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SOME PROBLEMS OF PRINCIPAL AND INCOME

By
ROBERT BRIGHAM, Esq.*

Corporate Dividends and Share Rights

1. Dividends if payable:
   a. In cash; or
   b. In stock or bonds of a different corporation; or
   c. In property; or
   d. In bonds or scrip of the declaring corporation; or
   e. In stock of the declaring corporation, but of a different kind and rank are declared to be income. (Note: Under the Uniform Principal and Income Act of May 3, 1945, P.L. 416, effective between May 3, 1945 and July 2, 1947, both inclusive, a dividend payable in stock of the declaring corporation was principal, even though the stock was of a different kind or rank.)

2. All dividends payable in stock of the declaring corporation, if of the same kind and rank, are declared to be principal.

Neither the Act of 1945 nor the Act of 1947 can constitutionally be applied to trusts created prior to the effective dates of those acts, so as to make principal of stock dividends which would have been awarded to income under the case law when the trusts were created. Consequently the vast majority of the trusts now in existence are still governed by the case law, not by the statute. This makes necessary a survey of the case law.

Ordinary Dividends

1. If payable in cash, these are income if payable to stockholders of record on a date when the life tenant was entitled to receive the income of the trust. Such a dividend is income even though declared prior to the creation of the trust. Ordinary dividends of investment companies, such as the Wellington Fund are income although paid in part out of capital gains.

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1 (ED. NOTE)—THIS ARTICLE IS AN OUTLINE OF A LECTURE GIVEN AT PHILADELPHIA BY ITS AUTHOR ON FEBRUARY 13, 1952, UNDER THE AUSPICES OF THE PHILADELPHIA BAR ASSOCIATION IN COOPERATION WITH THE COMMITTEE ON CONTINUING LEGAL EDUCATION OF THE AMERICAN LAW INSTITUTE COLLABORATING WITH THE AMERICAN BAR ASSOCIATION. IT IS INCLUDED HEREIN AS IT MAY AFFORD CONSIDERABLE AID TO THOSE WHO WISH TO SECURE A SIMPLIFIED VIEW OF A VERY DIFFICULT SUBJECT OR FOR USE AS A POINT OF DEPARTURE FOR FURTHER RESEARCH.

2 Sec. 3 (1).

3 Sec. 5 (1).


5 Opperman's Estate, 319 Pa. 455.

6 Lovett Estate, 1 Fiduciary Reporter 543.
2. If payable in stock of any kind, the Pennsylvania cases are not clear. Usually however, they can easily be shown to have been declared out of current earnings and therefore are income.

3. What are ordinary dividends? Dividends are "ordinary" if paid at customary rates and uniform intervals, or as periodic declarations involving small sums or rates.  

**Extraordinary Dividends**

An extraordinary dividend has been defined as one which is unusual in form and amount and paid at irregular intervals. Dividends payable in stock are treated as extraordinary dividends. The main objective of the Pennsylvania rule is very simple, 

\[ \text{viz: To award to income so much of the dividend as represents earnings accumulated by the corporation after the shares of stock came into the trust.} \]

If this can be done without impairing the "intact value" of the shares held by the trustee as principal. To give an example:

Testator died June 15, 1930, leaving 100 shares of common stock of XYZ Corporation in trust to pay the income to A for life, with remainder to B. On this date, namely June 15, 1930, the balance sheet of the corporation showed:

| Capital (Consisting of 1,000,000 shares of common stock) | $100,000,000 |
| Surplus ....................................................................... | 50,000,000 |
| **$150,000,000** |

Book value of common, per share ................................ $150  
Book value of 100 shares held by trustee ....................... $15,000  

The latter figure, $15,000, is the "intact value" of the 100 shares held in this trust.

Now let us suppose that on November 1, 1937, when the surplus has grown to $95,000,000, the corporation declares a 50% stock dividend, as a result of which the trustee receives 50 additional shares of stock, bringing his total holdings to 150 shares. After giving effect to the distribution of this stock dividend, the balance sheet of the XYZ Corporation now reads as follows:

| Capital (Consisting of 1,500,000 shares of common stock) | $150,000,000 |
| Surplus ....................................................................... | 45,000,000 |
| **$195,000,000** |

Book Value per share .................................................. $130  
Book Value of $150 shares held by trustee ....................... $19,500  
Intact Value of original 100 shares ............................... $15,000  

Excess over intact value (to be awarded to income) .......... $ 4,500

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8 Earp's Appeal, 28 Pa. 368.  
9 Nirdlinger's Estate, supra.  
10 Waterhouse's Estate, 308 Pa. 422.
Obviously, therefore, the entire 50 shares received as a stock dividend cannot be awarded to income, for this would leave the trustee holding the original 100 shares now having a book value of $130 each or a total of $13,000 for the 100 original shares, and thereby impairing intact value by $2,000. Therefore it is necessary to award to principal sufficient new shares, at $130 each, to make good this impairment. This requires the award of 15.38 shares to principal (130 x 15.38 equals $2,000) and leaves 34.62 shares for income (130 x 34.52 equals $4,500).

The foregoing is an outline, in simplified form, of the method of apportioning an extraordinary stock dividend. The same method is applied whether the extraordinary dividend was paid in cash, shares of stock of the same corporation, shares of stock of another corporation, scrip or dividend obligations, or liberty bonds. However, even the court sometimes gets into trouble as, for example, in Nirdlinger's Estate, 327 Pa. 160, where it is said at page 170:

"Practical difficulties sometimes make apportionment of even an extraordinary cash dividend impossible, and for this reason it becomes a discretionary matter."

Proceeds of Sale of Stock by Trustee

Under Section 3 (2) of the Principal and Income Acts of 1945 and 1947, if the trustee sells stock the proceeds are declared to be entirely principal. These acts, however, do not apply to any trust created prior to May 3, 1945.\textsuperscript{11}

In Nirdlinger's Estate, 290 Pa. 457, it was held for the first time in Pennsylvania that the life tenant was entitled to receive so much of the proceeds of a sale of stock as he could show to be attributable to earnings accumulated by the corporation during the time the stock was held by the trustee, provided that the intact value of the trustee's investment was maintained.

Suppose the testator, as in the previous example, died June 15, 1930 leaving 100 shares of common stock of XYZ Corporation in trust and, as before, the balance sheet of the corporation on that date showed capital of $100,000,000 (represented by 1,000,000 shares of common stock) and surplus of $50,000,000. As before, the intact value is $150 per share or $15,000 for the 100 shares held by the trustee. Let us suppose that on November 1, 1937 the trustee sells the stock. At this date the balance sheet reads:

\begin{tabular}{ll}
Capital (consisting of 1,000,000 shares of common stock) & $100,000,000 \\
Surplus & 95,000,000 \\
\hline & $195,000,000 \\
\end{tabular}

It will be observed that the surplus has increased by $45,000,000 during this time and it will be assumed that this was due to accumulated earnings and not to write-ups or similar transactions. Under these circumstances, what the life tenant gets will depend on the price at which the trustee sold the stock. The increase in

\textsuperscript{11} Crawford Estate, \textit{supra}. 
surplus amounted to $45,000,000 or $45 per share and this places an automatic
limit on the life tenant. Moreover, intact value, which is $150 per share, must be
preserved at all events. Consequently

<table>
<thead>
<tr>
<th>If the trustee sold at</th>
<th>Income will get</th>
</tr>
</thead>
</table>
| $150 a share or less  | Nothing. All the proceeds are needed to pre-
|                       | serve intact value.              |
| $175 a share          | $25 a share. The balance is needed to preserve
|                       | intact value.                    |
| $195 a share          | $45 a share—the amount of the accumulated
|                       | earnings.                        |
| $250 a share          | $45 a share—The balance does not represent ac-
|                       | cumulated earnings.              |

Other Transactions

By similar methods the proceeds of other transactions are apportioned so as to
give the income beneficiary the benefits of income accumulated by the corporation.

This applies to:

1. Under Section 5 (2) of the Principal and Income Acts of 1945 and 1947,
   all rights to subscribe to the stock of the same corporation are made principal,
   but rights to subscribe to the stock of a different corporation are made income.
   These acts, however, do not apply to any trust created prior to May 3, 1945.12
   Under our cases rights to subscribe to stock of the same corporation are apportion-
   able, whether the rights are exercised or sold.13 However, our earlier cases hold
   that rights to subscribe to stock of a different corporation are income as a matter
   of law.14

2. Proceeds of liquidation. Under Section 5 (3) of the Principal and Income
   Acts of 1945 and 1947, when the corporation is wholly or partially liquidated,
   all of the proceeds are principal except such as are actually paid as dividends. Under
   the cases, however, the life tenant can get such part of the proceeds as represents ac-
   cumulated earnings, even though not paid as dividends.15

   However, certain transactions do not entitle the life tenant to any apportion-
   ment. For example:

   1. A corporate merger resulting in an exchange of stock.16
   2. The termination of the trust does not entitle income to an apportion-
      ment of stocks having accumulated earnings.17

12 n. 4.
13 Jones v. Integrity Trust Co., 292 Pa. 149; Waterhouse's Estate, 308 Pa. 422; Hostetter's Trust,
   319 Pa. 572.
14 Eisner's Appeal, 175 Pa. 143; Kemble's Estate, 201 Pa. 523; Wiltbank's Appeal, 64 Pa. 256.
15 Connolly's Estate, 198 Pa. 137; McKeown's Estate, 263 Pa. 78; Lewis Estate, 351 Pa. 576.
16 Buist's Estate, 297 Pa. 537; King Estate, 349 Pa. 27.
17 Daily's Estate, 323 Pa. 42.
3. An extraordinary dividend declared after the termination of the trust is not apportionable.\textsuperscript{18}

**Successive life tenants**

It sometimes happens that during the running of the trust there will be a series of life tenants. In a later life tenancy, the trustee may receive a large stock dividend or sell stock at a large profit. In such cases, an apportionment among the succeeding life tenants may be required.\textsuperscript{19}

**Preferred Stock Distributions**

During depression times many cumulative preferred stocks paid no dividends. In one case, a trustee held such stock having a substantial total of dividend arrearages, most of which accrued before the death of the testator. Thereafter, these were paid out of subsequently accruing earnings and were awarded to the life tenant.\textsuperscript{20}

In other cases, the unpaid preferred dividends were discharged as a by-product of a corporate reorganization. The court, after much vacillation, managed to give the life tenant something as partial compensation for the unpaid preferred dividends. Since the status of this problem is far from clear, I can only refer you to the cases and wish you luck: *Fisher's Estate*, 344 Pa. 607; *King Estate*, 349 Pa. 27; *King Estate*, 355 Pa. 64; *King Estate*, 361 Pa. 629.

Section 5 (4) of the Principal and Income Act of 1947 attempts to cope with the problem by giving the life tenant (1) such portion of the new securities as are designated by the corporation as being in payment of the dividend arrearages or (2) if such designation is not made, the new securities are allocated first to principal in an amount sufficient to cover the inventory value or cost of the original shares and second to the dividend arrearages, any balance remaining being awarded to principal.

**General Conclusions**

The Pennsylvania rules are theoretically perfect, but practically difficult to apply. I have been able only to indicate the outlines of the subject. To go into all of the numerous refinements found in the cases would require a series of lectures and you would be exhausted. These refinements concern subjects like the determination of capital gains to be added to intact value and capital losses to be deducted therefrom; what constitutes earnings; the effect of certain corporate accounting practices and similar matters of detail. A more complete discussion will be found in 85 Univ. of Penna. L. Rev. 358 (1937) to which I refer you for my views. Since that time, there have been additional decisions, as follows:

\textsuperscript{18} Green v. Philadelphia Inquirer, 329 Pa. 169.
\textsuperscript{19} Neafie's Estate, 325 Pa. 561.
\textsuperscript{20} Crozer's Estate, 27 D & C 179 (O.C. Del. Co.) 1936.
What can the Settlor or Testator Do about this?

In any trust created prior to September 1, 1939, the testator's freedom to provide his own rules for determining what is principal and what is income was limited to directing that all extraordinary dividends, rights to subscribe and the like be turned over to the income beneficiary. He could, of course, have given the entire trust property to the life tenant outright and therefore he could give him all extraordinary dividends. However, if he directed, for example, that all extraordinary stock dividends should be principal, such a direction would violate the statute against accumulations, unless the remainderman was a charity for whom accumulation of income is permitted.

By the Act of May 25, 1939, P.L. 201 (effective September 1, 1939 but applying only to trusts created on or after that date) the testator or settlor was authorized to direct that all extraordinary dividends, profits on the sale of stock, etc. should be deemed to be principal.

By Section 6 (8) of the Estates Act of April 24, 1947, P.L. 100 (effective January 1, 1948 and applying to trusts created on or after that date), the creator of the trust may direct that extraordinary dividends and rights to subscribe to stock shall be deemed principal in whole or in part. Under Section 3 (2) of the Principal and Income Act of 1947, profits on sales of stock are deemed principal unless the trust instrument directs otherwise. By Section 2 of the same act, the creator of the trust may authorize the trustee to allocate all such items in his discretion.

Of course, any will or deed of trust executed at this time is governed by the Principal and Income Act of 1947 and, if the trust instrument is silent, the provisions of that act will determine what is principal and what is income. A summary of these provisions, so far as they relate to corporate shares and their proceeds has been given above. In my opinion these provisions are perhaps a little hard on the income beneficiary although they are more favorable to him than the corresponding provisions of the Uniform Principal and Income Act of 1945. By far the most common extraordinary dividend is one declared in the stock of the corporation of the same kind and rank as the stock held by the trustee. Under the Act of 1947, all such distributions are made principal unless the creator of the trust directs otherwise.

21 Maris's Estate, 301 Pa. 20.
22 Ferguson Trust, 354 Pa. 367.
On the other hand, it is by no means easy to draft any testamentary provisions on the subject which are free from serious objection. The following types of testamentary provisions, among others, may be considered:

1. A direction that the case law prior to the Principal and Income Act shall govern. This is theoretically perfect because the rules established by the decided cases work exact justice as between life tenant and remainderman, so far as this is humanly possible. In practice, however, the rules are somewhat difficult to apply. Each one of the cases decided by the Supreme Court, and many that never reach that court, involve long costly and sometimes vexatious litigation.

2. A direction that all dividends, whether ordinary or extraordinary and whether paid in cash, stock or other property, together with all rights to subscribe to stock, shall be deemed income but that all proceeds of sales of stock shall be principal. This is a very simple formula, which can be applied automatically by the trustee without submitting any questions to the court and without any expensive accounting services. It is liberal to the income beneficiary but gives the remainderman substantial protection by assuring to him all capital gains made by the sale of stocks. However, it has one drawback, which may be serious in some cases. Suppose on November 1, the corporation declares a 50% stock dividend, payable to stock of record on November 15. If the trustee holds the stock and gets the dividend, the suggested formula will award the entire dividend to the life tenant, clearly and without any question. However, if the trustee, instead of holding the stock, sells it on November 10 before it goes ex dividend, the formula will award the entire proceeds of the sale to the principal of the trust. It is obvious, therefore, that this formula gives the trustee the power to determine the allocation. If he holds, he favors the life tenant and if he sells he favors the remainderman. This could lead to accusations of favoritism no matter what the trustee does or does not do.

3. A direction that the trustee may, in his discretion, allocate between principal and income all extraordinary dividends whether payable in cash, stock or other property, all rights to subscribe and all profits on the sale of stock. This formula leaves the trustee squarely "in the middle." How should he exercise his discretion? Would it be an abuse of discretion if he failed to follow common law principles on the one hand, or the rules of the Principal and Income Act on the other? If so, the formula really accomplishes nothing. In any event, the formula provides a fertile field for accusations of bad faith or favoritism on the part of the trustee.

4. A direction that all dividends of every kind, all rights to subscribe to stock and all profits on the sale of stock shall be income. This is very simple but it gives the remainderman no protection whatever. Such a formula might be used in the rare cases where the life tenant is really the sole object of the testator's concern, although he wishes to protect the life tenant by a spend-thrift trust, and where he regards the remainderman as merely a dumping ground for what remains after the life tenant passes on.
5. Of course, one could avoid the entire situation by merely directing that his trustee should not retain or invest in common stocks. However, this remedy is too drastic for the disease and the chances are ten to one that, in all cases where the parties were of full age and fully ascertained, the life tenant and the remainderman would get together and authorize the trustee to invest in corporate common stocks notwithstanding the provisions of the trust instrument.

The precise type of direction to be employed in any particular case depends on the wishes of the creator of the trust, in the light of the particular facts. There is no simple formula which can be used in every case to dispose of these questions.

Wasting Assets

Wasting assets are those which depreciate inevitably in the course of time.

The most common type of wasting assets is a natural resource, such as a coal mine, oil or gas well, slate or stone quarry, etc. Proceeds from such a resource cease upon exhaustion of the resource. When such a resource is held in trust, a problem of allocation of its proceeds between principal and income is presented.

Pennsylvania is a pioneer in this branch of the law. From a very early date natural resources of this kind have been held, either in legal life estates, or in trust for life of A with remainder to B. Therefore the rules by which the receipts derived from such resources have been allocated between income and principal have been well worked out and long established. They have become settled rules of property in this state.23 These rules may be summarized as follows:

1. All royalties derived from such an asset are income if:
   a. The mineral lease or contract was owned by the testator;24 or
   b. The mine or oil well was opened at the time of the creation of the trust although the particular lease was made by the trustee;25 or
   c. Even though no mine or well was opened at the creation of the trust, the trustee was given power to execute a mineral lease26 or was given merely a power to lease real estate generally.27
   d. The foregoing rules apply even though the agreement made by the trustee, even though called a lease, is technically a sale of the coal or other minerals.28
   e. Dividends on the stocks of corporations engaged in the exploitation of natural resources may be awarded to income without requiring the maintenance of any depletion reserve.29

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23 McFadden's Estate, 224 Pa. 443; Knox's Estate, 328 Pa. 177, 183.
25 McFadden's Estate, supra.
26 Eley's Appeal, 103 Pa. 300; Shoemaker's Appeal, 106 Pa. 392; Bedford's Appeal, 126 Pa. 117.
27 Wentz's Appeal, 106 Pa. 301; McClintock v. Dana, 106 Pa. 386.
28 McClintock v. Dana, 106 Pa. 386.
29 Knox's Estate, 328 Pa. 177; Crozer's Estate, 336 Pa. 266; Pardee's Estate, 343 Pa. 79.
2. On the other hand, all royalties from a mineral lease if (a) the mine or well was not opened in the lifetime of the testator and (b) the trustee was given no power to execute a mineral lease or to lease real estate generally. A general power of sale of real estate is not the equivalent of a power to lease.\(^{30}\)

In passing it may be remarked that when a Pennsylvania trustee has mineral lands in another state, say Illinois, the laws of that state determine whether or not the trustee could make a valid mineral lease, but the allocation of the royalties therefrom, as between income and principal of the trust, is a matter which is governed by the law of Pennsylvania.\(^{31}\)

Such are the common law rules. As pointed out above, they have become established rules of property and therefore they cannot be changed by the legislature so as to apply to trusts already in existence. With this reminder, we therefore turn to the statutory changes.

The first statute to consider is Section 9 of the Uniform Principal and Income Act of May 3, 1945, P.L. 416, which was in effect from that date to its appeal on July 3, 1947. It can constitutionally apply only to trusts created during that interval. It provides that in the absence of contrary directions in the trust instrument, the proceeds from a natural resource are income if received as rent on a lease but are principal if received as consideration for the permanent severance of the natural resource from the land. Inasmuch as the vast majority of the coal, oil, gas and mineral contracts in this state, although called leases, are in reality sales of the minerals, this statute completely reverses our case law in the trusts to which it applies. If it were applied to trusts created before its passage, life tenants would find their income drastically reduced in many cases. Before May 3, 1945, they would have got practically everything and after that date they would get practically nothing.

This statute was revised in the Principal and Income Act of July 3, 1947, P.L. 1283, Section 9. This section applies only to trusts created after that date (See Section 15 of the same act). It provides, in the absence of contrary directions in the trust instrument, as follows:

1. One third of the net proceeds from natural resources if received as rent or payment on a lease, or as royalties, shall be income and the balance shall be principal. An exception is made where the surviving spouse of the creator of the trust is the sole life tenant, in which case such spouse gets such share of the net proceeds as he or she would receive under the Intestate Law, but not including the $10,000 allowance.

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\(^{30}\) Bruner Estate, 363 Pa. 552.

\(^{31}\) n. 30.
2. If the net proceeds are received as consideration for the permanent severance of the resources from the land and are payable otherwise than as rents or royalties they shall be deemed principal. (Note: Even though the so called lease made by the trustee may be technically a sale, as most are, if the consideration takes the form of rents or royalties the life tenant will be entitled to share under Rule 1).

Conclusion

Obviously it is impossible to discuss in a brief time and to consider in all its details and ramifications the question of what receipts are income and what are principal and what expenses are chargeable against income and what are chargeable against principal.

I must refer you to the Principal and Income Act of July 3, 1947, P.L. 1283 where you will find many rules set forth. With the exceptions of receipts derived from corporate stocks and from natural resources, I see no reason why this act cannot constitutionally be applied to all trusts, no matter when created. I do not think that the case law on the other subjects covered by the act has established rules which have attained to the dignity of rules of property and, if I am correct in this, there is no reason why the act should not have general application.