

Michigan Law Review

Volume 58 | Issue 7

1960

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Recommended Citation

James H. DeVries, *Trusts - Principal and Income - Apportionment Under Pennsylvania Rule of Stock Dividends Based on Capital Surplus*, 58 MICH. L. REV. 1077 (1960).

Available at: <https://repository.law.umich.edu/mlr/vol58/iss7/12>

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TRUSTS—PRINCIPAL AND INCOME—APPORTIONMENT UNDER PENNSYLVANIA
RULE OF STOCK DIVIDENDS BASED ON CAPITAL SURPLUS—Under the terms of
a trust established in New York in 1915 income was to be paid to a bene-

fiary for life and upon his death the principal was to be distributed to certain descendants of the settlor. Two extraordinary stock distributions were received by the trust during the life of the income beneficiary. In issuing the additional shares each of the corporations¹ had transferred to capital stock account its entire capital surplus and sufficient earned surplus to support the additional shares at their par value. At the time of creation of the trust New York applied the Pennsylvania rule² for apportioning stock dividends between principal and income. The trustee determined what percentage of the amount transferred to capital stock account on the corporate books represented earned surplus and allocated to income that percentage of the additional stock received by the trustee. The remainder of the stock, which represented capitalization of capital surplus, was allocated to principal, although part of it could have been given to income without impairing the "intact value" of the stock given to the trust by the settlor, that is, the book value at the time of the creation of the trust plus any "natural capital increments."³ The life beneficiary's executors objected to the allocation. In a proceeding to settle the trustee's accounts the lower court ordered a referee to determine whether certain items were properly includible in capital surplus for trust purposes. The appellate division upheld the apportionment as made by the trustee. On appeal, *held*, affirmed, two judges dissenting. The income beneficiary is entitled to no more of a stock distribution than can be connected with the capitalization of earned surplus. *In re Bingham's Will*, (N.Y. 1959) 163 N.E. (2d) 301.

The intention of the settlor of a trust controls as to the allocation of dividends between principal and income.⁴ In the absence of a manifested intention three different rules have been used.⁵ The Kentucky rule provided that all dividends declared out of earnings should go to the income beneficiary.⁶ The Massachusetts rule allocates all stock dividends to principal and all cash or property dividends to income.⁷ The Pennsylvania rule gives ordinary dividends, whether stock or cash, to income. Extraordinary dividends are apportioned, with that portion attributable to corporate earnings prior to the creation of the trust going to principal and

¹ The corporations involved were the Standard Oil Company of Indiana and Borg-Warner Corp.

² New York adopted the Massachusetts rule by statute in 1926. 40 N.Y. Consol. Laws (McKinney, 1949) §17a.

³ See dissent in principal case at 309-310.

⁴ E.g., *Re Conway's Estate*, 29 N.J. Super. 598, 103 A. (2d) 57 (1954); *Re Lloyd's Estate*, 292 N.Y. 280, 54 N.E. (2d) 825 (1944); *In re Robinson's Trust*, 218 Pa. 481, 67 A. 775 (1907).

⁵ See, generally, 3 SCOTT, TRUSTS, 2d ed., 1804-1848 (1956); 44 A.L.R. (2d) 1279 (1955); 130 A.L.R. 492 (1941).

⁶ *Hite's Devises v. Hite's Executor*, 93 Ky. 257, 20 S.W. 778 (1892). Kentucky has now adopted the Massachusetts rule. *Bowles v. Stilley's Executor*, (Ky. 1954) 267 S.W. (2d) 707, note, 39 MINN. L. REV. 338 (1955).

⁷ *Minot v. Paine*, 99 Mass. 101 (1868). The Uniform Principal and Income Act incorporates the Massachusetts rule. 9B UNIFORM LAWS ANNOTATED 373-374 (1957).

that portion attributable to earnings subsequent to the creation of the trust going to income.⁸ The Pennsylvania rule is based on the presumption that the settlor intended the income beneficiary to have all corporate earnings accrued during the existence of the trust and the remainderman to get only that value which was represented by the stock at the time the trust was created.⁹ However, the income beneficiary can get the earnings only if the corporation makes some sort of a distribution.¹⁰ If the presumption were applied to its logical extreme the income beneficiary would be entitled to everything distributed by the corporation so long as the "intact value" of the corpus was not impaired. Apparently no court has carried the presumption this far, however. The courts, as in the principal case, look to the capital structure of the corporation to see whether the distribution comes from earnings or capital.¹¹ The dissent in the principal case, in keeping with the presumption underlying the Pennsylvania rule, would have allocated the entire stock distribution to income except for that portion required to maintain the intact value of the principal. The majority opinion refused to allocate any of the part of the distribution attributable to capital surplus to income because it was not possible to identify the capital surplus as earnings.¹² Logically the court should have examined the capital surplus account to see what part of it was attributable to earnings.¹³ One of the reasons for the court's evident desire to restrict the application of the Pennsylvania rule may be that it wished to avoid the expense involved in examining corporate statements and making adjustments to determine accurately the ultimate source of the funds used to capitalize the new stock.¹⁴ Another reason is that the court considered the intact value principle to be merely a minimum safeguard

⁸ *Earp's Appeal*, 28 Pa. 368 (1857); *Matter of Osborne*, 209 N.Y. 450, 103 N.E. 723 (1913); *Equitable Trust Co. v. Prentice*, 250 N.Y. 1, 164 N.E. 723 (1928). See, generally, *Evans*, "Calculating the Distribution of a Stock Dividend Between Life Tenant and Corpus," 77 UNIV. PA. L. REV. 981 (1929); *Brigham*, "Pennsylvania Rules Governing the Allocation of Receipts Derived by Trustees From Shares of Stock," 85 UNIV. PA. L. REV. 358 (1937); *Cohan and Dean*, "Legal, Tax and Accounting Aspects of Fiduciary Apportionment of Stock Proceeds: The Non-Statutory Pennsylvania Rules," 106 UNIV. PA. L. REV. 157 (1957).

⁹ See *Equitable Trust Co. v. Prentice*, note 8 *supra*, at 8; *Earp's Appeal*, note 8 *supra*; 3 SCOTT, TRUSTS, 2d ed., 1817-1818 (1956).

¹⁰ See 3 SCOTT, TRUSTS, 2d ed., 1818 (1956). In Pennsylvania an apportionment may be made when the trustee sells the stock. *Re King's Estate*, 349 Pa. 27, 36 A. (2d) 504 (1944); *Buist's Estate*, 297 Pa. 537 at 543, 147 A. 606 (1929).

¹¹ E.g., principal case at 4; *In re Cunningham's Estate*, 395 Pa. 1, 149 A. (2d) 72 (1959); *In re Terhune*, 50 N.J. Super. 414, 142 A. (2d) 684 (1958); *Wehrhane v. Peyton*, 133 Conn. 478, 52 A. (2d) 711 (1947); *Nirdlinger's Estate*, 290 Pa. 457, 139 A. 200 (1927), note, 26 MICH. L. REV. 555 (1927).

¹² Principal case at 6. For a discussion of the capital surplus account, see MOORE, LAW AND ACCOUNTING 176 (1952).

¹³ This is what the lower court desired to do by ordering a reference. *In re Bingham's Trust*, 11 Misc. (2d) 367, 161 N.Y.S. (2d) 217 (1957).

¹⁴ For a discussion of the accounting aspects of apportionment of dividends, see note, 36 IOWA L. REV. 543 (1951).

of the rights of the remainderman and not a limit on his rights.¹⁵ Hence the court was not averse to seeing principal retain a share of any increase in the value of the stock.¹⁶ Still another reason may be that since New York has legislatively adopted the Massachusetts rule¹⁷ for trusts created after 1926, the court did not want to apply the Pennsylvania rule to new situations, even though it might be appropriate.

In the principal case the court did not have before it the question whether the income beneficiary should get less than he was given by the trustee.¹⁸ If that question should come before the court in the future, it might further restrict the Pennsylvania rule by holding that a stock distribution supported in part by capital surplus goes entirely to principal.¹⁹ Another possibility is that the court would allocate to income only so many shares as would have been distributed if the new stock had been capitalized at its fair market value.²⁰

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¹⁵ Principal case at 4.

¹⁶ The trust fund in the principal case had grown from \$10,500,000 to \$36,000,000. In *re* Bingham's Trust, note 13 *supra*.

¹⁷ 40 N.Y. Consol. Laws (McKinney, 1949) §17a.

¹⁸ The remaindermen accepted the allocation as made by the trustee and did not appeal from the decision of the appellate division.

¹⁹ This has been done by the Pennsylvania court. In *re* Cunningham's Estate, note 11 *supra*.

²⁰ See *In re* Terhune, note 11 *supra*. See also Niles, "Fosdick, Cunningham and Chaos," 98 TRUSTS AND ESTATES 924 (1959). The New York court has indicated in dictum that such a change is for the legislature. *Matter of Fosdick*, 4 N.Y. (2d) 646 at 655, 152 N.E. (2d) 228 (1958). Another possible method of allocation was recently proposed in McCaffrey, "Stock Dividend or Split?" 99 TRUSTS AND ESTATES 366 (1960).