

Trusts - Stock Dividends - Allocation to Income or Corpus

Richard P. Buellesbach

Follow this and additional works at: <http://scholarship.law.marquette.edu/mulr>



Part of the [Law Commons](#)

Repository Citation

Richard P. Buellesbach, *Trusts - Stock Dividends - Allocation to Income or Corpus*, 36 Marq. L. Rev. 124 (1952).
Available at: <http://scholarship.law.marquette.edu/mulr/vol36/iss1/14>

This Article is brought to you for free and open access by the Journals at Marquette Law Scholarly Commons. It has been accepted for inclusion in Marquette Law Review by an authorized administrator of Marquette Law Scholarly Commons. For more information, please contact megan.obrien@marquette.edu.

also give the trustee the advantage of leasing for longer periods to the benefit of both the life beneficiary and the remaindermen, and thereby carry out the purposes of the trust in those instances where a beneficial short term lease cannot be made.

LOUIS R. GILBERT

Trusts — Stock Dividends — Allocation to Income or Corpus — Testator created a testamentary trust, using as corpus 1300 shares of stock. Subsequent thereto a stock dividend was declared, increasing the "corpus" by 1219 shares. The life tenant under the trust brought an action for a declaratory judgment seeking to have the stock dividend declared income so as to be distributable to him. *Held*: In the absence of any intention to the contrary by the settlor, a stock dividend declared at a regular director's meeting to be paid from current earnings becomes part of the corpus, and is not distributable to the life tenant as ordinary income. *Armentrout v. Armentrout*, 100 N.E. 2d 555 (Ohio Probate Court, 1951).

The Ohio court, in the principal case, had little difficulty in justifying its position because of a well-reasoned earlier Ohio decision which had clearly established the law in that state.¹ A study of other jurisdictions, however, reveals at least a four-way split of authority, with some jurisdictions following a modified form of one or the other of the four principal rules.² The Massachusetts rule,³ followed in the principal case, distinguishes between a stock dividend and a cash dividend, and declares that the stock dividend becomes part of corpus while the cash dividend goes to income.⁴ The application of the Massachusetts rule has been held not to be affected by the fact that the stock dividend is a regular dividend, although it would seem that this application of the rule is open to severe criticism.⁵ Having once decided that a particular

¹ *Lamb v. Lehmann*, 110 Ohio St. 59, 143 N.E. 276, 42 A.L.R. 437 (1924).

² This article is limited to a discussion of the disposition of stock dividends in the declaring corporation. No attempt is made to discuss the problems presented by stock rights, liquidating dividends, extraordinary cash dividends, stock dividends in another corporation etc. For an extensive discussion of these problems, see the annotation in 130 A.L.R. 486; 1942 Wis. L. Rev. 299.

³ *Minot v. Paine*, 99 Mass. 101, 96 Am. Dec. 705 (1868).

⁴ This rule has been adopted in the UNIFORM PRINCIPAL AND INCOME ACT, § 5, 9A U.L.A. 233.

⁵ *Rhode Island Hospital Trust Co. v. Tucker*, 51 R.I. 507, 155 Atl. 661, 83 A.L.R. 1253 (1931); modified on rehearing, 52 R.I. 277, 160 Atl. 465, 83 A.L.R. 1259 (1932). Generally stock dividends are considered to be "extraordinary" in nature, i.e., dividends which represent an accumulation of corporate earnings other than those accruing during regular dividend periods, which are not paid at regular intervals, which are unusual in size etc. When, as in this Rhode Island case, the Massachusetts rule is applied to an "ordinary" or "regular" dividend, and it is the policy of the corporation to declare only "regular" stock dividends, the life tenant will be deprived of all benefit in the trust. While in the cited case, the court (on rehearing) did give relief to the life tenant, by stating that it was the duty of the trustee (there

dividend is cash or stock, no consideration is given to the time covered by the accumulation of earnings which the dividend represents, nor is any attempt made to apportion the dividend in the event the earnings it represents accrued partly before and partly after the time when the stock became subject to the life interest.⁶

The Pennsylvania rule,⁷ followed by the Wisconsin Supreme Court,⁸ is concerned primarily with preserving the "intact" value of corpus, rather than with considering the type of dividend (stock or cash) declared.

"The effect of the rule is to give the life tenant the income which has been earned since the trust came into being, but, at the same time, to preserve the value of the corpus as it was at the date of the death of the testator, or, to use a more convenient term, to preserve the intact value of the estate. This intact value includes the par value of the stock, plus any accumulation of income earned before the death of the testator. . . . An extraordinary dividend paid out of accumulated earnings, presumptively belongs to the life tenant, but if it be shown that the distribution impairs the intact value of the estate, the court will make an apportionment."⁹

The Kentucky rule¹⁰ appears to be an amalgamation of the Pennsylvania and the Massachusetts rules. Like the Pennsylvania rule, it rejects the character of the dividend (stock or cash) as the controlling factor, and like the Massachusetts rule, it refuses to inquire as to the time that the earnings covered by the dividend were earned. If the dividend (stock or cash) is declared during the life interest, and does not represent capital, it goes to the life tenant regardless of when the earnings were accumulated. Since this doctrine could easily deplete corpus, it has little support in judicial decisions.¹¹

being no contrary intention expressed in the trust) to sell the stock corpus, and reinvest the proceeds in "income producing" stock, the inequities of the original rule are apparent. Under the RESTATEMENT, TRUSTS, § 236, comment *h*, regular stock dividends belong to income.

⁶ *Supra*, note 3. 130 A.L.R. 486, 524, indicates that there are sixteen jurisdictions, including the United States Supreme Court, which follow the Massachusetts rule.

⁷ *Earp's Appeal*, 28 Pa. 368 (1857), was apparently the first case to adopt a system of apportionment between income and corpus.

⁸ *Estate of Paddock*, 213 Wis. 409, 251 N.W. 229 (1933); *Will of Jenkins*, 199 Wis. 131, 225 N.W. 733 (1929). See also, *Estate of Boyle*, 235 Wis. 591, 294 N.W. 29, 130 A.L.R. 486 (1940); *State ex rel. Coykendal v. Karel*, 215 Wis. 505, 255 N.W. 132 (1934); *Estate of Dittmer*, 197 Wis. 304, 222 N.W. 323 (1928); *Soehnlein v. Soehnlein*, 146 Wis. 330, 131 N.W. 739 (1911).

⁹ *Nirdlinger's Estate*, 290 Pa. 457, 139 Atl. 200, 56 A.L.R. 1303 (1927). 130 A.L.R. 486, 538, indicates that there are twelve jurisdictions which follow the Pennsylvania rule.

¹⁰ *Hublely v. Wolfe*, 259 Ky. 574, 82 S.W. 2d 830, 101 A.L.R. 1359 (1935). The Kentucky rule, however, has since been modified in Kentucky by statute, L. 1950, Sen. B. 147. Stock dividends of the same corporation and the same class and equaling ten percent or more of the outstanding shares are trust capital; otherwise stock dividends are income.

¹¹ Only Kentucky and some early New York cases seem to have clearly approved

The final rule, the English rule,¹² resembles somewhat the Massachusetts doctrine, and repudiates the Pennsylvania concept of apportionment. It seems to be primarily concerned with the intent of the declaring corporation; if that intent was to convert accumulated earnings into capital, the dividend belongs to corpus; if it was to distribute those earnings as profits, then it belongs to the life tenant.¹³ This would appear to be quite similar to the Massachusetts inquiry into whether a dividend is stock or cash.

A brief resumé of the three principal American rules reveals that the Massachusetts rule considers as controlling the external *character* of the dividend; the Pennsylvania rule looks to the *source* of the dividend; and the Kentucky rule is concerned with the *time* the dividend is declared.¹⁴ All rules, of course, are rules of construction, and apply only if a contrary intent of the settlor is not expressed in the trust instrument. A stock dividend earned and declared during the life estate, which does not reduce the book value of corpus, will, under the Massachusetts rule, become part of corpus, while under the Pennsylvania and Kentucky rules, it will be distributed to the life tenant. A similar dividend, earned before the life estate has commenced, will become a part of corpus under the Massachusetts and Pennsylvania rules, but will go to income under the Kentucky rule. If the stock dividend is earned partly before and partly after the commencement of the life estate, Massachusetts will give it to the corpus; Kentucky will distribute it to income; and Pennsylvania will apportion it so as to preserve the intact value of corpus as of the date it became subject to the life estate.¹⁵

Under both the English and Pennsylvania rules, it would seem that an inquiry is necessary into the internal functioning of the corporation, and that regardless of the action of the board of directors, the court

of the Kentucky rule. However, *In re Osborne*, 209 N.Y. 450, 103 N.E. 723, 50 L.R.A. (NS) 510, Ann. Cas. 1915A 298 (1913) reversed the earlier New York cases and followed instead the Pennsylvania rule. In 1926, New York, by statute, adopted in effect the Massachusetts rule. Delaware has "repudiated" the Massachusetts and Pennsylvania rules, and adopted the "American" rule, to which, says the Delaware court, Kentucky has also subscribed. *Bryan v. Aiken*, 10 Del. Ch. 446, 86 Atl. 674, 45 L.R.A. (NS) 477 (1913); *DuPont v. Peyton*, 15 Del. Ch. 255, 136 Atl. 149 (1927).

¹² *Bouch v. Sproule*, 12 App. Cas. 385 (1887).

¹³ *Ibid.* "When a testator or settlor directs or permits the subject of his disposition to remain as shares of stock in a company which has the power either of distributing its profits as dividend, or of converting them in to capital, and the company validly exercises this power, such exercise of its power is binding on all persons interested under the testator or settlor in the shares; and consequently what is paid by the company as dividend goes to the tenant for life, and what is paid by the company to the shareholder as capital, or appropriated as an increase of the capital stock in the concern, inures to the benefit of all who are interested in the capital."

¹⁴ *Long v. Rike*, 50 F. 2d 124, 81 A.L.R. 521 (7th Cir. 1931); cert. den. 284 U.S. 657, 52 S.Ct. 35, 76 L.Ed. 557 (1931).

¹⁵ 33 AM. JUR., LIFE ESTATES, REMAINDERS, AND REVERSIONS, § 381; 130 A.L.R. 486, 558.

could, in the interests of the life tenant, declare that a stock dividend, which is basically a recapitalization of surplus,¹⁶ is instead a "severance" of the surplus in the nature of a cash dividend. Perhaps this "dual" aspect of a stock dividend, on the one hand a recapitalization and on the other hand, a "severance," can in some abstract manner promote "justice" between the life tenant and the remainderman. On the other hand, in a state like Wisconsin, where ordinary cash dividends are apparently payable to the life tenant regardless of their source,¹⁷ it could also work a great injustice. Thus a corporation with a capital investment of \$100,000 and a surplus of \$50,000 at the time of the settlor's death may increase its surplus to \$100,000 and declare a stock dividend of \$50,000. Under the Pennsylvania (and Wisconsin) rule, this would be payable to the life tenant since there was no "entrenchment" on the "intact value" of the corpus as it existed when the trust was created. Should the corporation then pay a series of ordinary cash dividends out of its remaining surplus, which dividends would go to the life tenant,¹⁸ the interest of the remainderman could be reduced considerably below the amount existing at the time the trust was created, and thus presumably violate the settlor's "intent." While this "deficit" could be regained in a "prosperous" year, it is usually the practice of corporations to provide in advance (by adding to surplus or recapitalizing by means of a stock dividend) for the "lean" years. For the courts to intervene and declare that any provision made for the "lean" years is payable to the life tenant, and then to allow the life tenant to collect his dividends during those "lean" years, is to substitute the judgment of the court for the judgment of the board of directors, at the expense of the remainderman.¹⁹

A further objection to the Pennsylvania rule, which objection is also applicable to the Kentucky rule, is that it tends to reduce the proportionate interest and voting power of the trust in the corporation.²⁰ This, however, does not appear to be too valid an objection. There is no rule of law which requires that the voting power of a trust corpus be main-

¹⁶ The principle of recapitalization (as opposed to a "severance") which a stock dividend represents, is recognized in Federal Tax Law. *Towne v. Eisner*, 245 U.S. 418, 38 S.Ct. 158, 62 L.Ed. 372, L.R.A. 1918 D. 254 (1917); *Eisner v. Macomber*, 252 U.S. 189, 40 S.Ct 189, 64 L.Ed. 521, 9 A.L.R. 1570 (1920).

¹⁷ "It may be taken as established in this state that in the absence of directions in the will to the contrary, ordinary cash dividends are considered as income and belong to the life tenant." *Estate of Boyle*, *supra*, note 8; *Estate of Dittmer*, *supra*, note 8.

¹⁸ *Ibid.*

¹⁹ "The Pennsylvania doctrine is not a rule at all, but leaves the chancellor a wide latitude and discretion and permits an utter disregard of well-settled rule pertaining to control by corporations over their net earnings. It results logically and inevitably in substituting the judgment of the court for that of the board of directors, and makes the corporate policies a matter of judicial determination." *Lamb v. Lehmann*, *supra*, note 1.

²⁰ *Hayes v. St. Louis Union Trust Co.*, 317 Mo. 1028, 298 S.W. 91, 56 A.L.R. 1276 (1927).

tained, if the corpus itself is kept intact. Certainly if the corporation issued new stock, giving to the trustee preferential subscription rights, the trustee could not charge the life tenant in order to buy the necessary new stock needed to preserve proportionate voting power. The problem is relegated to the academic level where the trust corpus consists of only a few shares in a large corporation.

The Massachusetts rule, on the other hand, while criticized as a mere rule of expediency and lacking in fundamental justice, does offer a much easier and more logical solution to the problem. It is founded on the premises that a stock dividend is in fact no dividend, but only a recapitalization,²¹ and that the testator "intended" (in the absence of a contrary intent) to abide by the decisions of the board of directors.²² Certainly this "intent" to abide by the decisions of the board of directors would seem to be a sound "presumption" in the case of stock in a large corporation; and in the case of a small, closely-knit corporation, (a fact which certainly must have been known to the testator at the time the trust was created), the testator, if he did not desire to abide by directors' decisions, could quite easily have inserted a contrary provision in the trust agreement. Relief from fraud or collusion on the part of the remainderman and the directors to the detriment of the life tenant, can always be granted by a court of equity. In the great majority of cases, however, there will exist a bona fide board of directors declaring a bona fide stock dividend. The danger of "imposing" upon the life tenant under such circumstances seems indeed remote. Certainly the Massachusetts rule cannot be said to do such violence to the settlor's "intent" as to warrant a repudiation of the basic concept of a stock dividend, an invasion of corporate management by the courts, and the imposition of the complicated computations often necessary to determine the effect of a proposed stock dividend upon the "intact value" of a corpus created many years previously.

RICHARD P. BUELLESBACH

²¹ *Supra*, note 16. "As a matter of logic, it is difficult to resist the reasoning leading to the conclusion that stock dividends are, in fact, principal; for the life tenant, as is universally held, is not, in the absence of fraud or improper conduct, entitled to the earnings until they are distributed. They are not, in fact, distributed, but, on the contrary, put permanently into capital account when new stock is, without any money equivalent, allotted to the whole body of stockholders." *Ballantine v. Young*, 79 N.J.Eq. 70, 81 Atl. 119 (1911).

²² "The Massachusetts rule operates in perfect harmony with the testamentary intent, assuming that when that intent is expressed in general terms there is an implication that corporate policies and the recognized legal relations between the corporation and its stockholders should be the polestar of interpretation." *Lamb v. Lehmann*, *supra*, note 1.