rule is to stand unchanged. In any event, they are not applicable to savings bonds, which have no coupons and do not fluctuate in value except as they become more valuable through the regular accruals in value, and which, being redeemable at the holder's option, are equivalent at any given date to cash.

Assuming, accordingly, that the trustee should be able to make distribution to the life tenant periodically either out of idle funds or by liquidating invested capital, it follows that the trustee should be permitted to purchase savings bonds even when no income is to be accumulated. The next question is, how much shall the life tenant be paid at each period?

The most scientific method of accumulation when a bond has been bought at a discount has been described by others.<sup>41</sup> Briefly, this consists of determining the interest rate which the bond will earn from a table of bond values, and crediting income with the difference between the amount so found due and the coupon rate. The book value of principal is written up in an equal amount. For the second interest period, the interest rate which the bond will earn is reckoned on the increased principal. In the case of savings bonds, however, the value of the bonds at any given time is already known, and the discount should be accumulated therefore in accordance with the known periodic increments. The book value will thus be written up in terms of actual value, and not in terms of a theoretical value. If the bond is then redeemed before maturity there is no need for adjustments, and at any given time the book value of principal reflects the immediate redemption value of the bond. Where then no income is to be accumulated under the terms of the trust, the life tenant should be paid periodically an amount equal to the accrual in redemption value of the savings bonds during the income period.

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<sup>41</sup>Edgerton, *Premiums and Discounts in Trust Accounts*, (1918) 31 *Harv. L. Rev.* 447, 467; Vierling, *Amortization of Premiums and Accumulation of Discounts on Trust Investments*, (1923) 36 *Trust Cos.* 177, 184, 185.