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Stock Dividends as Principal or Income in the Administration of Trusts

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STOCK DIVIDENDS AS PRINCIPAL OR INCOME IN THE ADMINISTRATION OF TRUSTS

A TRUST is a device enabling one person to deal with property for the benefit of another.[1] In its origin, emphasis was laid upon the personal relation between the trustee, the person holding the property in trust, and the beneficiary, the person for whose benefit the property was held in trust.[2] As the modern trust has developed, the emphasis has shifted, so that today the trust is frankly a method of disposing of property.[3] It is this aspect of trusts, as employed in family settlements or decedents' estates, that will be emphasized in this discussion.

In the administration of the trust, the trustee is under a number of duties to the beneficiary of the trust, once he has accepted the trust. Among other things, he must render clear and accurate accounts with respect to the administration of the trust;[4] he must use reasonable care and skill to preserve the trust property;[5] he must use reasonable care and skill to make the trust property productive;[6] he must pay to the beneficiary at reasonable intervals the net income of the trust property,[7] *etc.* As thus enumerated, the task of a trustee may appear to be an easy one, but, as a rule, the trustee is beset with problems of conflicting loyalties, especially where there are successive beneficiaries.[8] For example, if a trustee is directed to pay the income to one beneficiary during a designated period, and then, at the expiration of the period, to pay the principal to another beneficiary, he must act with due regard to the respective interests of the life tenant and the remainderman. He must make the property productive so that the life tenant will have a reasonable income and he must preserve the trust property so that the remainderman will have the estate that he is entitled to

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[1] TRUSTS RESTATEMENT (Am. L. Inst. 1930) 11-12.
[2] *Id.* at 12 and 21.
[3] *Supra* note 1.
[4] PERRY ON TRUSTS—*passim.*
[5] *Ibid.*
[6] *Ibid.*
[7] *Ibid.*
[8] TRUSTS RESTATEMENT (Am. L. Inst. 1933) §224.

receive. The safety of the principal must not be endangered for the sake of increased income, and, on the other hand, income must not be sacrificed to increase the value of the principal. It becomes important, therefore, where there are successive beneficiaries, to distinguish between what is income belonging to the life tenant and what is principal belonging to the remainderman. Money received as rent on realty, or interest received on bonds and notes would clearly represent income. In the case of dividends on stock of corporations, it is not always a simple matter to determine which beneficiary is entitled to receive such dividend. The nature of the problems arising from dividend distributions will be the subject of this discussion.

Income accrues to the life beneficiary from the date of death of the testator, where the trust is created by will, so that income received after the date of death may have to be apportioned between income and principal. For example, a testator leaves a bond in trust, the interest being payable January 1st and July 1st. The testator dies March 1st. When the trustee receives the July payment of interest, that portion of the payment representing interest accrued from January 1st to March 1st is principal, and the portion accruing from March 1st to July 1st is income. The trustee will be obliged to make an apportionment of the July 1st payment of income to reflect the respective interests of the income beneficiary and the remainderman. Rents and annuities as well as interest are apportionable.[9]

The difference between such income and the return on shares of stock arises chiefly from the nature of an investment in a corporation. Such an investment is usually represented by certificates of stock, showing the interest of the shareholder in the capital and surplus of the corporation. The return of the shareholder takes the form of a dividend, representing a distribution among the shareholders according to their respective interests, from the profits and surplus of the corporation.[10] Such a distribution may be made only when authorized by a valid resolution of the board of direc-

[9] Dexter v. Phillips, 121 Mass. 178. See also UNIFORM PRINCIPAL AND INCOME ACT, §4.
[10] BOUVIER'S LAW DICTIONARY, 311.

tors.[11] The effect of a declaration of a dividend is to create a liability of the corporation to its stockholders and to reduce the net worth of the corporation by reducing its surplus. A dividend may be declared out of current earnings (profits) or accumulated earnings (surplus). If a trustee holds stock for a designated period and a dividend has been declared to stockholders of record during such designated period, payable in cash, such a dividend is income payable to the beneficiary. It should be noted that such cash dividend by reducing the surplus has reduced the net worth of the corporation, and consequently the value of each individual share. If the dividend has been covered by current earnings, the reduction in net worth will not affect the value of the individual shares held by the trustee. If the dividend has been declared out of accumulated earnings, the value of the individual shares may be impaired by the reduction in net worth. Such impairment obviously affects the remainderman and so creates the confusion that courts have labored under in determining the apportionment or distribution of dividend income.

In spite of the possibility that the corpus of an estate may thus be impaired by the declaration of an ordinary cash dividend, courts are agreed that ordinary cash dividends represent income that should be distributed to the life tenant.[12] However, in the case of an extraordinary cash dividend, courts are divided as to the proper distribution, and so have evolved two different rules.

One rule, the Pennsylvania rule, is to consider as income only that portion of the dividend that was earned by the corporation subsequent to the acquisition of the stock by the trustee. The rule was first enunciated in *Earp's Appeal* [13] and the effect of the rule is to consider the source of the dividend. The money value of the stock at the beginning of the estate is considered the corpus of the estate, and this value is kept intact.

The second rule considers all cash dividends, however large, as income. The form, rather than the source of the

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[11] *Ibid.*

[12] Greene v. Huntington, 73 Conn. 106, 46 Atl. 883 (1900).

[13] 28 Pa. 368 (1857).

dividend, controls. The theory of this rule is that in the case of a cash or property dividend there is an actual severance of the subject of the dividend from the corporation assets for the benefit of the stockholders. The leading case is *Minot* v. *Paine*.[14] It would appear that the Pennsylvania rule is fairer to the life tenant and remainderman, although its application is often difficult and might involve considerable investigation into the finances of the corporation declaring the dividend.

Consider next the case of a stock dividend. Such a dividend differs from a cash dividend in that the liability to the stockholders created by the board of directors is liquidated not in cash but in stock of the corporation declaring the dividend. From an accounting standpoint, the effect of the declaration and payment of the dividend is to reduce the surplus of the corporation and to increase the outstanding capital stock. Stated differently, a certain portion of the surplus has been capitalized, with the result that the net worth of the corporation remains the same after the payment of the stock dividend as before the declaration of the dividend. From the point of view of the individual stockholders, their interests in the corporation remain proportionately the same, except that such interests are now represented by a larger number of certificates. For the reason that there has been a distribution of a surplus and, in effect, a reinvestment of such surplus in the corporation, it might be said that the stockholders have received income. Such had been the view of Congress which taxed stock dividends as income under the Revenue Act of 1916.[15] However, the Supreme Court, in *Eisner* v. *Macomber*,[16] held that stock dividends were not income and, therefore, could not be subject to an income tax. Applying the reasoning of the Court to the administration of estates, it might be said that, since stock dividends are not income, they should be considered as part of the principal belonging to the remainderman. Courts, however, have divided on the question. The Pennsylvania rule, mentioned

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[14] 99 Mass. 101 (1868).

[15] 39 Stat. 756 (1916).

[16] 252 U. S. 189, 40 Sup. Ct. 189 (1920).

above, considers a stock dividend as income to the extent that such dividend has been declared out of earnings of the corporation which have accrued subsequent to the acquisition of the shares by the trustee. This rule has been accepted in a number of jurisdictions.[17] New York courts followed this rule in the *Matter of Osborne*.[18] In this case, the principal part of an estate held in trust consisted of 3,000 shares of the capital stock of the Singer Manufacturing Company. The trust estate was created in 1908 at the time of the testator's death. At that time the corporation had a surplus of accumulated earnings amounting to thirty-seven million dollars and a capital of thirty million dollars. By June, 1910, the surplus of the corporation had increased to $51,500,000. During that month the corporation declared a stock dividend of thirty million dollars. Prior to the payment of the stock dividend, regular cash dividends were paid to the executor, who distributed such dividends to the life beneficiary. The question at issue was whether the life beneficiary is entitled to the whole of the stock dividend.

The court held that ordinary cash dividends should be paid to the life beneficiary regardless of the time when the surplus out of which the dividends are payable was accumulated. As to the stock dividend, the court apportioned the dividend between the beneficiary of the life estate and the corpus, the basis of the division being that the surplus earned after the creation of the testator's trust should be awarded to the life beneficiary, and the portion earned prior to the creation of the trust should go to the trust fund itself for the benefit of the remainderman. This follows the Pennsylvania rule.

The Massachusetts rule, already referred to in the case of extraordinary cash dividends, considers stock dividends as principal for the reason that such dividends do not represent money or property actually severed from capital assets. This rule has been followed in numerous cases.[19] In a Missouri case, *Hayes* v. *St. Louis Union Trust Company*,[20] a testator

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[17] *Supra* note 8, at §228.
[18] 209 N. Y. 450, 103 N. E. 723 (1913).
[19] *Supra* note 17.
[20] 317 Mo. 1028, 298 S. W. 91 (1927); POWELL, CASES AND MATERIALS ON THE LAW OF TRUSTS AND ESTATES, 768.

had placed his residuary estate in trust, the net income to be paid in equal shares to his children and their descendants, *per stirpes,* until the death of the last surviving child, when the then principal, and undistributed income were to be divided equally *per stirpes* among his grandchildren then living. The trust estate consisted of 200 shares of stock of the American Tobacco Company.

In May, 1920, fifteen months after the testator's death, and in March, 1921, the tobacco company declared a 75% and 3% stock dividend respectively. The stocks were issued to the trustees of the trust fund. The plaintiffs included three of the children and they contended that the stock received as dividends was income within the meaning of the will and, as such, should go to the life beneficiary. The defendants included the testamentary trustees, and minor grandchildren, and they contended that the stock received as dividends constituted merely accretions to the principal of the trust estate and, therefore, should go to the remainderman. The court held that a scrutiny of the will did not reveal any specific intention of the testator as to the disposition of stock dividends and, therefore, the words "net income" had to be given a meaning which the law gives them. In this manner the court established the Missouri law to be the rule usually referred to as the Massachusetts rule. In developing its argument the court ably states the different rules obtaining in different jurisdictions before positing its own rule. It might be stated that, from an accounting viewpoint, the creation of a liability to stockholders amounts to a severance of the capital assets, even though no specific money or property is actually set apart for the liquidation of the liability. The fact that the liability is liquidated by a contribution of the stockholders to the capital of the corporation, in effect means that the stockholders have received the severed assets of the corporation and then in effect purchased additional stock from the corporation. In essence, the surplus has been distributed and is no longer available for ordinary cash dividends. To permit the distribution of current earnings to be made in this manner results in a favoring of the remaindermen, to the detriment of life beneficiaries who may thus be deprived of all income on the shares of stock held by the trustees, where the Massachusetts rule is followed.

Two jurisdictions, Kentucky and Delaware, have followed a third rule. Under this ruling, no distinction is drawn between cash or stock dividends. Any dividends from earnings, cash or stock, ordinary or extraordinary, belong to income, if declared during the term of the principal estate, without regard to whether such earnings accrued prior or subsequent to the creation of the trust. The leading case is *Hite* v. *Hite*,[21] and the rule has been followed in later cases.[22] In *Goff* v. *Evans*, the trust held 30 shares of Mt. Sterling National Bank stock, upon which a 100% stock dividend was declared in 1922. The executor, under the will of his mother and also his father, asked the court for instructions as to the distribution of the dividend. If the dividend was declared to be income belonging to the life tenant, it would go to the executor of the mother's estate and so be distributed, under the mother's will, equally to all the children. If the dividend was declared to be principal, it would be distributed, under the will of the father, to four daughters. The Kentucky court, following its own precedent, ruled that all dividends, whether paid in stock or cash, belong to the life tenant and directed the distribution to all seven children.

New York courts have at different times followed each of the three rules. Prior to 1913, New York followed the Kentucky rule.[23] From 1913 to 1922 the courts followed the Pennsylvania rule of apportionment.[24] In 1922 the legislature enacted Section 17A of the Personal Property Law, which provides that a direction in a deed of trust thereafter executed to the effect that all stock dividends be added to principal, was not to be regarded as directing an invalid accumulation. In 1926 this section was amended to read, "Unless otherwise provided in a will, deed or other instrument, which shall hereafter be executed and shall create or declare a trust, any dividend which shall be payable in the stock of the corporation or association declaring or author-

[21] 93 Ky. 257, 20 S. W. 778 (1892).

[22] Goff v. Evans, 217 Ky. 664, 290 S. W. 490 (1927). POWELL, *op. cit. supra* note 20 at 764.

[23] Note, 12 L. R. A. (N. S.) 775.

[24] *Supra* note 18.

izing such dividend and which shall be declared or authorized hereafter in respect of any stock of such corporation composing, in whole or in part, the principal of such trust, shall be principal and not income of such trust. The addition of any such stock dividend to the principal of such trust, as above provided, shall not be deemed an accumulation of income within the meaning of this article."

The effect of this statute, as amended, was to make the Massachusetts rule applicable in New York in situations covered by the statute and in the absence of a contrary provision in the instrument creating the trust.

Several recent New York cases will now be considered to show how courts are ruling with respect to the perplexing question of the allocation of stock dividends. In *Equitable Trust Co. of New York* v. *Prentice* [25] we have a decision by the court regarding the allocation of stock dividends in a trust deed, to which the statute is not applicable, the latter having been first enacted in the year of 1922 and amended in 1926.

In that case a deed of trust was made in the year 1917 which trust gave the net income of shares of stock to certain beneficiaries with remainder over. By its terms the trustee was to have the privilege, acting with the consent of others, to allocate stock dividends to capital rather than to income. This privilege was exercised. There was no question that the allocation would be lawful if the trust had been created in 1922 or as amended by the laws of 1926. The question here presented was whether the trust which was created in 1917 is to be condemned as an unlawful accumulation under a trust founded prior to 1922. Prior to the enactment of the statute, the rule was settled in this state that as between life beneficiary and remainderman a stock dividend would be apportioned as principal or income according to the origin of the surplus out of which it was declared. To the extent that it distributed a surplus existing at the *creation of the trust,* stock dividends would be allocated to principal; to the extent that it distributed a surplus earned thereafter, it would be allocated to income. In other words, the Pennsyl-

[25] 250 N. Y. 1, 164 N. E. 723 (1928).

vania rule of apportionment was applied in New York before the enactment of the statute.

The court held that the allocation of stock dividends to the corpus of the estate, pursuant to the discretion granted by the testator to the trustee, did not result in an unlawful accumulation, even though the statute of 1922 or 1926 did not apply to the facts of the case, the trust having been created in 1917. The court points out that what is principal for a shareholder may be income when held in trust to be divided among others. And what is income for a corporation may not be income for a shareholder.

In *Pratt* v. *Ladd*,[26] Charles Pratt died in 1891, leaving a will whereby he created trusts of his residuary estate for the benefit of each of his eight children.

On June 5, 1925, each trust created by the will contained 7,500 shares of the Anglo-American Oil Company, an English corporation. On that day the company declared a stock dividend of 33⅓% to each trust fund. This represented an item of 495,000 pounds transferred to capital by the corporation. The trustee considered the dividend as part of the principal. Surplus out of which the dividend was declared arose out of a transaction involving the borrowing of American dollars in 1920, after the trust was created. At the time of payment, an extraordinary profit was made on the exchange due to the appreciation of the English currency.

The courts there laid down the rule that the corporation's resolution to consider the profit as a capital profit cannot change the accumulated earnings into capital, as between life tenant and the remainderman. Therefore, the court held that the stock dividends declared by the English corporation, representing profits earned through borrowing dollars and making payment in pounds, goes to the life beneficiary of stock under the testamentary trust. This case being one not governed by the New York Statute, Personal Property Law, 17A, seemed to be decided either in accordance with the Kentucky or the Pennsylvania rule.

In the *Matter of Jackson*,[27] decided January, 1932, one Theodore F. Jackson, by his will and codicil executed in 1911

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[26] 253 N. Y. 213, 170 N. E. 895 (1930).
[27] 258 N. Y. 281, 179 N. E. 496 (1932).

and 1913 respectively, gave certain real and personal property to his wife.

The residuary estate was placed in trust. Included in the property held by the trust were 660 shares of stock in the Vandervoort Realty Company. The Vandervoort Realty Company declared a 100% stock dividend in 1927, which dividend the widow now claims as "profits" and which the remainderman claims as "capital."

The court upheld the contention of the widow and awarded all the stock dividends to her for the reason that the dividends were declared out of the surplus earnings accruing after the trustee received the stock. An advantageous sale of land, made immediately before the dividend was declared, created a large surplus. Apparently a profit may result from the operations of a business, and may include the sale at a profit of capital assets. It should be noted that the corpus of the estate was in no way impaired by distributing the dividend to the life tenant. This case, the statute not being applicable, also followed the Pennsylvania rule, or the Kentucky rule. Had the will creating the trust come under the New York statute, the stock dividend would have gone to the remainderman, following the Massachusetts rule.

The Reporter and Advisers in submitting their draft on this aspect of the restatement of the law of trusts found themselves evenly divided between the Pennsylvania rule of apportionment of extraordinary cash dividends and stock dividends and the Massachusetts rule, and, therefore, submitted both rules governing receipts from shares of stock, Section 228 and an alternative section. The Massachusetts rule is followed in the proposed Uniform Principal and Income Act.[28]

It is felt that the Pennsylvania rule is the most realistic of the three rules that courts have applied in the case of the distribution of stock dividends. Such a rule is based upon the scientific analysis of the financial condition of the corporation issuing the dividend, and is in accord with the principles of accounting, which latter courts have recently been adopting more and more as principles of law.

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[28] *Supra* note 9.

The Massachusetts rule is an attempt at a simplification of the problem. Courts have fought shy of becoming involved in mathematical computations and have preferred to adopt a rule of thumb rather than attempt economic and scientific analyses.

The Kentucky rule is an oversimplification of the problem, and while it may have resulted in doing justice in individual cases, its application would in the long run be disastrous.

While in New York the statute follows the Massachusetts rule in the case of trusts created prior to 1922, the New York courts may be obliged to follow either the Pennsylvania or the Kentucky rules set up by them in earlier cases.

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