

ALLOCATION OF STOCK DIVIDENDS BETWEEN THE LIFE BENEFICIARY AND REMAINDERMAN

The task of a trustee who is required to distribute the income of a fund which includes corporate securities is complicated by the issuance of stock dividends—distributions to shareholders of additional shares of stock of the distributing corporation¹—on the trust's shares.

1. HENN, CORPORATIONS § 329, at 509 (1961). A stock dividend does not result in a reduction of the assets of the corporation and a distribution of these assets to the stockholders, as is the case with a cash dividend. The only effect of the stock dividend on the internal structure of the corporation is the rearrangement of the shareholder's equity section of the corporate balance sheet. An amount equal to the par or stated value of the shares is deducted from the surplus account and transferred to the capital stock account. SUSSMAN, THE STOCK DIVIDEND 10-11 (1962). ABA-ALI MODEL BUS. CORP. ACT § 40(d) (1953) [hereinafter cited as MODEL ACT]. *But see* AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULL. NO. 11, ACCOUNTING FOR STOCK DIVIDENDS AND STOCK SPLITS 101-A (1952). This factor aside, the effect of such a dividend on the balance sheet of the corporation may be illustrated by the example of a 100% stock dividend:

Assume market price of \$10 per share.

Accounts before the 100% stock dividend:

Common stock, par \$10, authorized 200 shares, issued and outstanding	
100 shares	\$1,000
Retained Earnings	4,000
	\$5,000

Following the 100% stock dividend:

Common stock, par \$10, authorized, issued and outstanding	
200 shares	\$2,000
Retained Earnings	3,000
	\$5,000

It will be noticed from the above example that the total stockholders' equity in the corporation has not been reduced by the distribution of the share dividend. It remains \$5,000. However, although each shareholder's proportionate interest remains unchanged, each share of stock owned prior to the distribution has been diluted so that it represents one-half the interest in the corporation that it formerly represented. Another factor of importance to the shareholder is the fact that the earned surplus account has been reduced by \$1,000. This is significant because earned surplus, undistributed net profit, is recognized in all jurisdictions as a legal source of cash dividends. HENN, *op. cit. supra* § 320, at 492. While \$4,000 was available for cash distributions to shareholders before the stock dividend, only \$3,000 is available after the dividend.

However, the Model Act gives the shareholders the power, with a 2/3 vote, to reduce stated capital. MODEL ACT §§ 53(e), (h), 54(c). The surplus arising therefrom is a capital surplus, MODEL ACT § 64, which, within certain limitations, can be distributed

Under many trust instruments, with income payable to a beneficiary for life, the corpus then going to a remainderman, the issue is whether a stock dividend shall be considered income or principal. The intent of the settlor, as evidenced by the instrument creating the trust, will control the allocation.² The difficulty is that under usual trust terminology the settlor's intention regarding stock dividends is not often made clear.³ General provisions allocating income to the life beneficiary and principal to the remainderman give no indication that the settlor intended that stock dividends go to either.⁴

When the testator's intent as evidenced by the trust instrument is found to be ambiguous,⁵ two distinct rules—the so-called Massachusetts and Pennsylvania rules—have been developed to help trustees and courts determine the proper allocation of stock dividends between the successive beneficiaries.⁶

I. TRADITIONAL APPROACHES TO A SOLUTION

A. *The Massachusetts Rule*

The Massachusetts rule places primary reliance on the form of the distribution, not its source, in determining its allocation.⁷ This approach dates from 1868 when the Supreme Judicial Court of Massachusetts resolved a dispute about the destination of two stock dividends by holding: "A simple rule is to regard cash dividends, however large, as income, and stock divi-

to shareholders in cash or property, MODEL ACT § 41. Thus, in Model Act jurisdictions, the issuance of a share dividend may affect the ability of a corporation to distribute cash to its shareholders differently. This fact would bear on some of the arguments advanced for the various allocatory rules.

2. 3 SCOTT, TRUSTS § 236.3, at 1819 (2d ed. 1956).

3. *Ibid.*

4. Provisions in the instrument giving to the life tenant income and profits, *Selleck v. Hawley*, 331 Mo. 1038, 56 S.W.2d 387 (1932), income and dividends, *Fifth-Third Union Trust Co. v. Davis*, 55 Ohio App. 377, 10 N.E.2d 4 (1936), and rents, dividends and profits, *Kirby v. Western Sur. Co.*, 68 S.D. 612, 5 N.W.2d 405 (1942), have all been held to be too ambiguous to indicate that the settlor intended stock dividends to go to the life beneficiary.

5. "[S]peculation as to probable intent can lead one almost anywhere he wants to go." *In re Arens*, 41 N.J. 364, 378, 197 A.2d 1, 9 (1964).

6. A third, the Kentucky rule, held that all dividends declared after the establishment of the trust belonged to the life beneficiary. Under this rule, the income beneficiary received the dividend whether it was cash or stock and regardless of its source; the time of declaration was the determining factor. *Hite v. Hite*, 93 Ky. 257, 20 S.W. 778 (1892). The doctrine is not recognized today in any jurisdiction. See generally Flickinger, *A Trustee's Nightmare: Allocation of Stock Dividends Between Income and Principal*, 43 B.U.L. REV. 199, 208-11 (1963).

7. *E.g.*, 3 SCOTT TRUSTS § 236.3, at 1813 (2d ed. 1956).

dends, however made, as capital.”⁸ This holding has been modified only slightly in nearly one hundred years; today if the “substantive nature of the distribution from the viewpoint of the corporation . . .”⁹ is that of a dividend made in stock, it will be allocated to principal.¹⁰

1. *Theoretical Justification for the Rule*

Courts seeking a rationale for the Massachusetts rule center their arguments in two areas—the corporation-shareholder relationship and the nature and effect of a share dividend. Their analysis concludes that the allocation of a stock dividend to the life beneficiary does not give proper effect to the settlor’s desire to award him only the income.¹¹

These courts have begun with the proposition that the earnings and profits of a corporation remain the property of the corporation until distributed;¹² until that time the stockholder has no vested property interest in them.¹³ In the absence of bad faith or fraud on the part of the directors

8. *Minot v. Paine*, 99 Mass. 101, 108 (1868).

9. *Flickinger*, *supra* note 6, at 205.

10. Like many in the field of law, the statement that the Massachusetts doctrine looks only to the form of the dividend and not to its source is subject to qualification. Thus, it has been held that an issue of treasury stock which had been purchased by the corporation with earnings accumulated since the inception of the trust should be allocated to income. *Leland v. Hayden*, 102 Mass. 542 (1869). Also, a stock dividend declared in stock of a corporation other than the declaring corporation has been held to be trust income. *Lloyd v. Lloyd*, 341 Ill. 461, 173 N.E. 491 (1930). Where a trustee has an option to receive a dividend in either cash or stock, the dividend is held to be income regardless of the trustee’s choice. *Coates v. Coates*, 304 S.W.2d 874 (Mo. 1957).

11. Courts have tried to justify their acceptance of the Massachusetts rule by falling back on the concept of settlor’s intent. Thus, although the settlor made no specific provision in the trust regarding stock dividends, it is said that the settlor intended a stock dividend to be allocated to the remainderman because the ordinary stockholder thinks of stock dividends as principal. *Powell v. Madison Safe Deposit Co.*, 208 Ind. 432, 196 N.E. 324 (1935); *Flynn v. Brownell*, 371 Mich. 19, 123 N.E.2d 153 (1956); *In re Joy’s Estate*, 247 Mich. 418, 225 N.W. 878 (1929); *Langdell v. Dodge*, 100 N.H. 118, 122 A.2d 529 (1956). In view of the lawful power of the corporation over the use and apportionment of its earnings, the settlor has been presumed to have intended that the determination of the rights of the life beneficiary and the remainderman depend upon the regular action of the corporation. *Gibbons v. Mahon*, 136 U.S. 549 (1890); *Lamb v. Lehmann*, 110 Ohio St. 59, 143 N.E. 276 (1924). One court, in a jurisdiction which had previously adopted the Massachusetts rule, held that the settlor was presumed to have been familiar with it and to have intended that it control. *Flynn v. Brownell*, 371 Mich. 19, 123 N.W.2d 153 (1963); see *In re Arens*, 41 N.J. 364, 197 A.2d 1 (1964).

12. *E.g.*, *Gibbons v. Mahon*, 136 U.S. 549, 558 (1890); *De Koven v. Alsop*, 205 Ill. 309, 68 N.E. 930 (1903); *Hayes v. St. Louis Union Trust Co.*, 317 Mo. 1028, 1044, 298 S.W. 91, 97 (1927); *Lamb v. Lehmann*, 110 Ohio St. 59, 143 N.E. 276 (1924); *Rhode Island Hosp. Trust Co. v. Tucker*, 51 R.I. 507, 155 Atl. 661 (1931); *Security Trust Co. v. Rammelsburg*, 82 W. Va. 701, 97 S.E. 122 (1918).

13. *Gibbons v. Mahon*, *supra* note 12; *In re Trust Under Will of Gardner*, 266 Minn.

in failing to distribute earnings, the stockholders cannot compel their distribution.¹⁴ The directors can lawfully retain them in the business, to be later used as they see fit. These retained and accumulated earnings, because they are corporate property, are capital,¹⁵ and the interest represented by shares issued against this capital as a stock dividend is likewise capital:¹⁶ "If the surplus represented by the new shares is capital, it follows that the shares are capital also."¹⁷ Thus, reasoning from the shareholder-corporation relationship, the Massachusetts rule courts have concluded that since share dividends are issued against, and represent, an amount which is corporate property and thus capital, they are also capital with regard to their allocation between beneficiaries.

The second theoretical justification for the Massachusetts rule is based upon the differences in the nature of share and cash dividends, and their differing effects on the distributing corporation and the recipient shareholder. A stock dividend, it is contended, is actually no dividend at all;¹⁸ the term is a misnomer.¹⁹ The "true" dividend implies a severance from the corporation of the subject matter of the dividend—cash or other corporate property—and a distribution of such subject matter to the stockholders.²⁰ The stock dividend, on the other hand, does not reduce the total

127, 123 N.W.2d 69 (1963) (holding Minnesota statute adopting Massachusetts rule constitutional when applied retroactively); *Hayes v. St. Louis Union Trust Co.*, *supra* note 12; *Catherwood Trust*, 405 Pa. 61, 173 A.2d 86 (1961) (holding Pennsylvania statute adopting Massachusetts rule constitutional when applied retroactively).

14. *E.g.*, *Gibbons v. Mahon*, *supra* note 12; *In re Joy's Estate*, 247 Mich. 418, 225 N.W. 878 (1929); *Hayes v. St. Louis Union Trust Co.*, *supra* note 12; *United States Trust Co. v. Cowin*, 121 Neb. 427, 237 N.W. 284 (1931); *In re Arens*, 41 N.J. 364, 197 A.2d 1 (1964); *Lamb v. Lehmann*, 110 Ohio St. 59, 143 N.E. 276 (1924).

15. *Rhode Island Hosp. Trust Co. v. Tucker*, 51 R.I. 507, 155 Atl. 661 (1931); *Kirby v. Western Sur. Co.*, 68 S.D. 612, 5 N.W.2d 405 (1942).

16. *Gibbons v. Mahon*, 136 U.S. 549 (1890); *Eastman v. State Bank*, 259 Ill. App. 607 (1931); *Langdell v. Dodge*, 100 N.H. 118, 122 A.2d 529 (1956); *Lamb v. Lehmann*, 110 Ohio St. 59, 143 N.E. 276 (1924). "It is universally conceded that so long as profits are carried in the 'surplus' account they are held for the remainderman, and it is difficult to find a valid reason why they are not *a fortiori* held for him after being transferred to 'stock' account." *Id.* at 79, 143 N.E. at 282.

17. *Rhode Island Hosp. Trust Co. v. Tucker*, 51 R.I. 507, 511, 155 Atl. 661, 663 (1931).

18. *E.g.*, *First Nat'l Bank v. Hill*, 241 Ala. 606, 4 So. 2d 170 (1941); *De Koven v. Alsop*, 205 Ill. 309, 68 N.E. 930 (1903); *Robert v. Mercantile Trust Co.*, 324 Mo. 314, 23 S.W.2d 32 (1929); *Hayes v. St. Louis Union Trust Co.*, 317 Mo. 1028, 298 S.W. 91 (1927); *Stipe v. First Nat'l Bank*, 208 Ore. 251, 301 P.2d 179 (1956).

19. *Lamb v. Lehmann*, 110 Ohio St. 59, 143 N.E. 276 (1924); *Armentrout v. Armentrout*, 63 Ohio L. Abs. 186, 100 N.E.2d 555 (P. Ct. 1951).

20. *Gibbons v. Mahon*, 136 U.S. 549 (1890); *United States Trust Co. v. Cowin*, 121 Neb. 427, 237 N.W. 284 (1931).

corporate property,²¹ but simply dilutes the interest represented by each share;²² the title to no corporate property passes to shareholders.²³ Corporate accounting practice is in accord with this dichotomy.²⁴ Furthermore, the issuance of a stock dividend is not a decision on the part of the directors to distribute earnings,²⁵ as is the issuance of a cash dividend, but is rather a decision to remove such earnings as a possible source of future distributions.²⁶ Thus, the stock dividend may be seen as the directors' statement

21. *Gibbons v. Mahon*, *supra* note 20; *De Koven v. Alsop*, 205 Ill. 309, 68 N.E. 930 (1903); *In re Joy's Estate*, 247 Mich. 418, 225 N.W. 878 (1929); *Hayes v. St. Louis Union Trust Co.*, 317 Mo. 1028, 298 S.W. 91 (1927); *Langdell v. Dodge*, 100 N.H. 118, 122 A.2d 529 (1956); *Lamb v. Lehmann*, 110 Ohio St. 59, 143 N.E. 276 (1924); *Rhode Island Hosp. Trust Co. v. Tucker*, 51 R.I. 507, 155 Atl. 661 (1931).

22. Thus, after a 100 per cent stock dividend each share of stock represents, as against its value before the dividend, only one-half the proportionate ownership in the corporation.

23. *Hayes v. St. Louis Union Trust Co.*, 317 Mo. 1028, 298 S.W. 91 (1927).

24. To record a stock dividend, it is standard accounting practice simply to rearrange the equity section of the balance sheet by transferring the par value of the stock dividend from retained earnings to capital stock. This does not reduce the assets of the corporation. Note 1 *supra*. In contrast, in the case of a cash dividend, the cash and retained earnings accounts are reduced by the amount of the dividend. The following simple balance sheets illustrate the effect of these transactions on the issuing corporation:
Before:

Assets		Equity	
Cash	\$10,000	Capital Stock	\$ 8,000
		Retained Earnings	2,000
	<u>\$10,000</u>		<u>\$10,000</u>

After a \$1,000 cash dividend:

Assets		Equity	
Cash	\$ 9,000	Capital Stock	\$ 8,000
		Retained Earnings	1,000
	<u>\$ 9,000</u>		<u>\$ 9,000</u>

However, after a \$1,000 stock dividend:

Assets		Equity	
Cash	\$10,000	Capital Stock	\$ 9,000
		Retained Earnings	1,000
	<u>\$10,000</u>		<u>\$10,000</u>

25. *In re Arens*, 41 N.J. 364, 197 A.2d 1 (1964); *Rhode Island Hosp. Trust Co. v. Tucker*, 51 R.I. 507, 155 Atl. 661 (1931).

26. In the *Arens* case, *supra* note 25, the court pointed out that a stock dividend, especially a large one, is often not intended to approximate the effect of a cash dividend or any other method of paying out accumulated surplus. It is rather intended to reduce the market value of the shares, thereby broadening their potential market by increasing

to the shareholders that earnings will not be distributed,²⁷ but will be retained permanently in the corporation.²⁸

Like their differing effect on the distributing corporation, share and cash dividends leave the recipient shareholders in dissimilar financial positions. For example, if a ten per cent stock dividend is issued, the shareholder who previously held ten shares of stock now holds eleven. However, since all other stockholders have received the same ten per cent dividend, the eleven shares represent the same proportionate interest in the corporation as did the original ten. The stock dividend seems to give the stockholder additional paper but little more.²⁹ It is true that the shareholder may sell his additional share for cash, which would seem to approximate the benefits he would have received from a cash dividend. There are, however, two important distinctions between the two transactions. In order to receive cash for a stock dividend, the shareholder must dispose of a part of his proportionate share in the corporation. If he sells his eleventh share, his proportionate interest in the corporation will be one-eleventh less than it was before the dividend. On the other hand, the stockholder who receives a cash dividend retains his proportionate ownership in the corporation. Furthermore, the tax consequences of the two transactions would be dif-

the number of stockholders, without changing the proportionate equity interest of any stockholder.

The readjustment of the corporate balance sheet incident to the issuance of a share dividend will, in some cases, more accurately represent the shareholders' interest in the corporate assets by indicating that the retained earnings have been reinvested in capital assets. This latter goal is especially important to a company engaged in a wasting assets business, as was the case with one of the corporations in *Arens*, where a substantial portion of current earnings had to be reinvested in developing new reserves. Obviously, earnings transferred to the stated capital account in such a situation will not be distributed as cash dividends, for they represent corporate capital assets. *But see* note 1 *supra*.

27. *In re Arens*, *supra* note 25; *Rhode Island Hosp. Trust Co. v. Tucker*, 51 R.I. 507, 155 Atl. 661 (1931).

28. Of the several reasons why a stock dividend may be issued, the basic consideration seems to be to retain cash for varied corporate purposes, such as expansion by the acquisition of new assets. The results of a survey of corporations which had at one or more times issued stock dividends revealed eight basic reasons: to conserve cash, to increase cash dividends, to reduce market price (increase the number of shareholders), to present evidence of the permanent retention of earnings, to avoid taxation under §§ 531-37 of the Internal Revenue Code, to increase the legal short-term borrowing capacity of public utility holding companies and their subsidiaries, to give stockholders an option to invest or liquidate, and to maintain good public relations or improve them. A majority, seventy-eight per cent, of the replies indicated that the primary objective of their stock dividend distribution was to conserve cash. *SUSSMAN, op. cit. supra* note 1, at 73-97.

29. The eleven shares may, however, be somewhat more marketable than were the original shares because of their lower unit price. For a full discussion of the effect of stock dividends on market prices see *SUSSMAN, op. cit. supra* note 1, at 50-72.

ferent. The recipient of the cash dividend has received income;³⁰ the share recipient who sold the dividend share has sold a capital asset,³¹ the proceeds of which are eligible for capital gains treatment.³²

According to the Massachusetts rule, the stock dividend has no effect. It does not change the financial position of the issuing corporation or the stockholder. It cannot be income to the shareholder since he receives nothing more than additional paper. If the stock dividend is not income, these courts reason that to give any part of it to the life beneficiary would constitute an invasion of trust corpus.

2. *Practical Considerations Favoring the Rule*

Irrespective of theory, courts almost uniformly have been impressed with the relative ease with which the Massachusetts rule can be administered.³³ There is a certainty resulting from its rigorous reliance upon form which cannot be approached by rules requiring inquiry by the trustee. Furthermore, by not demanding any such inquiry, the Massachusetts rule is said to add finality to the decisions of directors,³⁴ since their determination of a distribution as a share dividend automatically allocates it to corpus. Any other rule, it is contended, requires the courts to replace the directors' discretion with their own.³⁵

Recognizing that this rule, if unfair, is weighted in favor of the remainderman, courts have defended this one-sidedness in pragmatic terms. First, allocating a stock dividend to life beneficiary reduces the trust entity's proportionate interest in the corporation. When the stock is voting stock, this could be damaging to the interests of the remainderman.³⁶ Further, if there is doubt as to who should receive the stock dividend, it is better allocated to principal, since the life tenant will get its use for life and the remainderman the balance of its value.³⁷ Thus, neither party will be ex-

30. INT. REV. CODE OF 1954, § 61 (a)(7).

31. INT. REV. CODE OF 1954, § 1221.

32. INT. REV. CODE OF 1954, §§ 1201-23. The new basis for all the shares is determined by allocating the basis for the old shares between the old and new shares. INT. REV. CODE OF 1954, § 307.

33. *E.g.*, *Powell v. Madison Safe Deposit & Trust Co.*, 208 Ind. 432, 196 N.E. 324 (1935); *In re Joy's Estate*, 247 Mich. 418, 225 N.W. 878 (1929); *Lamb v. Lehmann*, 110 Ohio St. 59, 143 N.E. 276 (1924).

34. See *Lamb v. Lehmann*, *supra* note 33.

35. *E.g.*, *Gibbons v. Mahon*, 136 U.S. 549 (1890); *United States Trust Co. v. Cowin*, 121 Neb. 427, 237 N.W. 284 (1931).

36. *Hayes v. St. Louis Union Trust Co.*, 317 Mo. 1028, 298 S.W. 91 (1927).

37. *In re Arens*, 41 N.J. 364, 197 A.2d 1 (1964).

cluded from its enjoyment entirely, as would be the case if the dividend were to go to the life beneficiary.³⁸

B. *The Pennsylvania Rule*

The Pennsylvania rule³⁹ relies on the source of the distribution and the time of its accumulation, rather than its form.⁴⁰ This rule allocates, in theory, all dividends⁴¹ to the remainderman when the source of the distribution is earnings accumulated before the trust was established; when the source is income earned since the beginning of the trust, the dividend is allocated to the life tenant.⁴² If the court finds that the earnings against which the dividend was declared accrued partially before and partially after the establishment of the trust, the dividend is apportioned accordingly between the life beneficiary and the remainderman.⁴³ The one limitation on the distribution to the life *cestui* under this rule is that the so-called "intact value" of the corpus, the book value of the shares constituting the corpus as of the date of the trust's inception,⁴⁴ must not be impaired.⁴⁵ To the extent allocating the dividend to the income beneficiary would impair the intact value, it is allocated to principal.

The theory behind the Pennsylvania rule begins with the proposition that the life beneficiary is entitled to all the income from the trust corpus. When the latter consists of shares of common stock, the source of income is the earnings of the corporation whose shares are held by the trust.⁴⁶ The interest of the life beneficiary in the undistributed earnings of the corporation has been described by some of the courts adopting the Pennsyl-

38. BOGERT, TRUSTS AND TRUSTEES § 859, at 562 (2d ed. 1962)..

39. The rule was first stated in *Earp's Appeal*, 28 Pa. 368 (1857).

40. *E.g.*, *Holbrook v. Holbrook*, 74 N.H. 201, 66 Atl. 124 (1907); *In re Heaton's Estate*, 89 Vt. 550, 96 Atl. 21 (1915).

41. However, in practice, it does not apply to ordinary cash dividends. 3 SCOTT, TRUSTS § 236.1, at 1806 (2d ed. 1956).

42. *E.g.*, *In re Heaton's Estate*, 89 Vt. 550, 96 Atl. 21 (1915). In New Jersey, he did not receive the stock dividend itself but rather a charge against the corpus of the trust for its dollar value. *In re Arens*, 41 N.J. 364, 378, 197 A.2d 1, 9 (1964). To satisfy the charge, the trustee presumably would have to sell the proportion of the stock dividend allocated to the life beneficiary.

43. *In re Heaton's Estate*, *supra* note 42. Thus, the Pennsylvania rule is described as an apportionment rule, while the Massachusetts rule is an allocation rule. *In re Arens*, *supra* note 42, at 367, 197 A.2d at 3.

44. For a detailed discussion of how to ascertain "book value" see Flickinger, *supra* note 6.

45. *E.g.*, *Lindau v. Community Fund*, 188 Md. 474, 53 A.2d 409 (1947); *Nashville Trust Co. v. Tyne*, 194 Tenn. 435, 250 S.W.2d 937 (1952); *In re Jenkins' Estate*, 199 Wis. 131, 225 N.W. 733 (1929).

46. *Pritchett v. Nashville Trust Co.*, 96 Tenn. 472, 36 S.W. 1064 (1896).

vanian rule as an "inchoate" interest, one which cannot be defeated by a decision on the part of the directors to declare a stock rather than a cash dividend.⁴⁷ Although these courts tacitly grant that the decision to distribute or retain corporate earnings lies within the discretion of the directors,⁴⁸ once such decision and subsequent declaration are made, they argue that the directors should not be allowed to determine the rights of successive trust beneficiaries.⁴⁹ The courts' concern is not to define the rights of a stockholder in relation to the corporation but to achieve what they consider to be an equitable result between the beneficiaries.

The argument that this rule is more equitable is based on the theory that the undistributed earned surplus or retained earnings of a corporation is a fund which, potentially at least, may be distributed to the shareholders as income.⁵⁰ The declaration of a stock dividend destroys this potential income by turning the affected surplus into capital.⁵¹ Thus, the action of the corporation deprives the life beneficiary of what is normally "his"—the income of the corporation which has accumulated since the transfer in trust,⁵² the fund upon which all trust income (cash dividends) is based. To avoid this "inequitable" result, the courts allocate that portion of the stock dividend which is issued against earnings accumulated since the inception of the trust to the life beneficiary; that portion, if any, issued against past accumulated profits goes to corpus.

II. STATUS OF THE RULES TODAY

Although at one time the authorities in this country were fairly evenly divided, the Massachusetts rule is today supported by the distinct weight of authority,⁵³ having been adopted either by case law or statute in all but one or two jurisdictions.⁵⁴ The Restatement of Trusts Second⁵⁵ and the Uniform Principal and Income Act⁵⁶ have adopted this rule.

47. *Ibid.*

48. *In re Duffill's Estate*, 180 Cal. 748, 183 Pac. 337 (1919); *Bryan v. Aikin*, 10 Del. Ch. 446, 86 Atl. 674 (1913).

49. See *In re Jenkins' Estate*, 199 Wis. 131, 225 N.W. 733 (1929).

50. *Equitable Trust Co. v. Prentice*, 250 N.Y. 1, 164 N.E. 723 (1928); see *In re Paddock's Estate*, 213 Wis. 409, 251 N.W. 229 (1933).

51. *In re Terhune*, 50 N.J. Super. 414, 142 A.2d 684 (1958); *Equitable Trust Co. v. Prentice*, *supra* note 50; *In re Paddock's Estate*, *supra* note 50.

52. *Equitable Trust Co. v. Prentice*, *supra* note 50; *In re Cunningham's Estate*, 395 Pa. 1, 149 A.2d 72 (1959); *Pritchett v. Nashville Trust Co.*, 96 Tenn. 472, 36 S.W. 1064 (1896).

53. BOGERT, *op. cit. supra* note 38, § 859, at 562-63.

54. South Carolina adopted the Pennsylvania doctrine in *Wallace v. Wallace*, 90 S.C. 61, 72 S.E. 553 (1911). That doctrine recently was reaffirmed in *Cothran v. South Carolina Nat'l Bank*, 242 S.C. 80, 130 S.E.2d 177 (1963), in which the court held that

Undoubtedly one of the greatest factors in the overwhelming rejection of the Pennsylvania apportionment doctrine and simultaneous acceptance of the Massachusetts rule has been the relative ease with which the latter is administered. Under the Massachusetts rule, a cash dividend is simply regarded as income and a stock dividend as principal.⁵⁷ For the most part, then, the trustee is not forced to go beyond the declaration itself to determine to whom it belongs, since it is the form of the dividend which decides that question.

The Pennsylvania rule, on the other hand, requires the determination by the trustee of two factors: the source of the dividend and the time during which that source accumulated.⁵⁸ Both are needed, for the life beneficiary is only entitled to that part of the share dividend issued against corporate earnings retained since the inception of the trust.⁵⁹ This necessitates an analysis of the corporation's past and present financial posture, which, due to the complexity of modern corporate practices, has become an increasingly difficult task. When the account capitalized to support the share dividend is the general retained earnings account, corporate records may not be detailed enough to permit an answer.⁶⁰ Thus, the directors of the issuing corporation may themselves not be able to ascertain with any certainty the factors relevant to an allocation under the Pennsylvania rule.⁶¹ Forcing a trustee to "go behind the corporate scene" and obtain corporate documents other than the traditional balance sheets and income statements to determine the time that the dividend's source accumulated may indeed make this task "Herculean,"⁶² if not impossible.

Even if successful, the undertaking may be self-defeating because of its high cost. Complications involved in the collection and analysis of corporate documents may necessitate the hiring of experts such as accountants. Of

it "would not be justified in overthrowing a rule so long established." *Id.* at 93, 130 S.E.2d at 183. Delaware, which had previously adhered to the Pennsylvania rule, has now enacted a so-called "reasonably prudent man" statute. DEL. CODE ANN. tit. 12, § 3526 (Supp. 1964). For a discussion of the latter rule see notes 127-36 *infra* and accompanying text.

55. RESTATEMENT (SECOND), TRUSTS § 236 (1959).

56. UNIFORM PRINCIPAL AND INCOME ACT § 6(a) (1930). For a discussion of § 6 of the Revised Act see notes 83-88 *infra* and accompanying text.

57. *Minot v. Paine*, 99 Mass. 101 (1868).

58. *In re Heaton's Estate*, 89 Vt. 550, 96 Atl. 21 (1915).

59. Notes 45-46 *supra*.

60. Flickinger, *A Trustee's Nightmare: Allocation of Stock Dividends Between Income and Principal*, 43 B.U.L. Rev. 199, 222 (1963).

61. Even if this were not the case, the statement of the issuing corporation as to the source of the stock dividend and the time of its retention has been held not to bind the court. *In re Jenkins' Estate*, 199 Wis. 131, 225 N.W. 733 (1929).

62. *In re Arens*, 41 N.J. 364, 197 A.2d 1 (1964).

course, attorneys' fees impose another financial burden on the beneficiaries which could be prohibitive.⁶³ In addition, trustees, fearful of making an improper allocation and incurring personal liability, often assign all stock distributions to corpus and petition the court for guidance.⁶⁴ These problems are accentuated by the fact that trustees ordinarily hold a portfolio of many corporate stocks, often including small numbers of shares in each of many corporations.⁶⁵ To force the trustee to undertake a detailed analysis of a large corporation to insure the proper allocation of a few shares of stock is unrealistic.

Thus, it could be said that the Massachusetts rule has won by default, or, more properly, that the shortcomings of the Pennsylvania rule have encouraged courts to choose the least time-consuming and expense-producing approximation of justice. At any rate, the fault that the courts adopting the Pennsylvania rule found with the Massachusetts rule—that it was an arbitrary rule which did not look to justice between the parties—may apply with equal force to the Pennsylvania rule, because of the frequent inability of courts to determine with confidence either the source of a stock dividend or the time of its accumulation.⁶⁶ After great outlays of time, effort, and expense on the part of trustees, courts, and other interested parties, the intricacies of modern corporate practice may still defy any accurate solution. When this is so, the Pennsylvania rule is just as arbitrary as the Massachusetts rule, for some allocation must be made even if the source of the dividend is unclear. Thus, there has been no gain in fairness, and a loss of administrative ease.

III. SHOULD A CONTROVERSY STILL EXIST?

The dominance of the Massachusetts rule suggests that the dispute over proper allocation of stock dividends between successive beneficiaries may be a question of only historical interest, except in that minority of jurisdictions still concerned with the administration of the Pennsylvania rule. These include states in which it has never been replaced,⁶⁷ and states in

63. In *Arens*, fees totaled \$51,815.50. Of this amount, counsel for the trustee received \$5,500, counsel for the life beneficiary \$13,989.90, counsel for the remainderman \$25,825.60, and expert witnesses \$6,500, all of which was paid out of principal. After listing these costs, the court stated, "No wonder it is often said that the Pennsylvania rule benefits lawyers and accountants more than beneficiaries." *In re Arens*, *supra* note 62, at 374, 197 A.2d at 7.

64. *Id.* at 374, 197 A.2d at 6; Niles, *Fosdick, Cunningham and Chaos*, 98 *TRUSTS & ESTATES* 924, 927 (1959).

65. *In re Arens*, *supra* note 62.

66. *United States Trust Co. v. Cowin*, 121 Neb. 427, 237 N.W. 284 (1931).

67. Note 54 *supra*.

which it was first adopted by decision and later displaced by a Massachusetts rule statute held not to apply retroactively.⁶⁸ However, recent developments in the corporate use of share dividends⁶⁹ and the subsequent re-examination of the operation of the two rules under these conditions have reopened the debate. The continued acceptance of the Massachusetts rule in an era of increasing stock dividend issuance, a period in which the rule may unfairly favor remaindermen, may indicate that the adopting courts and legislatures have rejected the Pennsylvania rule's problems with too little thought as to the consequences.

Courts adopting the Massachusetts rule seldom fail to support their reasoning with a discussion of the practical difficulties of the Pennsylvania rule.⁷⁰ This stress on the practicality of the solution is evident in statements that what is needed is a rule that will serve as a guide to, as well as protection for, the trustee,⁷¹ regardless of the fact that it may fail, in an individual case, to accomplish what some may conceive of as justice between the

68. Pennsylvania itself offers a good example of the problems which develop in such jurisdictions. In 1947, the legislature enacted a statute which, with respect to stock dividends, was substantially the same as the Uniform Principal and Income Act. PA. STAT. ANN. tit. 20, § 3470.5 (1964). However, in *In re Crawford's Estate*, 362 Pa. 458, 67 A.2d 124 (1949), it was held that, despite a provision to the contrary, the Massachusetts rule statute could be constitutionally applied only to trusts created after the enactment date. Pennsylvania then had two rules of apportionment; the one applicable to a particular trust depended on the date of the trust's creation. Thus, trustees and courts still had not escaped from the burdens of administering the Pennsylvania rule. In 1961, however, the Pennsylvania Supreme Court overruled *Crawford* and held that the retroactive provision was not unconstitutional. *Catherwood Trust*, 405 Pa. 61, 173 A.2d 86 (1961); accord, *In re Gardner's Trust*, 266 Minn. 127, 123 N.W.2d 69 (1963); *In re Allis' Will*, 6 Wis. 2d 1, 94 N.W.2d 226 (1959); cf. *In re Arens*, 41 N.J. 364, 197 A.2d 1 (1964) (notwithstanding express provision that statute was prospective only). But cf. *In re Estate of Valiquette*, 122 Vt. 350, 173 A.2d 832 (1961).

69. The increased corporate practice of issuing stock dividends is indicated in the following statistics: in 1944, of all corporations with stock listed on the New York Stock Exchange, only 22 distributed their own shares in some manner; half of such distributions were stock dividends or splits of 25 per cent or more. In 1953, 138 distributions were made, a disproportionate number being small stock dividends—112 out of 138 were less than 25 per cent. By 1962, the total number of distributions was 258, with 188 of them less than 25 per cent. Of additional importance is the fact that of the 188 dividends issued in 1962 which were 25 per cent or less, 178 were dividends of 6 per cent or less. NEW YORK STOCK EXCHANGE FACT BOOK 37 (1963).

70. *Powell v. Madison Safe Deposit & Trust Co.*, 208 Ind. 432, 196 N.E. 324 (1935); *In re Joy's Estate*, 247 Mich. 418, 225 N.W. 878 (1929); *Hayes v. St. Louis Union Trust Co.*, 317 Mo. 1028, 298 S.W. 91 (1927); see *In re Arens*, 41 N.J. 364, 197 A.2d 1 (1964).

71. *Smith v. Dana*, 77 Conn. 543, 60 Atl. 117 (1905).

beneficiaries.⁷² Some courts emphasize the case-to-case uniformity which the application of a simple, general rule produces.⁷³

Granting that the shareholder-corporation relationship—specifically, the interest in corporate earnings—is accurately described by the Massachusetts courts,⁷⁴ the fact remains that a stock dividend grounded, as many are, in earnings accumulated since the beginning of the trust,⁷⁵ curtails the use of such earnings as a source of future cash dividends.⁷⁶ If a share dividend has this effect, the recent trend toward issuing stock dividends in lieu of cash dividends, or to supplement greatly reduced cash dividends, will defeat the settlor's intent that the life tenant enjoy current income from the trust corpus.⁷⁷ This point is especially significant when the practice of regularly issuing stock dividends has greatly increased since the creation of the trust.⁷⁸ This trend has resulted in the realization that under current financial conditions the Massachusetts rule may disproportionately benefit remaindermen. Hence, the renewed quest for an allocatory rule.

IV. PROPOSED SOLUTIONS

Recent proposals to alleviate the possible injustices of the Massachusetts rule are designed to prevent the life beneficiary from being excluded from present enjoyment because of the recent corporate policy of issuing stock dividends in place of, or in addition to, cash dividends.⁷⁹ One of these solutions gives to the life tenant all those stock dividends which are, in fact,

72. *Smith v. Dana*, *supra* note 71; *Lamb v. Lehmann*, 110 Ohio St. 59, 143 N.E. 276 (1924).

73. *E.g.*, *Lamb v. Lehmann*, *supra* note 72.

74. Notes 12-17 *supra*.

75. Barclay, *The Revised Uniform Principal and Income Act*, 101 TRUSTS & ESTATES 833 (1962).

76. However, for a discussion of distribution possibilities from the stated capital account in Model Act jurisdictions see note 1 *supra*.

77. However, in those cases in which the corporation, after issuing a stock dividend, continues to pay the same proportionate cash dividends, the allocation of the stock dividend to the remainderman under the Massachusetts rule does not result in injustice to the life beneficiary. In this infrequent situation, he will receive the same amount of cash had the stock dividend not been issued—a smaller amount per share on a larger number of shares.

78. In many trusts, the life beneficiary is the wife or child of the settlor, while the remaindermen are unborn grandchildren or charitable institutions. This adds weight to the argument that the settlor did not intend that the remainderman get the lion's share of the benefit from the trust, at the expense of the life beneficiary. *But see Hayes v. St. Louis Union Trust Co.*, 317 Mo. 1028, 298 S.W. 91 (1927). There, the court rejected a similar line of reasoning in a dispute over whether the Pennsylvania or Massachusetts rule should be the law of Missouri.

79. Barclay, *supra* note 75.

issued "in lieu of" cash dividends.⁸⁰ Another allocates to income all small stock dividends, up to a stated maximum percentage of the shares outstanding.⁸¹ The third takes a different approach and vests the trustee with discretion to allocate the stock dividend to either the life beneficiary or the remainderman, and sets a reasonably prudent man standard by which his actions may be measured.⁸²

A. *Stock Dividends Issued in Lieu of Cash*

In the Revised Uniform Principal and Income Act,⁸³ the commissioners rejected both a reasonably prudent man rule and a small stock dividends rule,⁸⁴ and adopted a rule which allocates to income stock distributions which have been expressly issued in lieu of cash dividends.⁸⁵ The trustee may rely on the statement of the corporation as to any fact, relevant under any provision of the Act, concerning the source or character of the distribution.⁸⁶

These provisions should protect the life *cestui* from being entirely deprived of income even if share distributions take the place of cash dividends in corporate practice. However, they are subject to the criticism that whether a dividend is to be considered as in lieu of cash dividends seems to depend entirely on an indication to that effect from the corporation. The nonmandatory language of the provision regarding the trustee's reliance on corporate statements as to the character of the distribution⁸⁷ may imply that he has the power to make an independent determination. However, it is highly doubtful whether a trustee would ever exercise that power when a corporation fails to indicate that the distribution is in lieu of cash dividends. The investigation could lead to considerable expense in relation to the amount involved, and to litigation should the trustee decide that the dividend should go to income when in fact it did not take the place of a cash dividend. Almost certainly, the trustee would treat the corporation's failure to indicate specifically that the distribution was one in lieu of cash dividends

80. REVISED UNIFORM PRINCIPAL AND INCOME ACT § 6.

81. *In re Pew's Estate*, 411 Pa. 96, 191 A.2d 399 (1963) (stock dividends of 6% or less belong to income); N.J. STAT. ANN. § 3A:14A-4 (Supp. 1965) (stock distributions of 4% or less belong to income); N.Y. PERS. PROP. LAW § 27-e(2) (stock distributions of 6% or less belong to income).

82. DEL. CODE ANN. tit. 12, § 3526 (Supp. 1964).

83. Hereinafter cited as REVISED ACT.

84. Dunham, Scott & Wolf, *Uniform Revised Principal and Income Act*, 101 TRUSTS & ESTATES 894, 896 (1962).

85. REVISED ACT § 6(b).

86. REVISED ACT § 6(e).

87. "The trustee *may* rely on the statement of the corporation as to any fact" REVISED ACT 6(e). (Emphasis added.)

as an implied statement that it was not, and would allocate the shares to corpus.

Furthermore, although this alternative might well protect an income beneficiary from being excluded from *all* benefit from his interest in the trust, it probably will not protect him from another hazard—*reduced* benefit resulting not from cash dividends being replaced by share dividends, but from cash dividends being reduced or postponed by share dividends. This danger to the income beneficiary is a more probable one, especially in good financial times; to maintain shareholder good will, corporations are likely to package stock dividends with at least some cash if they are able, rather than cutting out cash dividends entirely. The “in addition to” type of share dividend, while not stopping cash dividends, lowers the yield. It is this lowered rate of return for which the “in lieu of” provision of the Revised Act may fail to compensate the income *cestui*.⁸⁸

B. *Small Stock Dividends Allocated to Income*

While there are few cases on the point,⁸⁹ the courts using the Massachusetts rule have allocated all stock dividends, regardless of size in relation to shares outstanding, to the remainderman.⁹⁰ However, *In re Pew's Estate*,⁹¹ a recent Pennsylvania case, has held that regular stock dividends of six per cent or less are income rather than principal.⁹² This “small stock dividends” rule is the other major modification of the Massachusetts rule, adopted to lessen the latter's adverse effect on income beneficiaries under modern corporate financial policies.

The theory behind allocating small stock dividends to the life beneficiary rests on the presumption that they are generally of an amount well within the issuer's range of current earnings and are actually charged against such earnings.⁹³ If the life beneficiary is entitled to current earnings,⁹⁴ he should also be entitled to a stock dividend within the range of such earnings.

88. It is, of course, possible that a corporation could issue a stock dividend in addition to a reduced cash dividend and specifically state that the former was actually issued in lieu of the rest of the cash.

89. 3 SCOTT, TRUSTS § 236.7, at 1827 (2d ed. 1956).

90. *Eastman v. State Bank*, 259 Ill. App. 607 (1931) (stock dividends issued regularly in addition to cash dividends); *Rhode Island Hosp. Trust Co. v. Tucker*, 51 R.I. 507, 155 Atl. 661 (1931). A recent Minnesota case, *In re Trust Under Will of Gardner*, 266 Minn. 127, 123 N.W.2d 69 (1963), held that the Minnesota statute adopting the Massachusetts rule applied to all stock dividends both large and small.

91. 411 Pa. 96, 191 A.2d 399 (1963).

92. *Ibid.*

93. Barclay, *supra* note 75, at 833.

94. Flickinger, *A Trustee's Nightmare: Allocation of Stock Dividends Between Income and Principal*, 43 B.U.L. REV. 199, 212 (1962).

This rule gives the life beneficiary the benefits of a fund which, if it had been distributed as cash, he would have received, and avoids the administrative problems of the Pennsylvania rule. Under such a proposal, the trustee simply allocates the dividend to the life beneficiary if it is equal to or less than the maximum percentage figure, and to the remainderman if it is greater than that figure.

The most obvious problem with this proposal is that a dividing line between income and principal must be decided upon. Four per cent,⁹⁵ six per cent,⁹⁶ and ten per cent⁹⁷ have been adopted in different jurisdictions. Is there any justification for selecting any one of these figures rather than the others? The fact that the four jurisdictions which adopted such a provision have selected three different dividing lines suggests that no one is more meaningful than the others. However, the argument has been made that the six per cent provision is the most realistic.⁹⁸

Its justification is based primarily on its being consistent with current corporate practices. In the previously cited survey,⁹⁹ of the 188 stock distributions of less than twenty-five per cent made in 1962, 178 were dividends of six per cent or less. Such a stock dividend is probably charged against current earnings¹⁰⁰ which, if paid out, would be allocated to income. It is these earnings which form the totality of the income beneficiary's interest and to which he has the better claim. Furthermore, since so few stock dividends are issued in the range above six per cent,¹⁰¹ an allocation to income of stock dividends of six per cent or less would give the majority of income beneficiaries the protection they need under a modern Massachusetts rule. Thus, there is actually no need to determine exactly which line divides those distributions within current income from those without. The probability that only current earnings are involved is high enough to justify confidence in the fairness of the results. The number of distributions in the five to six per cent range¹⁰² suggests that choosing a four per cent

95. N.J. STAT. ANN. § 3A:14A-4 (Supp. 1965).

96. *In re Pew's Estate*, 411 Pa. 96, 191 A.2d 399 (1963); N.Y. PERS. PROP. LAW § 27-e(2).

97. Ky. Sess. Laws 1954, ch. 53. This statute was repealed by Ky. Sess. Laws 1962, ch. 133 and has been replaced by KY. REV. STAT. §§ 386.210(1), .230(1), (5) (1963).

98. Niles, *The New 6% Stock Distribution Rule*, 102 TRUSTS & ESTATES 648, 709 (1963).

99. Survey cited note 69 *supra*.

100. "Such small stock dividends are almost uniformly of an amount well within current earnings and are charged thereto." Barclay, *supra* note 75, at 833; see GRAHAM, DODD & COTTLE, SECURITY ANALYSIS 499-504 (4th ed. 1962).

101. Survey cited note 69 *supra*. Of the ten dividends between 7 and 25%, only three were in the 7 to 10% range.

102. Survey cited note 69 *supra*.

dividing line, as did New Jersey,¹⁰³ would deprive many life tenants of an interest in a substantial number of dividends well within current corporate earnings. There is little reason to believe that a six per cent dividend is less likely to be based on current earnings than is a four per cent distribution.¹⁰⁴

The New York statute, a six per cent small dividend statute, had, as originally enacted, two unique provisions.¹⁰⁵ First, the distribution would have been income *to the extent* it equaled six per cent or less of the outstanding shares. Thus, the life beneficiary would have received all of a six per cent distribution or six per cent of any larger share distribution, regardless of size. At first, this provision seemed appealing because it would have softened the possible harshness of any arbitrary allocatory line. In New Jersey, for instance, a four per cent dividend goes to income under the statute, but a five per cent or larger dividend is allocated entirely to principal.¹⁰⁶ If the justification for considering a six per cent dividend as income is that such an amount is probably within current earnings which "belong" to the life tenant, the same allocation should be made of the first six per cent of any larger distribution. However, as will be pointed out, this provision would have favored life tenants at the expense of remaindermen because corpus would have been invaded every time a stock split was so apportioned.¹⁰⁷

The other innovation in the New York statute is that it expressly applies to both stock dividends and stock splits.¹⁰⁸ Prior to the adoption of this statute, there had been fairly unanimous agreement that a stock split, under both the Massachusetts and Pennsylvania rules, belonged to principal.¹⁰⁹ The basis for distinguishing between a stock split and a stock dividend, relevant to the claims of the life beneficiary and remainderman, is the effect each has on the earned surplus of the corporation. As explained above, a stock dividend removes a dollar amount equal to the par or market

103. N.J. STAT. ANN. § 3A:14A-4 (Supp. 1965).

104. See Barclay, *supra* note 75, at 833.

105. N.Y. Sess. Laws 1963, ch. 1005. "Distributions by a corporation . . . made to a trustee in the shares of a distributing corporation . . . held in such trust, whether in the form of a stock split or stock dividend, to the extent that such distributions equal in any trust year 6% or less of the number of shares of such stock held in the trust, shall be income." This was repealed by N.Y. PERS. PROP. LAW 27-e(2), discussed note 119 *infra*.

106. N.J. STAT. ANN. § 3A:14A-4 (Supp. 1965).

107. Text accompanying note 118 *infra*.

108. See also N.J. STAT. ANN. § 3A:14A-4 (Supp. 1965).

109. *E.g.*, In the Matter of Security Trust Co., 198 Misc. 7, 96 N.Y.S.2d 75, (Surr. Ct. 1950), *aff'd mem.*, 277 App. Div. 1157, 101 N.Y.S.2d 1021 (1950); Cunningham's Estate, 395 Pa. 1, 149 A.2d 72 (1959).

value of the shares distributed from the earned surplus account and places it in the capital stock account.¹¹⁰ The result of this corporate action is to remove the amount transferred as a possible source of future cash dividends.¹¹¹ The stock split, on the other hand, does not result in the reduction of the earned surplus account or in a transfer of any amount to the capital accounts. Rather, the outstanding shares are increased and the par value per share is correspondingly decreased. Thus, the earned surplus account remains unchanged. Because of their differing effects on the issuing corporation, splits and share dividends serve different corporate purposes.¹¹² The principal reason for a stock dividend is to preserve cash,¹¹³ while that of a stock split is to reduce the market price of the shares, thus facilitating their trade in the market.¹¹⁴

Treating stock splits and stock dividends alike in regard to allocation between successive *cestuis* is based on expediency.¹¹⁵ While in theory it may be relatively easy to distinguish between a dividend and a split, such a determination is not easily made in practice because of the various kinds of hybrid issues.¹¹⁶ To insist upon such distinctions, it has been argued,¹¹⁷ would perpetuate the confusion and uncertainty which led to the demise of the Pennsylvania rule. Thus, the New York small dividend statute seems to be a step in the direction of ease of administration, and corresponding administrative certainty.

However, according to one writer, the decision to allocate stock splits, as well as stock dividends, to income, if they do not exceed the selected maximum figure, is to "give to income, in every case where a true stock split is involved, something to which income would otherwise never have a shadow of right."¹¹⁸ If the stock split does not result in a reduction of the earned surplus account, and thus a reduction in the source out of which

110. Note 1 *supra*.

111. *But see* Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 HARV. L. REV. 1357, 1388-89 (1957).

112. See generally 32 N.Y.U.L. REV. 878 (1959).

113. SUSSMAN, *THE STOCK DIVIDEND* 76-78 (1962).

114. HENN, *CORPORATIONS* § 330, at 512 (1961).

115. Barclay, *Allocation of Corporate Distributions: New York's Approach*, 102 TRUSTS & ESTATES 605 (1963); Niles, *supra* note 98, at 709.

116. Compare *In the Matter of Fosdick*, 4 N.Y.2d 646, 152 N.E.2d 228 (1958), with *Cunningham's Estate*, 395 Pa. 1, 149 A.2d 72 (1959). Both cases involved trusts which owned General Electric common shares on which a stock distribution was made. Approximately seven-twelfths of the par value of the new shares was capitalized. The New York court, with one dissent, held the distribution a stock dividend; the Pennsylvania court held it a split.

117. Niles, *supra* note 98, at 709.

118. Barclay, *Allocation of Corporate Distributions: New York's Approach*, 102 TRUSTS & ESTATES 605, 606 (1963).

the life beneficiary might receive future cash dividends, his claim to any such distribution is, at best, tenuous. Since the stock split does not change the internal structure of the corporation, the allocation of such a distribution, or any part of it, to the income beneficiary seems an invasion of principal. If the result of this provision is merely increased trustee confidence in the allocation, at the expense of the corpus beneficiary whenever the distribution is in fact a split, the advantages are clearly outweighed by the possible injustices.

One solution to this problem is to remove stock splits from the purview of the statute. However, this would disregard the original reason for including them—the difficulty in distinguishing, in practice, between stock dividends and stock splits. One suggested method of resolving the question without placing the burden of distinguishing between the dividend and the split on the trustee is to give the income beneficiary all distributions—splits or dividends—of six per cent or less, and no part of such distributions of more than six per cent.¹¹⁹ Since no distinction based on the form or source of the distribution would be required, the trustee need not determine anything beyond the size of the share distribution in relation to the shares outstanding. While this proposal is somewhat arbitrary because of its absolute dividing line,¹²⁰ practical considerations suggest that injustices would be minimized.

The possibility of invading corpus by allocating true splits to income is limited to those rare splits involving a sixteen to one—or larger—ratio. Likewise, while an individual income beneficiary may be injured by the allocation to principal of a stock dividend of over six per cent which is within the range of current earnings, this result can be tolerated because of its infrequent occurrence.¹²¹ This may be little consolation to an injured party, but this solution has the advantage of certain, even-handed application to both principal and income interests.

119. *Ibid.*; Niles, *supra* note 98, at 709. Precisely this approach was recently adopted by the New York legislature in its repeal of N.Y. Sess. Laws 1963, ch. 1005, discussed in note 105 *supra* and text accompanying notes 105-07 *supra*.

A distribution by a corporation . . . made to a trustee in the shares of the distributing corporation . . . held in such trust, whether in the form of a stock split or a stock dividend, at the rate of six per cent or less of the shares upon which the distribution is made, shall be income. Any such distribution at a greater rate shall be principal. N.Y. PERS. PROP. LAW § 27-e(2).

See *In re Pew's Estate*, 411 Pa. 96, 191 A.2d 399 (1963). It is unclear whether the Pennsylvania court in *Pew* was enunciating a rule for stock dividends only, or for both dividends and splits. By statute, New Jersey has such an absolute cutoff point, but has set it at four per cent. N.J. STAT. ANN. § 3A:14A-4 (Supp. 1965).

120. Text accompanying notes 95-104 *supra*.

121. NEW YORK STOCK EXCHANGE FACT BOOK 37 (1963).

As previously stated,¹²² the framers of the Revised Act rejected a small stock dividends rule, and accepted in its place an "in lieu of" rule, which allocates share dividends to income only when they have been expressly issued in place of cash dividends.¹²³

Among the reasons given by the Commissioners for rejecting a small stock dividends rule were the difficulty of drawing the line between income and principal,¹²⁴ and a fear that a small stock dividends rule allocating such dividends to income might encourage tax authorities to change their present position that stock dividends are nontaxable. Apparently, this fear is based on the theory that the Commissioner of Internal Revenue will treat as income any corporate distribution which is based on corporate earnings and made in respect to a shareholder's stock, especially if it is treated as trust income rather than corpus.¹²⁵ This concern seems unwarranted.¹²⁶

122. Authority cited note 84 *supra*.

123. REVISED ACT § 6(b).

124. Dunham, Scott & Wolf, *supra* note 84.

125. But my basic objection to the six percent rule is that up to this point stock dividends have been treated as non-taxable. The cases on the question reason that nothing has happened to the proportionate interests of the stockholders. Likewise, it is pointed out that in the administration of trusts such distributions have been considered as principal, and so they should be considered for tax purposes. If we were to change the trust law, would it not be encouraging the tax man to assert that these distributions should be taxable after all? Dunham, Scott & Wolf, *supra* note 84, at 894-95.

126. The incidence of income taxation is generally based on the nature of the receipt, not its source or destination. *E.g.*, INT. REV. CODE OF 1954, § 61(a); INT. REV. CODE OF 1954, § 502. *But cf.* INT. REV. CODE OF 1954, §§ 117 (b)(2)(A), 501. Allocating a stock dividend to a life beneficiary will have no effect on the nature of the distribution from the corporation's point of view; the same entries will be made transferring earned surplus to stated capital to support the dividend regardless of to whom the dividend is distributed. Note 1 *supra*. The rearrangement of the corporate balance sheet's equity section will thus not be effected by the identity of the recipient, nor by his involvement in a trust situation.

From the trust's viewpoint as the actual shareholder, it should likewise make no difference with regard to the taxability of the share dividend that the life beneficiary, rather than the remainderman, will receive it. In its shareholder capacity, the trust will hold a larger number of shares than before, but each of these shares will represent a correspondingly diluted proportion of the ownership of the corporation. At this point, the trust has received no income, and the fact that it later assigns the dividend to the income beneficiary for the reasons discussed in this note seems to be irrelevant to its taxability in the hands of the trust. Furthermore, §§ 652(b) and 662(b) provide that the items included in a beneficiary's gross income shall have the "same character in the hands of the beneficiary as in the hands of the trust." Thus, it seems clear that Congress intended to tax as income only receipts of actual income to the trust which a beneficiary receives, without distinction as to the nature of his interest—for life or in remainder. These Code sections lend further strength to the concept of tax incidence depending on the character of the receipt, not the position of the recipient in a trust situation.

C. The "Reasonably Prudent Man" Rule

A third proposed solution is the so-called reasonably prudent man rule. This alternative to the more inflexible Massachusetts and small stock dividend rules would give the trustee discretion to allocate stock dividends to

The receipt of shares of common stock as a dividend on a corporation's outstanding common shares was early held not to be a receipt of income within the meaning of the sixteenth amendment and the revenue acts. *Helvering v. Griffiths*, 318 U.S. 371 (1943); *Eisner v. Macomber*, 252 U.S. 189 (1920); *Towne v. Eisner*, 245 U.S. 418 (1917). Both the *Macomber* and *Towne* decisions relied on the earlier Supreme Court case of *Gibbons v. Mahon*, 136 U.S. 549 (1890), which adopted the Massachusetts rule as the federal rule. The Court, in the latter case, stated its conclusions as to the nature of a share dividend: "[T]he proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest . . ." *Id.* at 559-60. This conclusion became the principal test used in determining whether a particular transaction was a nontaxable stock dividend. That is, a distribution of shares by a corporation to its stockholders with respect to their stock was a nontaxable stock dividend only if it did not change the pre-existing proportionate interest of the stockholders in the corporation. *Cf. Pizitz v. Patterson*, 183 F. Supp. 901, 902 (N.D. Ala. 1960). *Towne* added to this proportionate interest test a phrase which was again used in *Macomber*: "[W]e cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman." *Towne v. Eisner*, *supra* at 426, quoted in *Eisner v. Macomber*, *supra* at 202. It is this phrase which presumably gave rise to the Commissioners' reticence, expressed in *Dunham, Scott & Wolf*, *supra* note 84, to adopt the small stock dividends rule.

It is contended, however, that this mere description of the Massachusetts rule in these cases regarding the pre-1954 Code taxability of share dividends was not the *ratio decidendi* of those cases, the proportionate interest test having become the *sine qua non* of nontaxable share dividends. See, e.g., *Chamberlin v. Commissioner*, 207 F.2d 462, 469 (6th Cir. 1953); *Dreyfuss v. Manning*, 44 F. Supp. 383, 384 (D.N.J. 1942).

Undue reliance on the trust language in these early cases seems to be unjustified. Under any apportionment rule whereby some part of the share dividend is allocated to the life beneficiary, the dividend will not entirely be capital, but it will not change the proportionate interest of the shareholder, the trust. This must have been realized by the Supreme Court in the *Towne* and *Macomber* decisions, for, although the federal courts used the Massachusetts rule, under which all share dividends were allocated to principal, in Pennsylvania rule jurisdictions some stock dividends were given to the life beneficiary. Share dividends seem to have been nontaxable regardless of the type of jurisdiction in which they were received.

The Internal Revenue Code's present treatment of stock dividends also lends credence to the position that a six per cent rule would not necessarily lead to the taxation of stock dividends. Section 305 of the Code, with a few exceptions not relevant to this discussion, excludes from gross income distributions made by a corporation in its own stock. However, § 306, while not changing the basic rule of § 305, provides, in essence, that upon the sale of any stock received as a dividend by a shareholder other than common issued on common, the proceeds shall be includible in gross income, and shall not be entitled to capital gains treatment.

The purpose of § 306 is to defeat the so-called "preferred stock bail-out," an attempt to make a payment of corporate funds to shareholders at capital gains rates, without adversely affecting their proportionate interest in the corporation. *Alexander & Landis, Bail-outs and the Internal Revenue Code of 1954*, Tax Counselor's Q., Sept. 1958, p. 49,

either principal or income as he sees fit, with the limit that he act as a reasonably prudent man would.¹²⁷ This rule would, of course, be more flexible than the other rules, and could presumably adjust to approximate equity between successive beneficiaries. However, the task of setting a standard for the trustee's actions is a difficult one.¹²⁸ If the "equitable" criterion previously discussed—that a life beneficiary is entitled to stock dividends paid out of earned surplus accruing since the inception of the trust—is employed, the trustee will have the same problems as he had under the Pennsylvania rule.¹²⁹ It apparently was this consideration that caused the drafters of the Revised Act to reject such a rule, even though it was favored by the head of the drafting committee.¹³⁰

If a trustee would have difficulty applying a standard based on the theory of the Pennsylvania rule, the problem could be alleviated somewhat by including a modified small stock dividend provision as a starting point

50. A preferred stock dividend was issued to common stockholders, when only common had been previously outstanding. The common stockholders then sold the stock to either the corporation or a pre-arranged buyer. See *Chamberlin v. Commissioner*, *supra*.

Congress has thus seen fit to modify the general provision of § 305 exempting stock dividends from taxation when it became evident that preferred stock dividends issued on common stock were being used to get earnings out of the corporation (what amounted to a dividend under § 316), while avoiding the payment of a gross income tax on the distribution.

If modification of § 305 is to come about as a result of using the stock dividend to get cash out of the corporation at capital gains rates, there is no danger that a six per cent rule would lead to any change. Though, under such a rule, many stock dividends will go to the life beneficiary instead of to the trust corpus, this will not affect the later payment by the life beneficiary of a gross income tax on any cash dividends paid on the shares involved in the stock dividend. Thus, there is no danger of the avoidance of the payment of a gross income tax, and there should be no reason for a six per cent rule to result in a change of attitude toward the taxability of stock dividends.

For an argument which reaches the same conclusion by taking the position that the pre-1954 decisions and the present Code treatment are insurmountable obstacles to the taxing of share dividends see Comment, 64 *MICH. L. REV.* 856, 868 (1966).

127. The insertion of such a provision in the trust instrument has long been held to be within the power of the settlor. *E.g.*, *Dumaine v. Dumaine*, 301 Mass. 214, 16 N.E.2d 625 (1938).

128. Delaware, the only state to adopt such a provision, has set the standard which the trustee must meet as that which "men of prudence, discretion, and intelligence [use] in the management of their own affairs . . ." *DEL. CODE ANN.* tit. 12, § 3526 (Supp. 1964).

129. For a discussion of the Pennsylvania rule see notes 39-52 *supra* and accompanying text.

130. Dunham, Scott & Wolf, *Revised Uniform Principal and Income Act*, 101 *TRUSTS & ESTATES* 894, 896 (1962). The "reasonably prudent man" proposal was rejected despite the fact that it was supported by Allison Dunham, principal draftsman of the Revised Act. According to Professor Dunham, the desire for certainty was the reason his proposal fell "with a dull thud." Dunham, *Revised Uniform Principal and Income Act*, 102 *TRUSTS & ESTATES* 210 (1963).

for the exercise of the discretion allowed him by the reasonably prudent man rule. The small dividend provision could be used to create a presumption that any distribution of the selected size or less is income and any distribution of more than that size is principal. The presumption raised by the size of the distribution would, unlike that of the small stock dividend rule,¹³¹ be rebuttable; the trustee would have the power to allocate any size dividend to either income or principal when he, acting as a reasonably prudent man, believes it so allocable because of non-size factors.¹³²

The basic drawback to any such provision is the possibility of producing an undesirable volume of litigation resulting from attempts to determine whether trustees have met the standard of care set for them. Older cases dealing with discretionary clauses in the trust instrument have held that, in absence of fraud, bad faith, or purely arbitrary action, the determination of the trustee is binding on the parties.¹³³ Such an interpretation would give the trustee much leeway, and the rule some much-needed certainty. However, in a more recent case, one court held that the trustee's allocation of a twenty per cent stock dividend to principal, under a clause giving him the "duty and power . . . to determine what is income and what is principal . . .,"¹³⁴ was not reasonable. In reaching this striking result, the court relied on the fact that the trustee had to exercise his discretion in accordance with the settlor's intent and the applicable law; her intent was assumed to include the Pennsylvania rule, the law of the state. Since the evidence supported the finding that the stock dividend in question was within the range of earnings accumulated since the inception of the trust, the allocation of the shares to principal was held to be an "abuse of discretion."¹³⁵

131. For a discussion of the small stock dividends rule see notes 89-126 *supra* and accompanying text.

132. Under this alternative he could, for instance, allocate all of a stock dividend of more than six per cent to income if, in his judgment, it was grounded in current earnings. Furthermore, in those hybrid situations in which neither beneficiary is clearly entitled to the dividend—for example, the distribution involved in *Matter of Fosdick*, 4 N.Y.2d 646, 152 N.E.2d 228 (1958) and *Cunningham's Estate*, 395 Pa. 1, 149 A.2d 72 (1959) (100% distribution of which seven-twelfths of par value was capitalized)—he could apportion the distribution, based on his judgment of the situation, so that neither cestui would be entirely excluded.

133. *E.g.*, *Dumaine v. Dumaine*, 301 Mass. 214, 16 N.E.2d 625 (1938).

134. *Estate of Heard*, 107 Cal. App. 2d 225, 226-27, 236 P.2d 810, 812 (1951).

135. *Id.* at 234, 236 P.2d at 816. Since the establishment of the *Heard* trust, California has enacted a law, CAL. CIV. CODE § 730.04, which empowers the settlor to grant discretion to the trustee to ascertain income and principal, and further provides that his ascertainment, where not contrary to law, shall control. In a case governed by this Act, *Estate of Bixby*, 55 Cal. 2d 819, 362 P.2d 43 (1961), a case not involving share dividends, the California Supreme Court has held that the rule in *Heard* no longer controls. This

Court review of the exercise of the trustee's discretion at the insistence of the "injured" beneficiary, and the possibility of liability for an "unreasonable" allocation would produce uncertainty in the rule and hesitation in allocation. Furthermore, it has been suggested that the tremendous pressure certain to be exerted by the various beneficiaries on the trustee, and the fact that corporate trustees tend to be "principal prone" would make the rule administratively unsatisfactory.¹³⁶ In total, these disadvantages seem to outweigh this proposal's inherent flexibility.

CONCLUSION

The acceptance of the Massachusetts rule by a majority of jurisdictions has not quieted the controversy as to the allocation of stock dividends between the life beneficiary and the remainderman. Many critics feel that the acceptance of the Massachusetts rule, which was in large part due to its ease of administration, often results in the life beneficiary receiving little or no benefit from his interest in the trust property.¹³⁷ This point is especially telling when one considers the recent trend toward more and more stock dividends issued entirely in lieu of cash dividends or in addition to reduced cash dividends. In Massachusetts rule jurisdictions, the remainderman will receive all of such distributions.¹³⁸ The proposals made to solve this problem have taken three forms—allocating stock dividends designated as being "in lieu of" cash dividends to the income beneficiary, allocating stock dividends in which the distribution amounts to less than an arbitrary percentage of the shares outstanding to the income beneficiary, and giving the trustee discretion to allocate the stock dividend as he sees fit within the confines of the reasonably prudent man standard. These solutions have a common objective: alleviating the rigidity and bias involved in the Massachusetts rule while avoiding the administrative complexities of the Pennsylvania rule. This latter intention is evidenced by the Revised Act's rejection of a reasonably prudent man provision, as well as the provision making the determination of whether a stock distribution is in lieu of cash dividends rest solely with the corporation.¹³⁹ Another example of the emphasis on

would seem to be a return to the prior case law which made the determination of the trustee final, irrespective of the allocation indicated by the Pennsylvania rule.

136. Flickinger, *supra* note 94, at 242.

137. Barclay, *The Revised Uniform Principal and Income Act*, 101 *TRUSTS & ESTATES* 833 (1962); Niles, *supra* note 98; Scott, *Principal or Income?*, 100 *TRUSTS & ESTATES* 180 (1961).

138. For a discussion of the operation of the Massachusetts rule see text accompanying notes 7-10 *supra*.

139. REVISED ACT § 6(b).

simplicity is the original New York solution,¹⁴⁰ which specifically included stock splits in its provision for giving the first six per cent of all distributions to the income beneficiary. These latter provisions would have obviated the necessity of a determination by the trustee whether a distribution was in fact a split or a dividend, as well as whether it *all* belonged to income or principal.

Because, after their experience with the Pennsylvania rule, the courts will probably require of any solution that it be simple and certain in application, the ultimate solution will not in every case insure the allocation of the shares to the beneficiary to whom they "belong." Some of the "justice" of any new rule must, of necessity, be sacrificed to expediency. The search, then, is not for a solution which will always accomplish perfect justice, but for one which will result in a proper allocation in the great majority of cases while admitting of easy administration.

With such goals in mind, the reasonably prudent man proposal¹⁴¹ seems an improbable choice. Although this solution gives the flexibility required to allocate distributions on the basis of the factors the trustee considers most important in the individual case, the administrative problems would be overwhelming. This provision would require a detailed analysis by the trustee of a distribution, and the allocation would always be open to change upon court review. This could cause problems for the recipient originally selected by the trustee and might result in personal liability for the trustee on a theory of wrongful allocation.

Of the remaining proposals—the "in lieu of" cash dividends alternative¹⁴² and the small stock dividend rules¹⁴³—the former, which was included in the Revised Act, does not, under present financial conditions, adequately protect the interest of the life tenant. Since the determination of whether a stock dividend is in lieu of cash dividends rests with the corporation, it would be unusual for the trustee to investigate the motive behind the distribution, assuming he could do so under the Act. A corporation which issues "in lieu of" share dividends but fails to express its policy for fear of possible investor reaction could effectively deprive a life beneficiary of any meaningful interest in the trust.

In addition to this drawback, this rule may offer no protection to the

140. N.Y. Sess. Law 1963, ch. 1005.

141. For a discussion of this proposed solution and its shortcomings see text accompanying notes 127-36 *supra*.

142. For a discussion of the "in lieu of" cash dividend solution see text accompanying notes 83-88 *supra*.

143. For a discussion of the small stock dividends rule see text accompanying notes 89-126 *supra*.

life tenant against reduced income from "in addition to" share dividends. That is, while all stock dividends expressly issued in lieu of cash dividends are saved to the income beneficiary, the more likely "in addition to" share dividend is allocable to corpus. Thus, the life tenant could be deprived of a large proportion of the benefits from his interest in the trust by the recent corporate practice of using share dividends to supplement reduced cash dividends, thereby retaining cash while maintaining the appearance of an attractive dividend policy.¹⁴⁴

Some type of small stock dividend rule is the most even-handed solution to the allocation problem. This rule retains the "equitable" features of the Pennsylvania rule—giving life tenants nearly all dividends, cash and stock, which are within the range of current earnings—while holding the duties of the trustee to a minimum. Because the allocation is based entirely on the size of the distribution relative to the number of shares outstanding, the rule is practically self-executing once the distribution is made. Ease of administration plus protection of income beneficiaries in a period when trust income is often reduced by the growing practice of issuing stock dividends recommend this solution as the best combination of practicality and fairness.

The problems involved in a small stock dividend rule—(1) what the cutoff line should be, (2) whether this line represents an absolute division between beneficiaries or whether the income beneficiary will always get everything up to the line, and (3) whether all distributions are covered—have workable solutions. Because of its relation to corporate practice,¹⁴⁵ a six per cent line should be adopted. Any smaller figure would limit income interests to distributions which are no more likely to be within current corporate earnings than are six per cent distributions; any larger figure might invade corpus by including hybrids of stock splits and stock dividends. Moreover, the frequency of share dividends issued in the five and six per cent range,¹⁴⁶ and the paucity of those over six per cent, recommend a six per cent cutoff.

The two remaining problems are those raised by the original New York small stock dividend statute's controversial provisions.¹⁴⁷ The six per cent line in New York was not an absolute cutoff point between distributions which went to income and those which went to corpus. Rather, the first six per cent of every distribution would have been allocable to income. This

144. For a discussion of this practice see p. 230 *supra*.

145. For a discussion of recent corporate practice in issuing stock dividends see note 69 *supra*.

146. *Ibid.*

147. N.Y. Sess. Laws 1963, ch. 1005.

made sense until it was combined with New York's other innovation—all corporate distributions are included in the purview of the statute. If an income beneficiary receives the first six per cent of a true stock split, he is actually invading corpus, getting something to which he has no valid claim. Though limiting the statute's coverage to dividends would eliminate this problem, this would again impose upon trustees the task of determining in every case whether a particular distribution is a dividend or a split or something between. The most workable, fair solution is to provide—as the New York legislature did when it reconsidered¹⁴⁸—an absolute dividing line. If the distribution is below this line it should all go to income; if above, it should all go to corpus. If the line accurately reflects current corporate practice, as the six per cent line seems to, the inequities inherent in its arbitrariness will be minimal.

148. N.Y. PERS. PROP. LAW § 27-e(2).