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LEGAL, TAX AND ACCOUNTING ASPECTS OF FIDUCIARY APPORTIONMENT OF STOCK PROCEEDS: THE NON-STATUTORY PENNSYLVANIA RULES

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This Article considers the legal, tax and accounting aspects of the non-statutory Pennsylvania rules of apportionment between income and principal of trustees' receipts from the sale of or distributions based upon stock investments.[1] Since the new statutory apportionment rules of the Pennsylvania Principal and Income Act[2] apply only to interests created after 1945,[3] non-statutory rules will continue to play

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1. Similar problems of apportionment arise in situations where businesses are held in trust for the benefit of an income beneficiary, where unproductive real estate is kept in trust pending "salvage operations" and where stock in wasting asset companies is held by the trust. These problems, although similar in that they require apportionments, are somewhat different in their bases of treatment and, therefore, are not considered. Most apportionment problems involve life tenants, but an apportionment can arise in the similar case of an estate for years or a legal life estate. Distinctions have been suggested; see, *e.g.*, 2 SCOTT, TRUSTS 1261 (1939), but neither the National Conference of Commissioners on Uniform State Laws, nor the *Restatement of Trusts* make any distinction; see RESTATEMENT, TRUSTS § 236 (b) (1935); NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, HANDBOOK 328-37 (1931).

2. PA. STAT. ANN. tit. 20, § 3470 (Purdon Supp. 1956), substantially reenacted the Uniform Principal and Income Act, PA. STAT. ANN. tit. 20, § 3471 (Purdon Supp. 1956).

3. Warden Trust, 382 Pa. 311, 115 A.2d 159 (1955); Steele Estate, 377 Pa. 250, 103 A.2d 409 (1954); Crawford Estate, 362 Pa. 458, 67 A.2d 124 (1949); Pew Trust, 362 Pa. 468, 67 A.2d 129 (1949); Note, 99 U. PA L. REV. 864, 865 (1951).

an energetic part in the law of apportionments in this state. And although the discussion centers on Pennsylvania decisions the problems, their analysis, and the mechanics of their solution are common to all states concerned with apportionments.[4]

Exploration into this changing area of the law will be divided into five segments: a survey of basic concepts and policy considerations; an analysis of qualifying apportionment events; a study and review of specific problems of the present apportionment situation; a review of the tax aspects of apportionment distributions; and, finally, an exploration of changes and nuances in the law of trusts occasioned by apportionment problems. The terminology used is that of testamentary trusts, for most of the cases involve decedents estates; but the principles discussed apply equally to the administration of inter vivos trusts.[5]

I. Basic Concepts

Pennsylvania apportionment rules have an Alice-in-Wonderland-like quality which makes the area a fertile field for litigation.[6] They seem designed to prove that the "truth" is what the proponent proposes, with the result that the truth too often depends upon expedient corporate accounting practices.

The leading American case requiring an apportionment of trustees' receipts from stock is *Earp's Appeal*[7] in which the testator had be-

4. For discussion of other jurisdictions which follow or have followed the Pennsylvania rule, see Nemmers, *Key Problems in the Apportionment of Increase Between Successive Interests in Personalty,* 41 Mich. L. Rev. 815, 827 (1943); 3 Scott, Trusts §§ 236.3, 241A (2d ed. 1956); Restatement, Trusts § 236 (Supp. 1948).

5. Brigham, *Allocation of Receipts of Shares Held in Trust,* 85 U. Pa. L. Rev. 358, 360 (1937).

6. By 1937 there had been 50 apportionment cases decided by the Pennsylvania Supreme Court alone. Faught, *Statutory Solution of the Problem of Allocation Between Life Tenant and Remainderman,* 11 Temp. L.Q. 139, 141 (1937).

7. 28 Pa. 368 (1857). This is the origin of the Pennsylvania rule of apportionments. Insofar as it concerns corporate distributions, the rule has had a wide acceptance, and prior to 1935 was followed in a majority of jurisdictions and in the 1935 version of the *Restatement of Trusts.* Restatement, Trusts § 236 (1935); Restatement, Trusts § 236 (Supp. 1948). In recent years, however, the trend has been toward the contrary Massachusetts rule in which the form of the distribution and not its source controls. This reversal has been due partially to judicial decisions and partly to the enactment by eighteen states of the Uniform Principal and Income Act, 9A Uniform Laws Ann. 80 (Supp. 1956), which follows the Massachusetts rule. This trend is manifested by the 1947 amendment to the *Restatement of Trusts,* which substitutes the Massachusetts rule for the Pennsylvania rule. Restatement, Trusts 940-42 (Supp. 1948); 3 Scott, Trusts 1816 (2d ed. 1956). Insofar as proceeds from the trustee's sale of stock are concerned, the rule has been accepted only in Pennsylvania. 3 Scott, Trusts 1837-38 (2d ed. 1956); *cf.* Restatement, Trusts § 233, comment *b* (1935). Moreover, no courts have followed the principle of *Earp's Appeal* to what Professor Scott calls "its ultimate logical conclusion [and] treat the earnings of the corporation as for all purposes as income to the shareholders." 3 Scott, Trusts 1818 (2d ed. 1956). The Pennsylvania rule has been supported for its fairness, but criticized for its unwieldiness, while the Massachusetts rule most often is justified because of its simplicity. 3 Scott, Trusts 1817-19 (2d ed. 1956). See Howes, The American Law Relating to Income and Principal (1905) for an early discussion of the various rules.

queathed shares of stock in trust for life with power of appointment in the life tenant. At testator's death, the corporation had a capital of $200,000 and surplus of approximately $300,000; thereafter in 1854, when surplus had increased to $714,000, the corporation declared a 150 per cent stock dividend which increased capital to $500,000. The auditor awarded the entire stock dividend to the life tenant, but the orphans' court held that "there [should] be taken as part of the principal and residue of the estate, to be held in trust, so many of the shares issued at the increase of the capital . . . in 1854, as shall be equal to the *value* of the five hundred and forty shares of the stock held by the trustees *at the testator's death*." [8] The decree was affirmed unanimously by the Pennsylvania Supreme Court on the theory that the life tenant's interest commenced only at the death of the testator and, therefore, he had no right to earnings accumulated prior thereto. On the other hand, earnings thereafter were " 'income' within the meaning of the will," [9] not merely because the earnings accumulated during the trust period but, more importantly, because that was construed to be the testator's intention.[10]

Apportionment is thus intended to preserve the initial trust corpus, called intact value, and yet give to the life tenant the equivalent of earnings retained by a corporation during the period of the trust's ownership of the stock.[11] Before a distribution can be made to the life tenant, however, there must first occur an apportionable event. The key concepts, therefore, are "intact value," "earnings," and "apportionable event."

In applying these concepts, certain judicial predispositions exist. The testator's intent controls where clear,[12] if it does not direct an un-

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8. 28 Pa. at 372.

9. *Id.* at 374.

10. The limitation to earnings retained during the trust period conflicted, in a sense, with the common-law rule that dividends are earned only when declared. This rule had formed the basis of the life tenant's case, since the dividend was declared and presumably earned only after the death of the testator. However, the court rejected this concept as being based on convenience and subject to variation where the purposes of justice so required.

11. See, *e.g.*, Steele Estate, 377 Pa. 250, 253, 103 A.2d 409, 411 (1954); Waterhouse's Estate, 308 Pa. 422, 427-28, 162 Atl. 295, 296 (1932); Nirdlinger's Estate, 290 Pa. 457, 463, 464, 470, 139 Atl. 200, 202, 203, 205 (1927); Stokes' Estate (No. 1), 240 Pa. 277, 284-87, 87 Atl. 971, 974-75 (1913); Frick Estate, 4 Pa. D. & C.2d 247, 257 (Orphans' Ct. 1955); Fownes Trust, 3 Pa. D. & C.2d, 637, 644 (Orphans' Ct. 1955); Damrau, *Apportionment of Stock Dividends in Trusts Created Prior to* 1945, 15 U. PITT. L. REV. 34, 43 (1953).

12. Crozer's Estate, 336 Pa. 266, 270, 9 A.2d 535, 537 (1939); Knox's Estate (No. 1), 328 Pa. 177, 182, 195 Atl. 28, 31 (1937); Boyer's Appeal, 224 Pa. 144, 153, 73 Atl. 320, 323 (1909); Robinson's Trust, 218 Pa. 481, 486, 67 Atl. 775, 777 (1907); Jordan Estate, 83 Pa. D. & C. 1, 10 (Orphans' Ct. 1952). See also RESTATEMENT, TRUSTS § 236, comment *b* (1935); Annots., 130 A.L.R. 492, 509 (1941), 44 A.L.R.2d 1277, 1281 (1955); Faught, *supra* note 6, at 150-52.

lawful disposition.[13] But where this intention is not expressed with sufficient specificity[14] or is considered unclear,[15] courts utilize certain presumptions to define the intent[16] which they will apply unless it is affirmatively shown that a contrary intention was expressed.[17] Moreover, life tenants are favored,[18] especially where they are the "primary concern of the testator's bounty,"[19] *i.e.*, wives and children.[20]

A. *Intact Value*[21]

Intact value represents that value assigned to the initial corpus or subsequently purchased stock which must be preserved prior to any distribution to the life tenant. This illusive term has seen much varia-

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13. *E.g.*, problem of accumulations in violation of PA. STAT. ANN. tit. 20, § 3251 (Purdon 1930) (repealed, *id.* tit. 20, § 3251 (Purdon Supp. 1956)). See, *e.g.*, Warden Trust, 382 Pa. 311, 315, 115 A.2d 159, 161 (1955); Maris's Estate, 301 Pa. 20, 23, 151 Atl. 577, 578 (1930); Quay's Estate, 253 Pa. 80, 82, 97 Atl. 1029, 1030 (1916); See also 3 SCOTT, TRUSTS §§ 235A, 236.15 (2d ed. 1956).

14. ". . . in every case the intention of the settlor of the trust, so far as it can be ascertained, must control. 'The intent of the grantor, or testator, is the pole-star, and will be carried out by the court' . . . ." Robinson's Trust, 218 Pa. 481, 486, 67 Atl. 775, 777 (1907); see also Jones v. Integrity Trust Co., 292 Pa. 149, 156, 140 Atl. 862, 864 (1928); Flaccus's Estate, 283 Pa. 185, 129 Atl. 74 (1925); Yates Estate, 281 Pa. 178, 185, 126 Atl. 254, 256 (1924); Boyer's Appeal, 224 Pa. 144, 153, 73 Atl. 320, 323 (1909); Spring's Estate, 216 Pa. 529, 533, 66 Atl. 110, 111 (1907); Annots., 130 A.L.R. 492, 509 (1941) and cases cited therein, 44 A.L.R.2d 1277, 1281 (1955) where it is said to be "well settled that the expressed intention of the trust settlor or testator will be given controlling effect in determining whether dividends or other corporate distributions should be regarded as income or principal for purposes of allocaton in a trust estate." *Cf.* Opperman's Estate (No. 1), 319 Pa. 455, 459, 179 Atl. 729, 732 (1935); Crozer's Estate, 336 Pa. 266, 9 A.2d 535 (1939), where the court stated, "In apportionment cases, under our settled rules, the rights of the parties must be determined in the light of the intent of the creator of the trust when it is possible to ascertain his purpose from the instrument creating the trust and the surrounding circumstances." *Id.* at 270, 9 A.2d at 537; 3 SCOTT, TRUSTS § 236.15 (2d ed. 1956); RESTATEMENT, TRUSTS § 236, comment *b* (1935).

15. See 3 SCOTT, TRUSTS 1819, 1846-48 (2d ed. 1956); Annot., 44 A.L.R.2d 1277, 1298 (1955).

16. Jordan's Estate, 83 Pa. D. & C. 1 (Orphans' Ct. 1952) and cases cited therein.

17. Waterman's Estate, 279 Pa. 491, 124 Atl. 166 (1924). In the great majority of instances, however, the testator or settlor uses general language and the judical rules of construction are applied. See Annot., 130 A.L.R. 492, 512 (1941).

18. Nirdlinger's Estate, 331 Pa. 135, 138, 200 Atl. 656, 657 (1938); Nirdlinger's Estate (No. 2), 327 Pa. 171, 173-74, 193 Atl. 30, 31-32 (1937); Neafie's Estate, 325 Pa. 561, 570, 191 Atl. 56, 60-61 (1937); Park's Estate, 173 Pa. 190, 195, 33 Atl. 884, 885 (1896). See also 3 SCOTT, TRUSTS 1820 (2d ed. 1956); Trachtman, *Use of Principal for Life Beneficiaries*, 83 TRUSTS & ESTATES 444 (1946); *Apportionment—Stock —Income Beneficiaries Favored*, Fiduciary Review, Jan. 1944, p. 3.

19. Steele Estate, 377 Pa. 250, 253, 103 A.2d 409, 411 (1954).

20. Crozer's Estate, 336 Pa. 266, 270, 9 A.2d 535, 537 (1939); Opperman's Estate (No. 1), 319 Pa. 455, 459, 179 Atl. 729, 732 (1935); Geyelin's Estate, 29 Pa. D. & C. 296, 304 (Orphans' Ct. 1937).

21. See generally Brigham, *supra* note 5, at 361; Damrau, *supra* note 11, at 43; Annot., 130 A.L.R. 492, 543 (1941).

tion in definition. It has been described as market,[22] appraised,[23] inventoried,[24] actual,[25] real and intrinsic value.[26] However, recent cases involving decedent-owned stock are consistent in holding that intact value is the adjusted book value at the testator's death,[27] unless it can be shown that the factors comprising book value are not true values.[28] And *Arrott's Estate*[29] lately resolved a hitherto vague issue[30] by holding that the intact value of trustee-purchased stock is cost.[31]

The inconsistency of using cost to determine intact value for trustee-purchased shares, but book value for decedent-owned shares, is

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22. Earp's Appeal, 28 Pa. 368, 371 (1857); Philadelphia Trust, Safe-Deposit & Ins. Co.'s Appeal, 16 Atl. 734 (Pa. 1889).

23. Quay's Estate, 253 Pa. 80, 83, 97 Atl. 1029, 1030 (1916).

24. "To preserve the shares at the inventoried price. . . ." Mandeville's Estate, 286 Pa. 368, 372, 133 Atl. 562, 563 (1926).

25. "The market value may aid in the ascertainment of the actual value. . . ." Boyer's Appeal, 224 Pa. 144, 152, 73 Atl. 320, 323 (1909); Moss' Appeal, 83 Pa. 264, 271 (1877).

26. Dickinson's Estate, 285 Pa. 449, 455, 132 Atl. 352, 354 (1926); "It is the intrinsic value . . . which governs. . . ." Smith's Estate, 140 Pa. 344, 357, 21 Atl. 438, 440 (1891).

27. Flinn's Estate, 310 Pa. 206, 211, 165 Atl. 31, 33 (1932); Waterhouse's Estate, 308 Pa. 422, 427, 162 Atl. 295, 296 (1932); Baird's Estate, 299 Pa. 39, 42, 148 Atl. 907, 908 (1930); Mallory's Estate, 285 Pa. 186, 191-92, 131 Atl. 714, 715-16 (1926); Fox's Trust Estate, 53 Pa. D. & C. 1, 6 (Orphans' Ct. 1945). For purposes of this Article the term "book value" refers to adjusted book value unless otherwise indicated.

28. King Estate, 355 Pa. 64, 68, 48 A.2d 858, 861 (1946). But the use of market value as intact value of decedent-owned stock has some foundation in logic. Thus the rule is expressed in some cases that where a gift is in general terms, comprising no specific items of property, there is an implied conversion into cash which establishes an intact value indicative of cash (*i.e.*, market) value. Park's Estate, 173 Pa. 190, 193, 33 Atl. 884 (1896); Jordan Estate, 83 Pa. D. & C. 1, 13 (Orphans' Ct. 1952). This rationale is especially persuasive if one considers that, when a testamentary trust is established sometime after death and completion of the executorship, the intact value may be determined as of the time the trust is created. Frick Estate, 4 Pa. D. & C.2d 247 (Orphans' Ct. 1955). Further, if the executor has converted the testator's assets into cash following the testator's death, and that cash had then been used to fund the trust, the intact value would be the conversion (market) value and not book value. It might also be significant that the trustee is surcharged on the basis of market value.

Perhaps the market value rule has not been accepted because intact value rules were evolved prior to and during the 1930 depression era when book value usually exceeded market value, and use of the higher book value tended to protect the trust corpus. Nevertheless, it is arguable that market value should be intact value, particularly if there is an expressed direction to convert assets into cash prior to creation of the trust. *Cf.* Jordan Estate, *supra.*

29. 383 Pa. 228, 118 A.2d 187 (1955); see also *Principal and Income-Stock Dividends-Cost as Intact Value,* Fiduciary Review, Dec. 1955, p. 1.

30. See, *e.g.,* Fownes Trust, 3 Pa. D. & C.2d 637 (Orphans' Ct. 1955); Hostetter's Trust, 319 Pa. 572, 181 Atl. 567 (1935); Waterhouse's Estate, 308 Pa. 422 (1932); Jones v. Integrity Trust Co., 292 Pa. 149, 140 Atl. 862 (1928).

31. *Arrott's Estate* contained a stipulation that cost exceeded the book value of *all* of the stocks in question, but the record indicates that some stock was acquired at a cost less than book value, and in those instances the parties disregarded book value and accepted the lower cost as intact value.

rationalized by explaining that cost must be used for the former lest the life tenant receive as income a portion of the corpus (the excess of cost over book value at date of purchase). But this reasoning would seem to apply equally to decedent-owned shares (substituting market value for cost), especially if the executor may convert them and reinvest the proceeds.

Arrott's Estate did not consider the situation in which a trustee exercises stock rights. This problem is an enigma because under the decisions the life tenant receives preferential treatment upon the exercise of rights,[32] even when this requires cash payments from corpus, but does not receive such treatment when the rights are sold. Nevertheless, in clarifying the related problem of stock dividends *Arrott's Estate* may have a tendency to influence other situations.[33]

Moreover, while the question of apportionment of the proceeds from the sale of trustee-purchased stock was not considered, it would seem that the same intact value rule would apply, as was hinted in *Hostetter's Trust*[34] and *Jones v. Integrity Trust Co.*[35] Indeed, the lower courts have twice reached this conclusion.[36]

The intact value to be preserved includes all value increments such as share purchases by the corporation, contributed surplus,[37] or other increments of a purely capital nature. It may be increased by agreement of the parties,[38] and it must be decreased to reflect capital losses which traditionally are not regarded as part of the life tenant's income share.[39] But no adjustment would be required upon the issuance of new stock at less than book value.[40]

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32. Hostetter's Trust, 319 Pa. 572, 181 Atl. 567 (1935).

33. *E.g.*, it may have some bearing on the valuation problem raised in Hostetter's Trust, *supra* note 32.

34. *Ibid.*

35. 292 Pa. 149, 140 Atl. 862 (1928). See also Steele Estate, 377 Pa. 250, 254, 103 A.2d 409, 411 (1954); King Estate, 361 Pa. 629, 635, 66 A.2d 68, 71 (1949); Waterhouse's Estate, 308 Pa. 422, 428, 162 Atl. 295, 296 (1932); Baird's Estate, 299 Pa. 39, 42, 148 Atl. 907, 908 (1930); Packer's Estate (No. 1), 291 Pa. 194, 197, 139 Atl. 867, 868 (1927). *But see* Stokes' Estate (No. 2), 240 Pa. 288, 291, 87 Atl. 975, 976 (1913); Boyer's Appeal, 224 Pa. 144, 152, 73 Atl. 320, 323 (1909); Smith's Estate, 140 Pa. 344, 357, 21 Atl. 438, 440 (1891) where the court said that market value may be of help in determining intact value; Philadelphia Trust, Safe-Deposit & Ins. Co.'s Appeal, 16 Atl. 734 (Pa. 1889); Earp's Appeal, 28 Pa. 368 (1857) where the court talked of market value as the basis of intact value. It should be noted, however, that these latter cases are not followed in later decisions.

36. Wilford's Estate, 72 Montg. Co. L.R. 535 (Pa. 1956); Robert's Estate, Civil No. 317, Orphans' Ct., Phila. Co., 1932.

37. Dobson's Estate, 26 Pa. D. & C. 154 (Orphans' Ct. 1936).

38. Bullitt's Estate, 308 Pa. 413, 419, 162 Atl. 288, 290-91 (1932).

39. Lueders' Estate, 337 Pa. 155, 159, 10 A.2d 415, 417 (1940); Dickinson's Estate, 285 Pa. 449, 453, 132 Atl. 352, 353 (1926).

40. Willcox's Estate, 66 Pa. Super. 182 (1917).

B. *Earnings*[41]

The life tenant is entitled to receive only income that the corporation earns as a business function.[42] He is not entitled to receive monies accruing to the corporation from the sale of capital assets,[43] nor the benefits of purely speculative values of the stock,[44] nor that value mirroring potential earning capacity,[45] nor good will,[46] nor the increased value of capital assets,[47] for such increases are not "earnings." Normally, a portion of distributable earnings of a corporation is retained in the earned surplus account, and from there may be shifted into reserve accounts or elsewhere.[48] It is immaterial in what form such accumulations may from time to time appear;[49] they will nevertheless be a source for apportionment.

In calculating the apportionment, there is a presumption that a corporation acts in good faith in its bookkeeping and the use of its surplus account,[50] and ordinarily the court will accept corporate bookkeeping where good faith is shown.[51] However, the valuation of assets carried at nominal value is a proper subject for proof,[52] and in certain instances accounting practices must give way to actualities.[53] Where a corporation creates an excessive depreciation reserve out of earnings, this will not preclude the right of the life tenant to recapture those

41. See generally Brigham, *supra* note 5, at 366; Note, 13 TEMP. L.Q. 237 (1939); Note, 33 VA. L. REV. 749 (1947); RESTATEMENT, TRUSTS §§ 236 (e), (f) (1935), which refers to a return on capital; Annots., 130 A.L.R. 492, 575 (1941), 44 A.L.R.2d 1277, 1304 (1955); 3 SCOTT, TRUSTS §§ 236.11, 236.14 (2d ed. 1956).

42. It should be noted that this "business function" does not have to be the primary one of the corporation. Profits derived from "miscellaneous sources" may be included in "earnings." Waterhouse's Estate, 308 Pa. 422, 428, 162 Atl. 295, 296 (1932); Chauncey's Estate, 303 Pa. 441, 448, 154 Atl. 814, 816 (1931); Dobson's Estate, 26 Pa. D. & C. 154 (Orphans' Ct. 1936).

43. Graham's Estate, 198 Pa. 216, 47 Atl. 1108 (1901); Vinton's Appeal, 99 Pa. 434 (1882). Although no cases can be cited, it has been suggested that if assets were originally acquired from earnings, this would be an exception. Brigham, *supra* note 5, at 367. Also, if a corporation deals in real estate, profits from its sale may be earnings. Mandeville's Estate, 286 Pa. 368, 133 Atl. 562 (1926); Thomson's Estate, 153 Pa. 332, 26 Atl. 653 (1893); Oliver's Estate, 136 Pa. 43, 20 Atl. 527 (1890).

44. Dickinson's Estate, 285 Pa. 449, 455, 132 Atl. 352, 353-54 (1926); Fox's Trust, 53 Pa. D. & C. 1, 7 (Orphans' Ct. 1945).

45. Waterhouse's Estate, 308 Pa. 422, 429, 162 Atl. 295, 296 (1932).

46. *Ibid.* Nirdlinger's Estate, 290 Pa. 457, 478-79, 139 Atl. 200, 208 (1927).

47. *Ibid.*

48. *Cf.* Cassatt's Estate, 105 Pa. Super. 14, 158 Atl. 586 (1931).

49. *Ibid.*

50. Neafie's Estate, 325 Pa. 561, 568, 191 Atl. 56, 59 (1937).

51. King Estate, 355 Pa. 64, 68, 48 A.2d 858, 861 (1946).

52. Neafie's Estate, 325 Pa. 561, 191 Atl. 56 (1937); Flinn's Estate, 320 Pa. 15, 181 Atl. 492 (1935); Baird's Estate, 299 Pa. 39, 148 Atl. 907 (1930).

53. Pardee's Estate, 343 Pa. 79, 21 A.2d 904 (1941); Flinn's Estate, 320 Pa. 15, 181 Atl. 492 (1935); Baird's Estate, 299 Pa. 39, 148 Atl. 907 (1930); Dobson's Estate, 26 Pa. D. & C. 154 (Orphans' Ct. 1936).

earnings upon an apportionable event;[54] but if a dividend is paid out of a proper depreciation reserve, it belongs in corpus.[55] However, where a dividend of new par value stock is bottomed upon the capitalization of a surplus other than earned, there can be no apportionment.[56] The capitalization of surplus attributable to a stock dividend is often an elusive problem, and the existence, nature, and amount of the apportionable item is all too frequently contingent upon the character of the surplus which is capitalized in order to support the newly issued stock.[57]

The delineation of book value, as a division point in segregating earnings, is not a mere mechanical exercise.[58] In brief, but subject to adjustments to reflect proper corporate accounting, it consists of contributed capital plus accumulated earnings as of the date of computation, and it can be considered as capital plus earned surplus divided by the outstanding shares.[59]

A capital gain or loss ordinarily requires an adjustment only to intact value and will not affect the amount of accumulated earnings.[60] However, operation losses, although unusually large, are charged against earnings and therefore reduce the life tenant's share.[61]

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54. McCahan's Estate, 18 Pa. D. & C. 171 (Orphans' Ct. 1933), *rev'd on other grounds*, 312 Pa. 515, 168 Atl. 685 (1933). There is a presumption that the most recently retained earnings are those first paid out by the corporation upon an apportionable event.

55. Woolston's Estate, 36 Pa. D. & C. 574 (Orphans' Ct. 1939), involved a distribution from a depletion reserve.

56. Opperman's Estate (No. 1), 319 Pa. 455, 179 Atl. 729 (1935); Chauncey's Estate, 303 Pa. 441, 154 Atl. 814 (1931); Dickinson's Estate, 285 Pa. 449, 132 Atl. 352 (1926); Fowne's Trust, 3 Pa. D. & C.2d 637 (Orphans' Ct. 1955).

57. The General Electric Company 3-for-1 stock split of May 17, 1954, is an excellent example. The company retired each share of no par stock having a stated value of $6.25 per share, and issued in exchange three shares of $5.00 par value stock. The difference between $6.25 and $15.00, or $8.75, was charged against earned surplus. This transaction is not a usual stock dividend in that a different type stock was used to capitalize earnings. In this situation there is not only the element of a stock dividend (up to $8.75 per old share) but also a sale or exchange to a sufficient degree to be treated as partially apportionable after reservation of intact value. The apportionable amount should be restricted to the amount of earned surplus capitalized. See Cunningham's Estate, Civil No. 187 (1934), Orphans' Ct., Phila. Co., Nov. 1956; *cf. In re* Fosdick's Trust, 147 N.Y.S.2d 509 (Sup. Ct. 1955); *In re* Muller's Estate, 145 N.Y.S.2d 283 (Surr. 1955). See note 75a *infra*.

58. Waterhouse's Estate, 308 Pa. 422, 162 Atl. 295 (1932); Nirdlinger's Estate, 290 Pa. 457, 139 Atl. 200 (1927).

59. Mallory's Estate, 285 Pa. 186, 191, 131 Atl. 714, 715-16 (1926).

60. Lueders' Estate, 337 Pa. 155, 10 A.2d 415 (1940); Waterhouse's Estate, 308 Pa. 422, 162 Atl. 295 (1932); Nirdlinger's Estate, 290 Pa. 457, 139 Atl. 200 (1927).

61. Lueders' Estate, *supra* note 60; Neafie's Estate, 325 Pa. 561, 191 Atl. 56 (1937). Dickinson's Estate, 285 Pa. 449, 132 Atl. 352 (1926), presents a strange anomaly in its holding that the balance of an extraordinary underwriting loss of a fire insurance company, after first being applied in reduction of earnings, should be charged against intact value; *i.e.*, as pointed out in the dissenting opinion, the loss was improperly regarded as part capital and part operating in character. *Id.* at 457, 132 Atl. at 358.

Once it is established that the transaction constitutes an apportionable event, it becomes "wholly immaterial in what *form* such accumulations appear." [62] The courts are not bound by the corporation's accounting methods, whether they concern day-by-day handling of the income and capital accounts or whether they involve adjustments in the company's asset values, as in a reorganization.[63]

C. *Apportionable Events*

The mere existence of profits in a corporation does not warrant an apportionment.[64] In addition, there must be an apportionable event.[65] An apportionable event may be precipitated by an act of the corporation or the trustee. Examples are a stock dividend,[66] a distribution in liquidation,[67] the sale of stock,[68] the sale [69] or exercise of rights to subscribe,[70] distribution of cash or scrip dividends,[71] distribution of dividends paid in the stock of another company,[72] and, in some instances, a distribution pursuant to a corporate reorganization.[73] In *Buist's Estate* [74] the court categorized the apportionment area as follows: distribution of a cash dividend or of a stock dividend, liquidation of a corporation, or the sale of stock by the trustees. It is not clear whether these areas were defined as examples or limitations, although it seems preferable to consider them as the former. In any case, Pennsylvania courts are apparently not bound by the form of the corporate transaction if its effect is that of a transaction giving rise to apportionment.[75] Although there appear to be no Pennsylvania cases

62. King Estate, 349 Pa. 27, 29, 36 A.2d 504, 506 (1944).

63. Pardee's Estate, 343 Pa. 79, 85, 21 A.2d 904, 906 (1941); Daily's Estate, 323 Pa. 42, 47, 186 Atl. 754, 756 (1936); Nirdlinger's Estate, 290 Pa. 457, 471, 139 Atl. 200, 205-06 (1927); McKeown's Estate, 263 Pa. 78, 84, 106 Atl. 189, 190-91 (1919).

64. King Estate, 355 Pa. 64, 68, 48 A.2d 858, 861 (1946).

65. Buist's Estate, 297 Pa. 537, 543, 147 Atl. 606, 608 (1929).

66. Earp's Appeal, 28 Pa. 368 (1857).

67. Connolly's Estate (No. 1), 198 Pa. 137, 47 Atl. 1125 (1901); McKeown's Estate, 263 Pa. 78, 106 Atl. 189 (1919).

68. McKeown's Estate, *supra* note 67; Nirdlinger's Estate, 290 Pa. 457, 139 Atl. 200 (1927).

69. See Waterhouse's Estate, 308 Pa. 422, 429-30, 162 Atl. 295, 296-97 (1932).

70. Hostetter's Trust, 319 Pa. 572, 181 Atl. 567 (1935). See also Jones v. Integrity Trust Co., 292 Pa. 149, 140 Atl. 862 (1928).

71. Nirdlinger's Estate (No. 1), 327 Pa. 160, 193 Atl. 33 (1937); Mandeville's Estate, 286 Pa. 368, 133 Atl. 562 (1926); Flaccus' Estate, 283 Pa. 185, 194, 129 Atl. 74, 77 (1925). See also Opperman's Estate (No. 1), 319 Pa. 455, 179 Atl. 729 (1935).

72. Barnes' Estate, 338 Pa. 555, 12 A.2d 912 (1940).

73. Daily's Estate, 323 Pa. 42, 186 Atl. 754 (1936).

74. 297 Pa. 537, 147 Atl. 606 (1929); *cf.* RESTATEMENT, TRUSTS § 236 (e), comment *y* (1935).

75. Nirdlinger's Estate, 290 Pa. 457, 470, 139 Atl. 200, 205 (1927).

on the point, it would seem that a pure stock split is not an apportionable event; but where a stock split is supported by a capitalization of earned surplus, this should constitute an apportionable event to the extent of the amount capitalized.[75a]

1. Extraordinary Dividends [76]

Under the English rule the life tenant received ordinary dividends, while extraordinary dividends were awarded to principal.[77] Moreover, designation by the distributing corporation was conclusive and, unless the distribution was labeled an "extraordinary dividend" or "bonus," it was treated as an ordinary dividend regardless of the form or amount of the payment.[78]

This arbitrary distinction is incorporated into the Pennsylvania rules in the sense that those payments which are "ordinary dividends" go to the life tenant notwithstanding that the intact value of the corpus may be impaired, while those which are "extraordinary dividends" are apportionable. Ordinary and extraordinary dividends are distinguished by considering regularity in amount and consistency in time interval. Ordinary dividends have been defined as "periodical payments becoming due at fixed intervals"; [79] as dividends "regularly declared at uniform intervals and rates theretofore or customarily used";[80] or as "usual or customary dividend[s] at a fixed per cent or sum per share, paid at regular periods." [81] The *Restatement of Trusts* regards as important "the designation, if any, [used] by the Directors of the corporation." [82] On the other hand, extraordinary dividends are those which are so

75a. See Soles v. Granger, 174 F.2d 407 (3d Cir. 1949); Matter of Sanford, 4 Misc. 2d 487, 161 N.Y.S.2d 507 (Surr. 1957); *In re* Davis Estate, 128 N.Y.S.2d 152 (Surr. 1953). See also note 57 *supra.*

76. See RESTATEMENT, TRUSTS § 236(b), comments *r-v* (1935); 3 SCOTT, TRUSTS §§ 236.3-236.5 (2d ed. 1956); Brigham, *supra* note 5; Brigham, *Some Problems of Principal and Income*, 56 DICK. L. REV. 377 (1952); Damrau, *supra* note 11; Faught, *supra* note 6, at 154, 155; Ives, *Allocating Stock Dividends*, 91 TRUSTS & ESTATES 851 (1952); Nemmers, *Key Problems in the Apportionment of Increase Between Successive Interests in Personalty,* 41 MICH. L. REV. 815, 831 (1943); Notes, 86 U. PA. L. REV. 765, 767 (1938); 12 OHIO ST. L.J. 588 (1951); Comment, 21 U. CHI. L. REV. 454 (1954); Notes, 33 VA. L. REV. 749 (1947); 1942 WIS. L. REV. 299; 39 MINN. L. REV. 338 (1955); 12 TEMP. L.Q. 266 (1938); 22 TENN. L. REV. 973 (1953); 5 WASH. & LEE L. REV. 288 (1948); Annots., 44 A.L.R.2d 1277 (1955), 50 A.L.R. 375 (1927), 42 A.L.R. 448, 449-58 (1926), 24 A.L.R. 9, 14-92 (1923).

77. Note, 86 U. PA. L. REV. 765, 767 & n.15 (1938); Annots., 130 A.L.R. 492, 518 (1941); 16 L.R.A. 461 (1892); 45 L.R.A. 392 (1899).

78. Note, 86 U. PA. L. REV. 765, 767 & n.16 (1938).

79. Earp's Appeal, 28 Pa. 368, 374 (1857).

80. Opperman's Estate (No. 1), 319 Pa. 455, 461, 179 Atl. 729, 734 (1935).

81. Nirdlinger's Estate, 290 Pa. 457, 462, 139 Atl. 200, 202 (1927).

82. RESTATEMENT, TRUSTS § 236(a), comment *c*(5) (1935). Other factors are: Whether similar dividends have been declared regularly in the past; whether such

"unusual in amount or form as to require an investigation into their source and apportionment according to equitable principles rather than an application of the common law rule that a dividend belongs to the party entitled to it at the date of its declaration. In other words, the unusual character of the dividend requires form and convenience to give way to substance and equity." [83]

Fortunately, the rules for apportionment of extraordinary dividends are now relatively clear and provide an example of operation of the Pennsylvania apportionment law under optimum conditions. An extraordinary dividend presumptively belongs to the life tenant,[84] but will be retained in corpus to the extent that remaindermen show that intact value of the trust investment would otherwise be impaired or that a portion of the value of the dividend is due to capital appreciation rather than retained earnings.[85] These principles apply regardless of the form of the extraordinary dividend. It may take the form of a cash or scrip dividend,[86] as well as the more common case of a stock dividend. Thus, a dividend paid in cash plus stock rights was held apportionable,[87] as was one paid in scrip [88] and one paid in the stock of another company.[89] Moreover, such payments may require apportionment not only between principal and income but also between past and present life tenants. Application of these rules will not be controlled by federal decisions in income tax litigation,[90] for the Pennsylvania Supreme Court has said that "the sole question is whether there is an impairment of the intrinsic value of the shares held in the trust; the rule is not concerned with the identity of the property constituting that value." [91]

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dividends are regularly paid out of current earnings; the size of the dividend in relation to the market value and the par value at the date of the creation of the shares; and the source of the earnings from which the distribution is made.

83. Nirdlinger's Estate (No. 1), 327 Pa. 160, 168, 193 Atl. 33, 37 (1937).

84. Hostetter's Trust, 319 Pa. 572, 574, 181 Atl. 567, 568 (1935); Waterhouse's Estate, 308 Pa. 422, 428, 162 Atl. 295, 296 (1932); Chauncey's Estate, 303 Pa. 441, 446, 154 Atl. 814, 815 (1931); Graham's Estate, 296 Pa. 436, 146 Atl. 111 (1929); Nirdlinger's Estate, 290 Pa. 457, 468, 139 Atl. 200, 204 (1927); McKeown's Estate, 263 Pa. 78, 86, 106 Atl. 189, 191-92 (1919); Boyer's Appeal, 224 Pa. 144, 152, 73 Atl. 320, 323 (1909); French's Estate, 84 Pa. D. & C. 525, 528 (Orphans' Ct. 1952).

85. Waterhouse's Estate, 308 Pa. 422, 429, 162 Atl. 295, 296 (1932). The remainderman bears the burden of proving not only that intact value is jeopardized, but also that the source of the dividend is capital increment rather than earnings.

86. Nirdlinger's Estate (No. 1), 327 Pa. 160, 168, 193 Atl. 33, 37 (1937).

87. In Thompson's Estate, 262 Pa. 278, 105 Atl. 273 (1918), the corporation was prohibited from declaring a stock dividend and instead, issued stock subscription rights plus a cash dividend which was used to exercise those rights.

88. Philadelphia Trust, Safe Deposit & Ins. Co.'s Appeal, 1 Mont. Co. L. Rep. 23, 16 Atl. 734 (Pa. 1889).

89. Barnes' Estate, 338 Pa. 555, 12 A.2d 912 (1940).

90. Harkness' Estate, 283 Pa. 464, 129 Atl. 458 (1925).

91. Barnes' Estate, 338 Pa. 555, 559, 12 A.2d 912, 914 (1940).

The apportionment rules apply even though the remainderman is entitled to a specific number of shares. In *Flaccus's Estate,*[92] the decedent bequeathed a specific number of shares to specific legatees following termination of an income interest. During the income tenure a 200 per cent stock dividend was distributed. The specific legatee was held to be entitled only to the intact value of the original shares, although measured in part by the new shares; he was not entitled automatically to three shares where before he would have had but one.

These rules are merely bases for construing the intent of a testator who has not dealt specifically with the apportionment problem. It follows that a testator may direct an apportionment, not otherwise invalid, that varies from the rules.[93] But once their relevance is determined, the rules are substantive and apply irrespective of action or inaction on the part of the life tenant. Thus, a life tenant does not lose his right to an apportionable dividend merely because the new shares were not transferred to his name during his lifetime;[94] and the fact that a dividend was declared after the life tenant's death does not necessarily deprive his heirs of the apportionment.[95]

2. Sale of Stock[96]

As previously stated, the philosophy of the Pennsylvania rule is to give to the life tenant that portion of the proceeds of the trustee's sale of stock representing corporate earnings retained during his tenancy. Consequently, the courts will make an apportionment to the life tenant where intact value is not impaired if there is a proper showing that the apportioned amount is attributable to retained earnings.[97] This rule was clearly expressed in *Waterhouse's Estate*[98] which said that

> ". . . where stock that produces income owned by the estate is sold for a price greater than the intact value . . . and such greater price is due to an accumulation of income, the proceeds are apportionable; that is, so much of the proceeds as [is] necessary to preserve the intact value [as defined] goes to the trustees for the corpus, and only so much of the balance that represents income goes to the life tenant.

92. 283 Pa. 185, 129 Atl. 74 (1925).
93. Robinson's Trust, 218 Pa. 481, 67 Atl. 775 (1907).
94. Mallory's Estate, 285 Pa. 186, 131 Atl. 714 (1926).
95. Simpson's Estate, 23 Pa. Dist. 27 (1914), and see discussion *infra* at pp. 178-79, 181.
96. See generally Brigham *supra* note 5, at 378; Nemmers, *supra* note 76, at 844; Faught, *supra* note 6, at 159; Notes, 61 HARV. L. REV. 721 (1948), 60 HARV. L. REV. 1361 (1947), 52 HARV. L. REV. 1369 (1939), 27 N.Y.U.L. REV. 488 (1952); *cf.* Note, 1942 WIS. L. REV. 299, 301-03.
97. Nirdlinger's Estate, 290 Pa. 457, 467-77, 139 Atl. 200, 204-07 (1927).
98. 308 Pa. 422, 429, 162 Atl. 295, 296 (1932).

"But where the greater value is due to the stock's earning power, good will, or its intrinsic, speculative, or enhanced market value, all the proceeds are part of the corpus and belong to the remainderman; the increase is capital gain."

The courts have been consistent in their interpretation of the foregoing rules, and have held that a gain reflecting unrealized appreciation in corporate assets,[99] or a rise in the value of bonds,[100] should be awarded to principal.[101] On the other hand, where the gain is partially from earnings and partially from capital enhancement, courts have given the amount attributable to earnings to the life tenant.[102] However, it is presumed that proceeds from the sale of stock belong to the corpus of the trust, and the life tenant must therefore sustain the burden of proof that he is entitled to share.[103]

If, as a matter of corporate accounting, there are accumulated earnings which adequately support an apportionment of the sales proceeds, the apportionment will be made even though the corporation could not distribute those earnings, as where Interstate Commerce Commission regulations require that such earnings be retained in the company in an "appropriated surplus" account.[104]

The courts give considerable deference to, and rely heavily upon, the exact words of "intention" used by the testator. Thus, in *Park's Estate* [105] and *Quay's Estate* [106] the court gave the realized profits from the trustee's sale of securities to the life tenant because the testator stated that the life tenant was to receive the "income and profits" of the trust; whereas, in *Graham's Estate*,[107] the court awarded similar profits from the sale of trust bonds and real estate to corpus, distinguishing *Park's Estate* on the ground that the will spoke of distributing only the "income" to the life tenant.

3. Distribution in Liquidation [108]

A true liquidation is similar to a sale of stock in that the trustee thereby severs his connection with the corporation and its operating

99. Fox's Trust Estate, 53 Pa. D. & C. 1 (Orphans' Ct. 1945).
100. Graham's Estate, 198 Pa. 216, 47 Atl. 1108 (1901); Hubley's Estate, 16 Phila. 327 (1884).
101. Packer's Estate (No. 1), 291 Pa. 194, 139 Atl. 867 (1927).
102. *Ibid.*
103. Waterhouse's Estate, 308 Pa. 422, 429, 162 Atl. 295, 296 (1932); Nirdlinger's Estate, 290 Pa. 457, 468, 139 Atl. 200, 204 (1927).
104. Cassatt's Estate, 105 Pa. Super. 14, 17, 158 Atl. 586, 587 (1931).
105. 173 Pa. 190, 33 Atl. 884 (1896). The court also intimated that the fiduciary power to invest and reinvest, under certain narrow circumstances, might be viewed as a direction that capital gain should go to income. *Cf.* Wiltbank's Appeal, 64 Pa. 256 (1870).
106. 253 Pa. 80, 97 Atl. 1029 (1916).
107. 198 Pa. 216, 47 Atl. 1108 (1901).
108. See generally 3 SCOTT, TRUSTS § 236.10 (2d ed. 1956); Brigham, *supra* note 5, at 375; Nemmers, *supra* note 76, at 844; Note, 78 U. PA. L. REV. 570 (1930); Note,

assets. In the typical situation, the trust owns shares of stock in a corporation which, in the course of liquidation, pays one or more liquidating dividends. If the entire distribution is less than intact value, it will remain wholly in corpus even though the life tenant is able to show that part of the distribution is based upon, or derived from, earnings accrued subsequent to the creation of the trust.[109] If the distribution exceeds intact value, the amount distributable to the life tenant is the excess attributable to accumulated earnings.[110]

The mechanics of a liquidation apportionment are illustrated in *McKeown's Estate*[111] where the trust held stock with an intact value of $12.22. The company distributed $24.50 per share in liquidation at a time when the book value was $15.18. The court found that $2.96, the difference between intact value and book value at the time of the liquidation, represented accumulated earnings and, therefore, held it should be paid to the income beneficiary. The $9.32 balance of the gain was considered a capital accretion and was awarded to principal.

Where the source of the liquidating dividend is the sale of a franchise,[112] or the sale of all the corporate assets,[113] the amount exceeding intact value presumptively remains in corpus as based on capital accretion and not accumulated earnings.[114] However, if the life tenant can prove that there are sufficient accumulated earnings, he will become entitled to a distribution.[115] If a liquidating dividend is derived from both capital accretions and earnings, the life tenant "is entitled to the proportion of such earnings as accrued subsequently to the testator's death,"[116] *i.e.*, from the beginning of the trust term.

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16 Va. L. Rev. 499 (1930); Comment, 21 U. Chi. L. Rev. 454 (1954); Restatement, Trusts § 236(d), comment *x* (1935); Annots., 130 A.L.R. 492, 586-90 (1941), 44 A.L.R.2d 1277, 1304-06 (1955).

109. Sternbergh's Estate, 337 Pa. 342, 10 A.2d 376 (1939).

110. McKeown's Estate, 263 Pa. 78, 106 Atl. 189 (1919); *cf.* Weschler's Estate, 212 Pa. 508, 61 Atl. 1091 (1905) (involving an unincorporated business).

111. 263 Pa. 78 (1919).

112. Vinton's Appeal, 99 Pa. 434 (1882). In this decision the court recognized that the same apportionment rules apply to partial as to complete liquidations, but held that the distribution should benefit corpus because of an implication that intact value might otherwise be impaired. It is significant that the vital fact of the existence of accumulated earnings does not appear in the reported decision. Brigham, *supra* note 5, at 375, cites this decision only for the foregoing principles and concludes that "the burden rests on the life beneficiary to prove the amount of such accumulated earnings and only to the extent that he does so will he participate in a distribution in liquidation."

113. Graham's Estate, 198 Pa. 216, 47 Atl. 1108 (1901); see Comment, 21 U. Chi. L. Rev. 454, 456 (1954).

114. Eisner's Estate, 175 Pa. 143, 34 Atl. 577 (1896). *Cf.* Mallory's Estate, 285 Pa. 186, 131 Atl. 714 (1926) where the court held that the entire surplus must be considered in apportioning a liquidating dividend.

115. Eisner's Estate, *supra* note 114, at 148, 34 Atl. at 579.

116. Connolly's Estate (No. 1), 198 Pa. 137, 143, 47 Atl. 1125, 1127 (1901).

In short, if a partial or complete liquidation is the apportionable event, there is a presumption that the entire proceeds of the liquidation accrue to principal; the life tenant has the burden of showing affirmatively that some portion of the fund distributed is based upon accrued earnings [117] and that intact value will be preserved.

4. Transfers Pursuant to Reorganization [118]

Modern corporate law has only recently emerged from the era when corporate reorganizations were more or less limited to the form of statutory merger or consolidation expressly permitted by local law. Today, many if not most business combinations result from transactions which legally constitute sales or exchanges. Thus, businesses are now combined—and existing shareholders retain a "continuity of interest"—through a transaction whereby the acquiring corporation *A* issues shares of its voting stock in exchange for the stock of corporation *B* which thereupon becomes the controlled subsidiary of *A*; or in which *A* uses its voting stock to acquire substantially all of the assets of *B*, whereupon *B* is dissolved and new *A* stock is distributed to *B's* shareholders in complete liquidation.[119] The result in each case is essentially the same as if there had been a merger or consolidation of corporations *A* and *B*. Nevertheless, current law indicates that the traditional merger or consolidation will not be the occasion for an apportionment, whereas the other described transactions will be treated as apportionable events.

In *Buist's Estate* [120] the court was concerned with a consolidation of banking institutions pursuant to federal law, whereunder the shareholders of the constituents received in exchange for their old shares the new shares of the resulting and enlarged bank. This exchange of stock was held not to be a transaction giving rise to an apportionment since "the issuance of the new capital stock is merely the issuance of new evidence of ownership to the shareholders." In other words, the receipt of shares of a merged company is not tantamount to a distribution or division of assets which calls for an apportionment between life tenant and remainderman. This decision is also significant because it holds that the right of a dissenting shareholder to demand cash does not of itself create an apportionable event (although doubtless if cash

117. Lewis Estate, 351 Pa. 576, 41 A.2d 683 (1945).

118. See generally Brigham, *supra* note 5, at 376; Note, 47 Colum. L. Rev. 310 (1947); Note, 32 Iowa L. Rev. 521 (1947); Annot., 44 A.L.R.2d 1277, 1308-10 (1955).

119. The stock-for-stock and the stock-for-assets types of reorganizations are included, together with merger or consolidation, and recapitalization, as the principal reorganization transactions which are tax-free. Int. Rev. Code of 1954, §§ 368, 354.

120. 297 Pa. 537, 147 Atl. 606 (1929).

was demanded and received there would arise the right to apportionment).

Where the distribution of reorganization stock to the trustee is not the result of a merger or consolidation, the distribution may fall within the area of a sale or exchange which requires an apportionment. Illustrative is *Daily's Estate*[121] in which the corporation had recapitalized by means of a transfer of assets to subsidiary companies followed by a distribution of the subsidiaries' stocks in complete liquidation of the former parent. Here the "continuity of interest" of the individual shareholders was more complete than in *Buist's Estate* (in which the individual shareholders, through merger with other corporations, acquired a new interest in corporate-owned assets), and yet the exchange resulting from the technical liquidation of the parent was held to require an apportionment. The same result was reached in *Fisher's Estate*[122] which involved merely the recapitalization of an existing company, but in which there was the further justifying factor that the new stock received as a result of the recapitalization was distributed in partial discharge of cumulated but unpaid dividends on the old preferred stock.

The line of demarcation between merger or consolidation and other reorganization transactions is confirmed by the three decisions in *King Estate*[123] which, in their order of promulgation, hold that stock received as the result of a merger cannot be the subject of apportionment; that the apportionable event will occur only upon a subsequent sale or similar disposition of the stock received in the reorganization; and that, in computing the intact value to be preserved, one must compare the intact value of the old stock with the book value of all of the new stock received as a result of the merger rather than making the comparison on a share-for-share basis.

Final confirmation of the non-apportionment rule in the merger situation was forthcoming in *Jones Estate*[124] which, like *Buist's Estate*, involved a bank merger, in the course of which earnings were capitalized as the source of new stock issued. Even though corporate earnings were thus transmuted into new stock, the fact that the new stock was issued in a merger was sufficient to exclude the distribution from the apportionment area.[125] The court returned to the arbitrary and perhaps

121. 323 Pa. 42, 186 Atl. 754 (1936).

122. 344 Pa. 607, 26 A.2d 192 (1942).

123. 349 Pa. 27, 36 A.2d 504 (1944); 355 Pa. 64, 48 A.2d 858 (1946); 361 Pa. 629, 66 A.2d 68 (1949).

124. 377 Pa. 473, 105 A.2d 353 (1954).

125. Of course, the earnings received from a constituent corporation as the result of the merger will be considered as a source for future apportionment, *e.g.*, upon the subsequent declaration by the merger corporation of a stock dividend. Chauncey's Estate, 303 Pa. 441, 154 Atl. 814 (1931).

archaic concept, first expressed in *Buist's Estate,* to the effect that an apportionment can occur only

> "upon the happening of any one of four events, namely, (1) the distribution by the corporation of an extraordinary cash or stock dividend, or (2) the liquidation of the corporation, or (3) a sale of the stock by the trustees, or (4) the issuance of stock rights." [126]

It is suggested that non-apportionment in the merger situation is correct in that the result of replacing an old share with a new "is merely the issuance of new evidence of ownership to the shareholders . . . [and] is not tantamount to a distribution or division of assets which calls for an apportionment between a life tenant and remainderman." [127] But even more so is this true in the case of a corporate recapitalization which involves the readjustment of interests of a single and continuing corporation. Though there might be a technical corporate dissolution in the course of such a recapitalization, nevertheless, the interests continue in precisely the same underlying assets.

Although it has been said that federal tax concepts should not control Pennsylvania apportionment rules,[128] it should be recognized that federal courts, in applying tax laws, have molded continuity of interest rules which are more in harmony with changing corporate reorganization practices than are the current apportionment rules. It is only reasonable that, where the corporate reorganization exchange produces the net effect of a merger or consolidation, no apportionment rights should result even though the transaction is cast in the mold of a sale or exchange.

A realistic judicial approach should limit the right to apportionment resulting from reorganization distributions to those cases where there is a clear change in the continuity of the shareholder's interest, or where the distribution is sufficiently similar to a stock dividend that, as in *Fisher's Estate,* the new stock is actually distributed in lieu of dividends otherwise payable in cash.[129]

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126. Jones Estate, 377 Pa. 473, 476, 105 A.2d 353, 354 (1954).

127. Buist's Estate, 297 Pa. 537, 542, 147 Atl. 606, 608 (1929).

128. Jones Estate, 377 Pa. 473, 475, 105 A.2d 353, 354 (1954).

129. INT. REV. CODE OF 1954, § 355, may provide an equivalent to a stock dividend in the so-called spin-off transaction whereby an existing corporation distributes separate business assets to a new subsidiary the stock of which may then be distributed tax-free to the shareholders of the existing corporation. If the subsidiary stock is distributed without an exchange, a dividend equivalent may result; but if a part of the stock of the existing corporation is surrendered in exchange for the subsidiary stock, there might be no apportionable event. It can reasonably be argued that an apportionment exists if, and to the extent that, in a reorganization earned surplus is capitalized which thereby assumes a substantial equivalent of a stock dividend. *See* Soles v. Granger, 174 F.2d 407 (3d Cir. 1949); note 75a *supra.*

5. Rights To Subscribe[130]

Rights to subscribe to additional shares of a corporate stock at a price lower than current market value are a valuable asset which can be realized upon in two ways: sale of the rights for cash, or purchase of new shares at a discount. The resulting inquiries are whether the stock rights are merely an incident of the ownership of underlying shares or whether they are a medium for distributing accumulated profits; whether life tenant or remainderman must carry the burden of proof of the apportionment; and when the apportionment should be made.[131]

Early decisions were conflicting: some held that stock rights were only a diluting incident of the ownership of the underlying shares and were not apportionable;[132] other decisions held that the rights were "manifestly a profit" and "a right incidental to the stock and . . . therefore income."[133] The latter view was adopted in *Thompson's Estate*[134] in which rights were awarded to the life tenants because surrounding circumstances indicated that the transaction was a disguised stock dividend. In *Nirdlinger's Estate* the court announced a rule that "the life tenant should receive the benefit of the right so far as it is attributable to earnings that have accumulated during the life interest, providing the intact value of the corpus be maintained."[135] In *Jones v. Integrity Trust Co.*[136] the court applied the rule to an exercise of stock rights, saying that

> "the benefit resulting therefrom must be apportioned in the same manner as an extraordinary stock dividend would be; that is, there would be allocated to the corpus of the trust sufficient . . . [of the new shares] to maintain unimpaired intact value of the stock held by it, and the life tenant should receive the balance,

130. See generally RESTATEMENT, TRUSTS § 236(c), comment *w* (1935); 3 SCOTT, TRUSTS § 236.9 (2d ed. 1956); Brigham, *Allocation of Receipts of Shares Held in Trust*, 85 U. PA. L. REV. 358, 376 (1937); Nemmers, *supra* note 76, at 840; Notes, 83 U. PA. L. REV. 98 (1934), 84 U. PA. L. REV. 796 (1936); Annots., 44 A.L.R.2d 1277, 1302-04 (1955), 130 A.L.R. 492, 570-75 (1941).

131. A distinct question has arisen where the trustee has been given rights to subscribe to shares of another corporation. Several early cases have held that the rights, Eisner's Estate, 175 Pa. 143, 34 Atl. 577 (1896), or the profits on the shares where those rights have been exercised, Kemble's Estate, 201 Pa. 523, 51 Atl. 310 (1902); Wiltbank's Appeal, 64 Pa. 256 (1870), are income.

132. Moss's Appeal, 83 Pa. 264 (1877).

133. Wiltbank's Appeal, 64 Pa. 256, 259, 260 (1870).

134. 262 Pa. 278, 105 Atl. 273 (1918). See also Stokes Estate (No. 1), 240 Pa. 277, 87 Atl. 971 (1913); Smith's Estate, 140 Pa. 344, 21 Atl. 438 (1891). In substance the court considered a declaration of a dividend coupled with a right to subscribe as a stock dividend.

135. 290 Pa. 457, 466, 139 Atl. 200, 203 (1927).

136. 292 Pa. 149, 140 Atl. 862 (1928). This was a declaratory judgment action in which the case stated was quashed on the ground that it did not appear in the record whether the rights had been sold or exercised.

> because it represents the corporate earnings which accumulated after he became entitled to all dividends at any time thereafter payable out of such accumulations." [137]

Subsequently, *Waterhouse's Estate* [138] applied the same principle to proceeds of the sale of rights.

Finally, in *Hostetter's Trust*,[139] the court permitted a trustee to pay the life tenant his share "of the benefit of the right" in stock acquired with rights, using book value figures to determine his portion, although it was indicated that the trustee could not have been required to apportion until there was a sale.[140]

It is now settled that the values received by a trust as stock rights must be apportioned, and that the time for apportionment is either when the rights are sold,[141] when the new shares are sold,[142] or, in the discretion of the trustee, at the time the rights are exercised.[143]

The presumptions applicable in this area are not clearly defined. In some situations the court states that the burden of proof is on the life tenant, as in the sale of stock.[144] In others, if the life tenant shows that the distribution to him will not impair intact value, he takes all unless the remainderman shows that it is based in part on capital appreciation.[145] It has also been said that these sums must be apportioned like an extraordinary stock dividend, *i.e.*, that the burden is on

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137. 292 Pa. 149, 153, 140 Atl. 862, 863 (1928).

138. 308 Pa. 422, 162 Atl. 295 (1932). The court found, however, that the value represented by the rights was capital appreciation rather than retained earnings and, therefore, the proceeds of the sale of the rights went to corpus. This case is interesting when compared with *Jones v. Integrity Trust Co.* In that case, the court denied a declaratory judgment on the ground that it was not established whether the rights would be sold or exercised and that such findings were essential to a decision, and then discussed the exercise of stock rights. And, although the *Jones* opinion would indicate a different rule in the case of a sale of rights, the same language was cited and approved in the *Waterhouse* case and applied therein to the proceeds of sale.

139. 319 Pa. 572, 181 Atl. 567 (1935). The principle announced was applied in a collateral situation where it was sought to surcharge a trustee for distributing shares. Bard's Estate, 339 Pa. 433, 13 A.2d 711 (1940).

140. *Contra*, Dickinson's Estate, 285 Pa. 449, 132 Atl. 352 (1926), which involved rights to subscribe to shares of a fire company which had suffered a substantial capital loss and which issued the rights in an effort to raise new capital. The court held that proceeds of the sale of the rights should be retained in corpus (and at the same time decided that intact value of the shares should be reduced by the amount of the loss).

141. See Waterhouse's Estate, 308 Pa. 422, 429-30, 162 Atl. 295, 296 (1932).

142. See Buist's Estate, 297 Pa. 537, 543, 147 Atl. 606, 608 (1929).

143. Hostetter's Trust, 319 Pa. 572, 575-76, 181 Atl. 567, 568 (1935), where the court said: "Here the trustees had income-producing shares of stock in their hands after a purchase such as was contemplated in Jones v. Integrity Trust Co. . . . They could have sold the stock so purchased and distributed the proceeds to the life tenant without impairing the intact value. Instead of selling it they allotted the stock in kind to the life tenant. We see nothing wrong about this . . . and there is nothing in Buist's Estate . . . that in any way offends this conclusion."

144. Waterhouse's Estate, 308 Pa. 422, 429-30, 162 Atl. 295, 296 (1932).

145. Noblitt's Estate, 15 Pa. D. & C. 202 (Orphans' Ct. 1931).

the remainderman to show that the value of the rights stems from capital appreciation rather than retained earnings.[146]

6. Dividends on Preferred Stock[147]

The issue here concerns preferred stock having cumulative dividend arrearages which are discharged by a lump cash sum or by the issuance of new stock pursuant to a corporate reorganization. Two case histories dominate the scene: *Fisher's Estate*[148] and the three decisions in *King Estate*.[149]

Fisher's Estate involved apportionment of the proceeds of a sale of preferred stock which had been received in an exchange of 1.4 shares of new $100 par value five per cent preferred stock for each old share of $100 par value seven per cent preferred stock with dividend arrearages of $40.75. The additional par value of the bonus shares was obtained from an impairment of the common capital stock accounts, and the remainderman objected to the apportionment because, *inter alia*, no part of the sum from which the new stock was created could be traced to earnings. The court ruled that the life tenant was entitled to the proceeds of the sale of the bonus shares, stating that,

> "We must distinguish between the rights and duties of the stockholders with relation to the corporate entity and the respective rights of life tenants and remaindermen. So considering the matter, the common stockholders procured available values by rearrangement of the capital structure of the corporation, all by proceedings legally conducted. This was a matter of corporation law. They then transferred those values to the preferred stockholders in discharge of rights which such stockholders had to receive dividends. In fact, in that manner the payment of dividends to such preferred stockholders was merely anticipated. As between life tenant and remaindermen the additional stock was in fact given in discharge of dividends and must be so treated."[150]

Fisher's Estate thus suggested that, at least where the trust holds only preferred shares, the concept of "earnings" does not necessarily mean corporate earnings but can mean earnings by the class of stock

146. Waterhouse's Estate, 308 Pa. 422, 430, 162 Atl. 295 (1932).

147. See generally Damrau, *Apportionment of Stock Dividends in Trusts Created Prior to 1945*, 15 U. PITT. L. REV. 34 (1953); Notes, 95 U. PA. L. REV. 424 (1947), 47 DICK. L. REV. 56 (1942), 32 IOWA L. REV. 521, 530-39 (1947), 33 VA. L. REV. 749, 752-54 (1947). See also SCOTT, TRUSTS § 236.8 (2d ed. 1956); RESTATEMENT, TRUSTS § 236(a), comments *o, p, q* (1935); Brigham, *Principal and Income-Accrued Dividends-Cumulative Preferred Shares*, Fiduciary Review, Nov. 1946, p. 1.

148. 344 Pa. 607, 26 A.2d 192 (1942).

149. 349 Pa. 27, 36 A.2d 504 (1944); 355 Pa. 64, 48 A.2d 858 (1946); 361 Pa. 629, 66 A.2d 68 (1949).

150. 344 Pa. 607, 611-12, 26 A.2d 192, 195 (1942).

involved; and that the trust may receive "income" regardless of the source of that income within the corporation. The decision further indicates that intact value does not include dividend arrearages accrued at the time the trust was created, on the reasoning that the testator's intention is presumptively to give all dividends to the life tenant.[151]

Fisher's Estate also decided that the intact value of preferred stock is its par value unless capital is impaired; but the court's application of this rule seems inconsistent. Impairment of preferred capital would occur only upon total impairment of the common capital and reduction of the company's net worth below the liquidation preference. In *Fisher's Estate,* the preferred was neither impaired at the time the trust was created nor at the time of the reorganization, for when the trust was established there were capital stock accounts from which the new preferred was taken, and at the time of the reorganization, there was a "legal" creation of new par value preferred. Yet the court gave the income tenants the proceeds of all the extra shares,[152] whereas if par value had been considered intact value, their portion would have been substantially less.[153] What the court in effect held was that, in an exchange of preferred shares, receipt of the same par value as shares left in trust will maintain intact value regardless of the actual value of the new shares.

King Estate[154] involved a testamentary trust which held cumulative preferred stock with arrearages and common stock of the same company. Pursuant to a reorganization, the trust received for each share of $100 par value preferred stock with arrearages, one-half share of $100 par value *A* preferred stock, one-half share of $100 par value *B* preferred stock, and one and one-fourth shares of no par value common stock. In return for each share of $100 par value common stock, the trust received one share of no par value common stock.

The majority held first, as in *Fisher's Estate,* that proceeds of the sale of the common stock received for old preferred stock should go to the life tenants, providing that intact value was not impaired. It compared the situation before it to the receipt of a stock dividend, and viewed the receipt of the new stock as "at least in lieu of, or compensation for, the surrender of the right to receive" back dividends. The majority further held that, in determining intact value, the entire trust

151. The court thus followed the rules of the New York courts, see, *e.g.,* Thompson v. New York Trust Co., 107 Misc. 245, 177 N.Y. Supp. 299 (Sup. Ct. 1919), and the *Restatement.* RESTATEMENT, TRUSTS § 236(a), comment *o* (1935).

152. $88.23, the average price received, times 38.8, the number of extra shares, or $3,423.32.

153. The difference between the par value of the 97 original ($9,700) and the proceeds of the sale of all the new shares ($11,982.04), or $2,282.04.

154. King Estate, 361 Pa. 629, 66 A.2d 68 (1949).

investment in the company should be considered; and since the reorganization diluted the old common shares, it was necessary to allot to corpus enough of the new shares to preserve the old common's intact value. With respect to preferred shares, the majority followed the conclusion *in fact* of *Fisher's Estate* by holding that the exchange of $100 par value preferred stock for $100 par value preferred stock is the substitution of identical values. Thus, the majority would use book value at the time of reorganization to determine the value of the new common shares, but par value to determine the value of the new preferred shares. It would lump together the investments in common and preferred for purposes of determining whether the old common shares were diluted, but would treat preferred separately in determining whether receipt of the new preferred shares would maintain the intact value of the old preferred.

The dissent, on the other hand, noted that the new preferred shares were sold for less than their intact (par) value, and argued that proceeds of the sale of the common stock should therefore have been applied toward satisfaction of this impairment. In its view it was improper to hold that intact value of the original preferred shares could be measured exactly by the new preferred simply because they had the same par value. The dissent would follow the *language* of *Fisher's Estate,* that intact value equals par value except where there is an impairment, and that therefore new shares of the same intrinsic value must be alloted to corpus before anything can be distributed to the life tenants.

7. Termination of a Trust: Who Is Entitled?

It has been held that termination of the trust will not of itself require an apportionment.[155] When shares held in trust are released to the remaindermen, the stock is freed from any and all claim by the life tenant even though the corporation later pays a dividend from income earned and retained during his tenancy. The remaindermen are entitled to all the value inherent in the stock immediately upon the dissolution of the life tenancy,[156] except as to regular dividends which are specifically provided for by statute.[157] On the other hand, if the

155. See RESTATEMENT, TRUSTS § 238 (1935); 3 SCOTT, TRUSTS § 236.13 (1956); Comment, 86 U. PA. L. REV. 111 (1937). This issue has not been specifically litigated in Pennsylvania, but it is reasonably arguable that an apportionment should be made.

156. Neafie's Estate, 325 Pa. 561, 191 Atl. 56 (1937).

157. PA. STAT. ANN. tit. 20, § 633-34, repealed by PA. STAT. ANN. tit. 20, § 3471-85 (Purdon 1950). The same result has been reached in the unproductive real estate cases, where the right of the life tenant to an apportionment of the proceeds of the sale of unproductive real estate will not continue after termination of the trust; otherwise, the remainder may be clogged and the intentions of the testator would be frustrated. Spear's Estate, 333 Pa. 199, 3 A.2d 789 (1939); Miller's Estate, 43 Pa. D. & C. 565 (Orphans' Ct. 1941); Myer's Trust, 35 Pa. D. & C. 492 (Orphans' Ct. 1939).

apportionable event occurred during the life of the trust, but the apportionment was never made, the termination of the trust will not cut off the right of the income beneficiary.[158]

Dividends Declared After the Termination of the Life Tenant's Interest.[159] Prior to 1947, it was provided by statute that where a corporation pays dividends "regularly declared at uniform intervals" over a period of years, the amounts of such dividends will be considered accruing from day-to-day and will, therefore, be apportioned to the death of the life tenant.[160] This principle did not include all ordinary dividends, since those which could not be characterized as "regularly declared at uniform intervals" went under the common law to the tenant in possession at the time they were declared.[161] Determination of the type of dividend involved in this apportionment situation rested in the discretion of the lower court.[162]

When the trust continues into a succeeding income estate, an extraordinary dividend received during the second income tenancy will be apportioned in part to the first income tenant upon a showing that the source of the dividend is income earned and retained during his tenancy.[163]

Where, however, the termination of the income estate terminates the trust, the income tenants have no claim on dividends subsequently declared, even though they can show the distribution came from funds earned and retained during their tenancy. Although allowance of such an apportionment would seem to follow the Pennsylvania rule "to its ultimate logical conclusion" [164] the courts have declined to go so far.[165]

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158. Daily's Estate, 323 Pa. 42, 186 Atl. 754 (1936); Kenny Estate, 7 FID. REP. 354 (1957).

159. See 3 SCOTT, TRUSTS § 236 (2d ed. 1956); Comment, 86 U. PA. L. REV. 111 (1937); Annot., 141 A.L.R. 1466 (1942).

160. PA. STAT. ANN. tit. 20, § 633-34, repealed by PA. STAT. ANN. tit. 20, § 3471-85 (Purdon 1950). The phrase quoted is not the language of the act which speaks of "All . . . dividends of any . . . personal property. . . ." but is a limiting interpretation placed upon this provision in Given's Estate, 323 Pa. 456, 460-61, 185 Atl. 778, 780 (1936) and followed in Nirdlinger's Estate (No. 1), 327 Pa. 160, 165-67, 193 Atl. 33, 36 (1937).

161. Nirdlinger's Estate (No. 1), *supra* note 160.

162. *Ibid.*

163. See Graham's Estate, 296 Pa. 436, 146 Atl. 111 (1929); see also the discussion of apportionment among successive income beneficiaries at p. 181 *infra*.

164. *Cf.* 3 SCOTT, TRUSTS § 236.6 (2d ed. 1956).

165. See Green v. Philadelphia Inquirer Co., 329 Pa. 169, 196 Atl. 32 (1938); Given's Estate, 323 Pa. 456, 185 Atl. 778 (1936); Waterman's Estate, 279 Pa. 491, 124 Atl. 166 (1924). Yates's Estate, 281 Pa. 178, 126 Atl. 254 (1924) is ostensibly *contra*, but distinguishable in that the parties stipulated that dividends paid after the life estate ended were to be treated similarly to those declared during the period of the income tenancy. *Cf.* Faught, *Statutory Solution of the Problem of Allocation Between Life Tenant and Remainderman*, 11 TEMP. L.Q. 139, 141, 154 (1937).

II. Special Problems

A. *Effect of Terms Used in the Trust Instrument*

Since the Pennsylvania rule of apportionment is an attempt to give effect to the intention of the testator,[166] his intention, as expressed in the language of the trust instrument, will be honored providing that it does not direct an unlawful disposition.[167]

Language supporting an apportionment to the life tenant may take a variety of forms, as for example, a direction to convert to cash and distribute profits to the life tenant,[168] or a limitation upon the remainderman to a sum certain, thereby leaving to others an increase in principal value of the investments.[169]

More frequently, however, the language of the testator is construed to favor the remainderman. Thus, where the trustee is directed to distribute only "income," but is instructed to collect a more broadly described group of increments such as "dividends, accretions, profits or benefits," the use of the narrower term "income" for distribution purposes will be indicative of an intent that the life tenant be denied apportionment benefits.[170] Occasionally the testator will affirmatively indicate that apportionable items shall remain in corpus, as where he states that "extra dividends . . . shall be added to and form part of the principal fund. . . ."[171] or "the principal and any accrued income" shall pass to the remainderman at the death of the life tenant.[172]

The testator may also define the intact value date to be used for apportionment purposes. Thus, where the testator directs certain income payments to be made to the life tenant "until the respective trust funds are established," the intact value will be determined as of the date that the trust is established, that is, the day when the securities

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166. Earp's Appeal, 28 Pa. 368 (1857).

167. A trust provision that certain receipts shall be considered principal by the trustee might violate the rule against accumulations, Pa. Stat. Ann. tit. 20, § 3251 (Purdon 1950), if the receipts include items which call for an apportionment. Maris's Estate, 301 Pa. 20, 151 Atl. 577 (1930). Decisions in this area consider various accumulations such as the direction that all the stock dividends shall be considered principal, Maris's Estate, *supra;* that allotments of bonds, stock, or stock dividends shall be treated as principal. Warden Trust, 382 Pa. 311, 115 A.2d 159 (1955); and that stock dividends or proceeds of the sale of rights should be considered as principal, Wentz's Estate, 12 Pa. D. & C. 398 (Orphans' Ct. 1929). Where such directions would not be repugnant to the rule against accumulations the courts will effect the expressed intention of the testator. Maris's Estate, *supra* at 28, 151 Atl. at 579.

168. Quay's Estate, 253 Pa. 80, 97 Atl. 1029 (1916).

169. Middleton's Appeal, 103 Pa. 92, 96 (1883).

170. Ferguson Trust, 354 Pa. 367, 47 A.2d 245 (1946); *cf.* Flaccus's Estate, 283 Pa. 185, 129 Atl. 74 (1925).

171. Ferguson Trust, *supra* note 170. *But see* note 165 *supra.*

172. Yates's Estate, 281 Pa. 178, 126 Atl. 254 (1924); *cf.* Coffman's Estate (No. 2), 31 Pa. D. & C. 93 (Orphans' Ct. 1937).

are turned over to the trustee,[173] whereas otherwise it will be determined as of the date of the testator's death.[174]

B. *Successive Income Beneficiaries*[175]

In some instances, trustee's receipts from stock may require apportionments of amounts attributable to income between successive income tenants. Where the apportionable proceeds are derived from sale or disposition of the stock, there will be an apportionment between successive beneficiaries based on the amounts earned and retained during their respective tenancies, apparently with no presumption that all should go to one life tenant or the other.[176] Where, however, the receipts stem from a corporate distribution, the entire amount apportionable to income will go to the current life tenant unless the prior life tenant can prove that part of the distribution was made from funds earned and retained during his tenancy.[177] In either case, the mechanics of apportionment are within the discretion of the lower court.[178]

Apportionment between successive life tenants of proceeds of the more complex apportionable events would depend on characterization of the receipts in question. Thus, in one case,[179] the court treated the receipt of rights as an extraordinary dividend, and it can be expected that apportionment of the proceeds of reorganizations would similarly depend on the type of transaction involved.[180]

C. *Apportionment of "Capital Gains Dividends" From Investments in Mutual Funds*

Apportionment of capital gains dividends from investments in mutual funds have involved a multitude of questions for which there are, as yet, few answers.[181] The court in *Lovett Estate*[182] held that

173. Frick Estate, 4 Pa. D. & C.2d 247 (Orphans' Ct. 1955).

174. Flinn's Estate, 310 Pa. 206, 165 Atl. 31 (1932).

175. See Brigham, *supra* note 130, at 381; Comment, 86 U. PA. L. REV. 111 (1937); Annot., 159 A.L.R. 589 (1945); *Trusts-Apportionment-Cash Dividends-Successive Life Tenants,* Fiduciary Review, Aug. 1937, p. 1.

176. See, *e.g.,* Neafie's Estate, 325 Pa. 561, 568, 570, 191 Atl. 56, 60-61 (1937).

177. Graham's Estate, 296 Pa. 436, 146 Atl. 111 (1929); *cf.* Fisher's Estate, 344 Pa. 607, 26 A.2d 192 (1942). In order to take a share the prior life tenant must show more than that the market value of the shares had risen during his tenancy, or that the corporation's surplus had increased. See Graham's Estate, *supra.*

178. Neafie's Estate, 325 Pa. 561, 570, 191 Atl. 56, 61 (1937).

179. See Neafie's Estate, *supra* note 178.

180. The problem of apportionment of proceeds from corporate reorganizations between successive income beneficiaries has not been specifically dealt with by the courts. However, the receipt of stock pursuant to a merger was considered an extraordinary stock dividend in Graham's Estate, 296 Pa. 436, 146 Atl. 111 (1929).

181. Only one Pennsylvania case, Lovett Estate, 1 FID. REP. 543 (1951), has considered this issue. The problem was considered in New York in *In re* Byrne's Estate,

such dividends should go to the income tenant, irrespective of Internal Revenue Code labeling, stating that:

> ". . . [T]he securities held are treated by the managers as funds to be turned over in the normal management of the business. . . . The gain resulting from turning over of any portfolio asset by an investment company is income occurring in the ordinary conduct and course of such business." [183]

The decision was supported by a determination that the buying and selling of securities is standard procedure in an investment company's operations and that all profits derived from these activities are income, not enhancements of principal.

The reasoning in *Lovett Estate* has been criticized on the ground that a capital item has been disposed of, and that such a policy would cause a depletion of the estate since the "capital gains" are forced out of the fund by the revenue laws,[184] yet there is no corresponding treatment of losses to encourage maintenance of the fund.[185] It has been suggested that the allocation should depend upon the management policies of the fund.[186] Thus, the trustee might attempt to determine whether the mutual fund is managed conservatively (retaining capital gains in principal) or speculatively (where all capital gains go to income). But this in turn has been criticized because it is too uncertain a test, and would require the trustee to place every payment in corpus as a matter of self-protection.

It is questionable whether securities held by a mutual fund can be considered as classical portfolio investments. Mutual fund investments are carried at market value, not cost, which creates doubt as to whether they are true capital assets. Similar doubt arises from the

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81 N.Y.S.2d 23 (Surr. 1948). The two principal approaches to the problem are discussed in Shattuck, *Capital Gain Distributions, Principal or Income,* 88 TRUSTS & ESTATES 160 (1949), which is a critique of the *Byrne* decision; Young, *Dissent on Capital Gain Distributions,* 88 TRUSTS & ESTATES 280 (1949), which is an answer to Mr. Shattuck's position; Shattuck, *Further Comment on Capital Gain Distributions,* 88 TRUSTS & ESTATES 429 (1949), which is a reply to Mr. Young. Ewart, *Principal and Income Problems of Trustees With Mutual Fund Dividends,* 95 TRUSTS & ESTATES 1025 (1956), discusses apportionment of income, but not the question of whether capital gain distributions should be considered income or principal. Rogers, *Capital Gain Distribution Clauses To Eliminate Question of Allocating Investment Company Dividends,* 90 TRUSTS & ESTATES 300 (1951); Anderson, *Should Capital Gains Distributions Be Principal or Income,* 90 TRUSTS & ESTATES 531 (1951), discuss the problem generally, and recommend provisions for use in trust instruments where funds may be invested in mutual fund shares. The question of the apportionment of common trust funds raises even more difficult problems. See also Lashley v. Lashley, Equity No. 23920, Alleghany Co. Circ. Ct. Md., Nov. 1956.

182. 1 FID. REP. 543 (1951).

183. *Id.* at 545-46.

184. See INT. REV. CODE OF 1954, §§ 852 b 3 (B), (C).

185. See Young, *supra* note 181.

186. *Ibid.*

fact that mutual fund holdings are bought and sold like working capital, not kept for years like the fixed capital assets of a trading or manufacturing business. It might be better to say that the mutual fund is a unique business entity and should be treated as such; otherwise, preconceptions that one might bring to the subject of apportionments may have too great an effect.[187] It is not clear whether the Internal Revenue Code provisions really will work a depletion of the capital fund,[188] nor is it certain that the dichotomy between trading funds and conservative funds is well taken, for values in the modern securities markets constantly change, and even conservative fund investments are traded in order to maintain minimal income standards.

For apportionment purposes, it would seem unreal to view a share in a mutual fund as a pro rata ownership of the securities; rather, it would seem that mutual fund shares should be treated like any other investment,[189] and that realized increments within the fund are income, for the mutual fund is, after all, in the business of investing money and spreading risk capital in such a way as best to afford a broad basis of investment. On the other hand, in some cases, where stock is sold or where the fund distributes stock, there might be cause for some inquiry into the effect of the distribution on intact value.

D. *Income Earned During the Administration of an Estate*

While income earned during the administration of an estate does not present an apportionment problem in the strict sense of that word, it is closely related and helpful to a full understanding of the apportionment problem.

The question is whether the income beneficiaries of a residuary trust are to receive income earned by the estate on principal funds used to pay costs of administration, debts and pecuniary legacies (over and above the interest due on such legacies). A majority of states hold that the income beneficiary of a residuary trust is entitled only to the income from the residue, and that other income of the estate goes to principal,[190] because such a result is said to reflect more accurately the testator's intention.[191] The minority (including Pennsylvania) hold that the life tenant is entitled to all income earned by the

187. This is evident from a series of articles written on this subject, Shattuck and Young, *supra* note 181. Mr. Shattuck's comments reflect the Massachusetts rule that capital gains are retained in principal, whereas Mr. Young's discussion reflects the Pennsylvania rule.

188. See Young, *supra* note 181.

189. See, *e.g.*, Lovett Estate, 1 FID. REP. 543 (1951).

190. See, *e.g.*, RESTATEMNT, TRUSTS § 234, comment *g* (1935); 3 SCOTT, TRUSTS § 234.4, at 1788 (2d ed. 1956).

191. *Ibid.*

estate during the administration.[192] This view is justified as favoring the primary objects of the testator's bounty and as being easier to administer, especially in view of the difficulty in determining what constitutes income on a residue not yet determined.[193]

No Pennsylvania cases have considered this problem, but the Fiduciaries Act of 1949 [194] provides that "All income from real and personal estate earned during the period of administration and not payable to others shall be distributed pro rata among the income beneficiaries of any trust created out of the residuary estate. . . ." The commissioners' comment [195] indicates that this is a restatement of the common law, for it notes that

> "[T]here is no statutory precedent for this section. However, it follows the usual practice of having the persons entitled to the income of the residuary estate receive the income gains or bear the income burdens during the period of administration, and in not restricting their income to income on the net share ultimately received by them. Any other rule is very difficult of application. . . . Since income is distributed to 'income beneficiaries' we avoid any possible claim that any part of it should be capitalized. . . ." [196]

E. *The Apportionable Income Item as a Vested Right* [197]

The Principal and Income Act of 1947,[198] which by its terms is to ". . . govern the ascertainment of income and principal and the apportionment of receipts . . . in all cases where a principal has been established. . . ." [199] prescribes rules quite different from the common-law Pennsylvania rules of apportionment. Thus, the act allocates to income all receipts other than shares of the same kind and rank as those held by the trust,[200] whereas under the common law such

192. 3 Scott, Trusts § 234.4, at 1789 (2d ed. 1956).

193. *Ibid.*

194. Pa. Stat. Ann. tit. 20, § 320.753 (d) (Purdon 1950).

195. Pa. Stat. Ann. tit. 20, commissioners' comment, § (d), at 421 (Purdon 1950). The comment cites Restatement, Trusts § 234, comment *g* (1935); 33 Va. L. Rev. 368 (1947); 158 A.L.R. 441 (1945).

196. The comment cites Bennett's Estate, 29 Pa. Dist. 148 (1920). This problem is no longer important in Pennsylvania, so far as the common law is concerned, for the Uniform Principal & Income Act applies to all administrations begun after 1945, but might still be applicable in other states following the Pennsylvania case law.

197. See Brigham, *Apportionment—Trusts Created Before May 3, 1945—Guides for Trustees,* Fiduciary Review, Aug. 1955, p. 1; *Apportionment—Stock Dividends—Principal and Income Acts,* Fiduciary Review, July 1949, p. 1.

198. Pa. Stat. Ann. tit. 20, § 3470.1 (Purdon Supp. 1956). For a discussion of the effect of this act on the apportionment problem, see *Principal and Income Act of 1947,* Fiduciary Review, Aug. 1947, p. 1; *id.* Sept. 1948, p. 1. The foregoing act superseded the Uniform Principal and Income Act, Pa. Stat. Ann. tit. 20, §§ 3471-3485 (Purdon 1950).

199. *Id.* § 3470.2.

200. *Id.* § 3470.3(1).

distributions may be apportionable between principal and income.[201] Moreover, the act provides that dividends paid in shares of the same kind and rank are to be retained in principal,[202] while the common-law rule required that such dividends, insofar as they represent profits earned and retained during the income tenancy, would go to the life beneficiary.[203] And where the prior case law required an apportionment of the proceeds of a sale of trust-held stock,[204] the act provides that in the absence of a contrary proper direction such proceeds be deemed principal.[205]

It is clear that if the act had been retroactively applied there would have been a need for change in the accounting procedures of all trustees whose trusts were created prior to its enactment. Depending on the apportionable event involved, this might have affected adversely the rights of remaindermen or of income tenants. It is not surprising, therefore, that soon after the act took effect the question of its applicability to pre-existing trusts was raised.

This issue first came before the Pennsylvania Supreme Court in *Crawford Estate*[206] in which it was held that, under the Pennsylvania apportionment rule, the life tenant of a trust created prior to the enactment of the Principal and Income Act possessed a *vested* right to receive a proper portion of a stock dividend or other nominally capital increment; and that the act could not constitutionally deprive the life tenant of this apportionment right. The remaindermen had argued that the apportionment interest of the life tenant "is *contingent, inchoate and a mere expectancy,* which the Legislature may constitutionally modify or destroy";[207] to which the court replied that a "gift of an equitable life estate in *'income'* is a grant of *a vested property interest,* . . . [which the] Legislature may not thereafter qualify or extinguish. . . ."[208] and further that it could not ". . . accept the remaindermen's contention that the life tenant's property right is inchoate or a mere expectancy simply because the *quantum* of income may vary upon *application* of the Pennsylvania Apportionment Rule."[209]

201. See pp. 166-68, 171-73 *supra.*

202. PA. STAT. ANN. tit. 20, § 3470.5 (Purdon Supp. 1956).

203. See pp. 166-68, 171-73 *supra.*

204. See pp. 168-69 *supra.*

205. PA. STAT. ANN. tit. 20, § 3470.3 (Purdon Supp. 1956).

206. 362 Pa. 458, 67 A.2d 124 (1949); see also Warden Trust, 382 Pa. 311, 115 A.2d 159 (1955); Steele Estate, 377 Pa. 250, 103 A.2d 409 (1954); Jones Estate, 377 Pa. 473, 105 A.2d 353 (1954); Pew Trust, 362 Pa. 468, 67 A.2d 129 (1949).

207. *Id.* 461, 67 A.2d at 126.

208. *Id.* 463, 67 A.2d at 127.

209. *Id.* 465, 67 A.2d at 128.

This decision was later held applicable in *Warden Trust* to a case where the securities involved had been *purchased* after the effective date of the Principal and Income Act.[210] In both cases the trust instruments contained provisions that stock dividends should be treated as principal, but the court disregarded these directions because they required an invalid accumulation of income forbidden by the Act of 1853.[211] The life tenant was then held to have a vested right to these accumulations.[212] The result is awkward because both decisions apply the apportionment rule based on the intention of the testator[213] to do just what the testator had expressly directed should not be done. Yet this inconsistency is doubtless due to the requirements of the anti-accumulations statute[214] rather than to any fallacy in the court's reasoning.

But what effect will *Crawford Estate* have on a trust established after the effective date of the act by exercise of a power of appointment existing within the framework of a trust created prior to that date? So far as general powers are concerned, it is arguable that such trusts will be subject to the act because the appointees under the exercised power cannot be said to have acquired a vested interest prior to the enactment of the statute. In fact the only persons with any interest traceable to the earlier trust's creation would be those taking in default of appointment.[215]

The answer is less apparent in the case of special powers. The Pennsylvania courts have held that, for purposes of the Rule Against Perpetuities, the exercise of a special power of appointment relates back to the time when the power was granted.[216] It might be argued, therefore, that the interest which vests by the exercise of the power should be considered vested from the time that the power was granted. On the other hand, it is one thing to forbid a testator or settlor to extend his control (qua the Rule Against Perpetuities) through the use of a special power; it is quite another to say that the interests vest from the time the special power is granted via the relation back

210. 382 Pa. 311, 115 A.2d 159 (1955).

211. Pa. Sess. Laws 1853, No. 304, at 503.

212. See PA. STAT. ANN. tit. 20, § 301.8(b)(1) (Purdon 1950) (repealed by Pa. Sess. Laws 1955, No. 347, at 1075). See also PA. STAT. ANN. tit. 20, § 301.7 (Purdon Supp. 1956).

213. See pp. 159-60, 180-81 *supra*.

214. See note 209 *supra*. Following the decision in Maris's Estate, 301 Pa. 20, 15 Atl. 577 (1930), the Act of May 25, 1939, P.L. 201 permitted the accumulation of substantially all apportionable items held in trusts created thereafter. The Estates Act of April 24, 1947, PA. STAT. ANN. tit. 20, § 301.6 (Purdon 1950) limited the accumulation of items otherwise apportionable to extraordinary dividends and stock rights. The Act of Feb. 17, 1956, PA. STAT. ANN. tit. 20, §§ 301.6, 301.7 (Purdon Supp. 1956) entirely eliminated the rule against accumulations in this respect.

215. See note 207 *supra* and discussion in text.

216. *Cf.* Hays's Estate, 288 Pa. 348, 135 Atl. 626 (1927).

doctrine. Even where the testator restricts the special power to a narrow class, no one member of the class can be said to possess a vested right, since the donee of the power can defeat the interest of any member either by exercising it in favor of other members or by declining to exercise it and allowing the property to pass in default of appointment.

Admittedly, where the testator has established a trust and directed that income should go to a life beneficiary, the meaning of "income" should not be changed during the administration of the trust. But in the power of appointment situation the testator has not directed that the income should go exclusively in an inflexible manner; he merely has said that at a future date another person may determine its devolution among a limited group. In effect, the testator has designated the donee of the power as his alter ego to determine the income distribution at a future date; and if that date be after the effective date of the Principal and Income Act, it is not unreasonable to regard the appointee's interest as having vested after the act which, therefore, becomes applicable as a limitation upon that income interest. The opinions in *Crawford Estate* and *Warden Trust* speak only of the vested rights of the beneficiary. And, so far as a frustration of the testator's desires is concerned, such an application would seem much less drastic than the conversion of a fee tail into a fee simple or the abolition of dower, both of which were noted in *Crawford Estate* as interests which are inchoate and which the legislature may modify or terminate.[217]

The applicability of the Principal and Income Act of 1947 and its predecessor, the Estate Act of 1945, to interests coming into enjoyment after the effective date of those acts, although pursuant to trusts created prior thereto, properly appears to depend upon whether such interests were previously vested. Thus, if the donee does not exercise his power of appointment and beneficiaries take in default thereof, an interest so acquired would be vested subject to divestment.[218] It would follow that any apportionment rights of such a beneficiary would be controlled by the prior case law.

Determination of the existence of a vested interest should also be the key to the solution of the apportionment problem in substantially similar situations, such as a revocable inter vivos life insurance trust,[219]

217. 362 Pa. 458, 464-65, 67 A.2d 124, 128 (1949).

218. Freeman's Estate (No. 1), 35 Pa. Super. 185 (1908), *aff'd*, 280 Pa. 273, 124 Atl. 435 (1924).

219. Conway Trust, 7 FID. REP. 467 (1957), in which a pre-1954 revocable inter vivos life insurance trust was unfunded until the death of the settlor after 1945; and the law at such death was held controlling. See also Riley v. Wirth, 313 Pa. 362, 169 Atl. 139 (1933).

an irrevocable inter vivos life insurance trust,[220] a revocable trust,[221] a case where a pre-1945 trust has assets poured over into it by a post-1945 will or other disposition,[222] and a tentative trust of the type common in Pennsylvania.[223]

F. *Allocation of Income Held in Trust at the Termination of Income Tenancy*

There is a strong presumption, favoring the life tenant, that "where there is an absolute gift of a thing, later words in the same instrument will not operate to reduce the estate thus given, unless it is reasonably certain that such was the intention of the donor." [224] Thus, where income is held in the trust but not paid out at the termination of the life tenancy, the heirs of the life tenants will take even though the will or trust deed states that remaindermen should take the "accumulated income" at the life tenant's death,[225] or that "any undistributed accumulations of income" should go to remaindermen.[226] The rationale of these decisions is that the phrases used are too vague to rebut the strong presumption that the testator intended all income received by the trust during the life tenancy to go to the income tenant.

This attitude is also reflected in *Mallory's Estate*,[227] where the court held a direction that the remainderman receive "unpaid income and dividends" should be interpreted as dividends not received by the

220. In the case of Knoche v. Mutual Life Ins. Co., 317 Pa. 370, 176 Atl. 230 (1934), the court said that where the right to change the beneficiary under an insurance policy had not been expressly reserved, the named beneficiary holds a vested interest subject to divestment in the event of his death before the insured. It would seem to follow, therefore, that the prior case law would apply if an irrevocable insurance trust contained policies providing the beneficiary with a vested interest as described.

221. In McKean Estate, 366 Pa. 192, 77 A.2d 447 (1951), the widow elected to take against the will under the Estates Act of April 24, 1947, PA. STAT. ANN. tit. 20, § 301.11 (Purdon 1950), and the court held that her election did not extend to a pre-1945 inter vivos revocable trust because such trust had created interests which were not merely expectancies but which were vested subject to divestment.

222. Where a pre-1945 trust is increased by a pour-over from a post-1945 disposition, it would be reasonable to segregate the two groups of assets and respectively apply to them the pre-1945 and post-1945 apportionment rules. A comparative situation is found in Vederman Estate, 78 Pa. D. & C. 207 (Orphans' Ct. 1951), wherein a widow was permitted to include in her election to take against the will under the Act of April 24, 1947, those assets which were contributed after 1947 to a trust created prior thereto. (The widow also reached the pre-1945 assets but only because the trust was deemed to be in the nature of a testamentary disposition.)

223. Iafolla Estate, 380 Pa. 391, 110 A.2d 380 (1945), states that a tentative trust creates no vested interest because the trust is effectuated only by the subsequent death of the settlor. A true revocable trust is distinguishable in that it is held to create a vested interest subject to divestment through the act of revocation by the settlor.

224. See Mallory's Estate, 285 Pa. 186, 189, 131 Atl. 714, 715 (1926).

225. Yates's Estate, 281 Pa. 178, 126 Atl. 254 (1924); Kenney Estate, 7 FID. REP. 354 (1957).

226. Coffman's Estate (No. 2), 31 Pa. D. & C. 93, 95 (Orphans' Ct. 1937).

227. 285 Pa. 186, 131 Atl. 714 (1926).

trust, not dividends received but not paid to the income tenant; and in *Thaw's Estate*,[228] which held that a direction in a trust instrument for semi-annual payments of income would require an apportionment of income accrued between the last income payment and termination of the life estate.

G. *Charitable Trusts*

When the sole beneficiary of a perpetual trust is a charity, there usually is but one object of the testator's bounty. However, the intention of the testator, which is the basic guide in apportionment matters, may be construed in varying ways. For example, in *Jordan Estate*[229] the trust's capital gain was awarded to income beneficiaries (a church and church academy) because the testator could not have intended "the building up of a large fund for the benefit of a charity or charities of which he had no knowledge . . . [or] connection . . . and to whom under the *cy pres* . . . interest and income would inure in the event of the non-existence of the Church and Academy. . . ."[230] In *Girard's Estate*[231] and *Trexler's Estate*,[232] the trusts were for the benefit of public bodies less likely the subject of *cy pres*, and the courts awarded the benefit to principal.

It seems evident that the permanency of the beneficiary is the basis for reconciling these apparently conflicting decisions. The beneficiaries in the latter cases were the cities of Philadelphia and Allentown which, in one form or another, are likely to continue; whereas the beneficiary in *Jordan Estate* was a private organization which might be terminated and supplanted under the *cy pres* doctrine with another private organization outside the testator's intention.

H. *Request for Apportionment of Items Included in Prior Adjudication*

Audit of a fiduciary's account is a formal legal proceeding in which all interested parties should appear to present objections which they may have to a fiduciary's management, following which the court adjudicates the accountant's stewardship for the period covered by the account. All competent interested beneficiaries, upon receiving notice that an account has been filed, are charged not only with their actual

228. 73 PITT. L.J. 289 (1925).

229. 2 FID. REP. 561 (1952). See also *Principal and Income—Apportionment—Capital Gains—Charitable Trusts*, Fiduciary Review, Nov. 1952, p. 1.

230. *Id.* at 566.

231. 49 Pa. D. & C. 217 (Orphans' Ct. 1945).

232. 32 Pa. D. & C. 427 (Orphans' Ct. 1938).

knowledge of the affairs of the estate, but also with knowledge of all that could have been discerned by the exercise of reasonable diligence.[233]

However, even after adjudication, an audit may be reviewed in Pennsylvania through (1) a petition for review; (2) a petition to the orphans' court to correct its records; or (3) the use of different accounting procedures or exceptions at a later audit.

1. Petition for Review

Since 1840 a Pennsylvania statute has authorized interested parties to petition the orphans' court, within five years, for review of certain decisions.[234] Even though the statute is couched in general terms, until recently a review of a prior proceeding was not granted in every case as a matter of right.[235] Rather, courts considered the statute as a provision designed to confer upon them a type of equity jurisdiction which called "for a dispensation of equity's grace, and not for the recognition of a legal right . . . [and] consequently, before equity will grant relief, 'it must appear that good conscience and substantial justice will require it. . . .' "[236] Review as a matter of right had been limited to cases where an error of law appears on the face of the record, where new matter has arisen or "where justice and equity require and no one will be injured thereby."[237] However, subject to the five year limitation period, *Stotesbury's Estate*[238] implies that the right of review is mandatory and that as long as an apportionable item remains within reach of the court it must be awarded to the life tenant if he demands it in a proper proceeding.

233. Mershon Estate, 364 Pa. 549, 73 A.2d 686 (1950).

234. Act of October 13, 1840, P.L. 1, § 1, limited to settled accounts; in the 1917 act, reprinted in PA. STAT. ANN. tit. 20, § 321.1143 (Purdon 1950), and the 1949 act, PA. STAT. ANN. tit. 20, § 320.721 (Purdon 1950), now in force, the review extends to "any part of the account, or of an auditor's report, or of the adjudication, or of any decree of distribution. . . ."

235. See Riddle's Estate, 19 Pa. 431 (1852).

236. Stewart Estate, 358 Pa. 434, 439, 58 A.2d 42, 44 (1948).

237. Bailey's Estate, 291 Pa. 421, 424, 140 Atl. 145, 146 (1927); Priestley's Appeal, 127 Pa. 420, 17 Atl. 1084 (1889); Scott's Appeal, 112 Pa. 427, 5 Atl. 671 (1886); Riddle's Estate, 19 Pa. 431 (1852). In addition to review as a matter of right, it sometimes is said that review will be allowed as a matter of grace where new evidence is presented (apparently distinguishable in some shadowy way from new matter) which bears on the issues. It seems well established that laches will preclude consideration of a petition for review, Michener's Estate, 225 Pa. 66, 73 Atl. 1059 (1909), where petitioner alleged no notice of the audit but accepted its benefits and did not file a petition for 4 years and 9 months; Kachline's Estate, 7 Pa. Super. 163 (1898), where review was not sought for more than 3 years after discovery of grounds; Poh's Estate, 12 Pa. Dist. 160 (1903), involving a delay of 14 months in pressing a claim raised at an adjudication in which plaintiff was represented by counsel; see also Gottshalk's Estate, 344 Pa. 135, 23 A.2d 454 (1942); Clothier's Estate, 18 Phila. 230 (1887); *cf.* Sherwood's Estate, 206 Pa. 465, 56 Atl. 20 (1903); Cassatt's Estate, 45 Pa. D. & C. 185 (Orphans' Ct. 1942); Stocker's Estate, 25 Pa. Dist. 1013 (1916).

238. 387 Pa. 591, 128 A.2d 587 (1957).

Moreover, review is possible even after expiration of the five-year period in the case of a fraud[239] which has operated "to prevent the fiduciary or 'any person interested' from taking action within the five years. . . ."[240] But, to obtain such a review, the petitioner must prove both the fraud and the reasons why it was not discovered within the five-year statutory period.[241]

2. Petition To Correct the Record

Orphans' courts have an inherent equitable power to correct their records.[242] This power will be liberally exercised,[243] especially "where no rights have changed in consequence of the decree."[244] The power of the court to correct its own records extends not further than the five-year period permitted by the statutes discussed previously.[245] The current function of the proceeding is to provide a remedy in those cases not covered by the statutory remedies.[246]

3. Review by Later Accounting

While in a second accounting the auditing judge is not bound by erroneous conclusions of law in the preceding account,[247] nevertheless, finality will attach to a previous finding of fact if the prior proceeding had "properly call[ed] to the attention of the parties the specific matters to which they must object, if dissatisfied."[248] Moreover, the five-year

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239. Hamilton Estate, 351 Pa. 419, 41 A.2d 567 (1945).
240. Thorne's Estate, 344 Pa. 503, 510, 25 A.2d 811, 815 (1942).
241. Netter Estate, 68 Pa. D. & C. 309 (Orphans' Ct. 1949); *cf.* Thorne's Estate, *supra* note 240; Daub's Estate, 313 Pa. 35, 169 Atl. 379 (1933). The act also provides that review is not available to alter a distribution of funds paid pursuant to a decree, PA. STAT. ANN. tit. 20, §§ 320, 1401 (Purdon 1950), but this would not be a bar in a proceeding to surcharge an accountant for misappropriated property not accounted for and, therefore, not within the decree of confirmation. Kinter's Appeal, 62 Pa. 318 (1869); *cf.* Hamilton Estate, 351 Pa. 419, 41 A.2d 567 (1945); Chappel's Estate, 264 Pa. 486, 107 Atl. 846 (1919).
242. Gerlach Estate, 364 Pa. 207, 214-15, 72 A.2d 271, 275 (1950); Stetson's Estate, 305 Pa. 62, 65, 155 Atl. 856, 857 (1931); Huff's Estate, 300 Pa. 64, 66, 150 Atl. 98, 99 (1930); Chappell's Estate, *supra* note 241; Young's Estate, 99 Pa. 74, 83 (1881); George's Appeal, 12 Pa. 260 (1849).
243. Chappell's Estate, *supra* note 242; see Sloan's Estate, 254 Pa. 346, 350, 98 Atl. 966, 967-68 (1916).
244. Bender's Estate, 278 Pa. 199, 203, 122 Atl. 283, 284 (1923).
245. Stetson's Estate, 305 Pa. 62, 155 Atl. 856 (1931); *cf.* George's Appeal, 12 Pa. 260 (1849).
246. See, *e.g.*, George's Appeal, *supra* note 245.
247. Reamer's Estate, 331 Pa. 117, 120-21, 200 Atl. 35 (1938); Bullitt's Estate, 308 Pa. 413, 162 Atl. 288 (1932); *cf.* Kellerman's Estate, 242 Pa. 3, 88 Atl. 865 (1913).
248. Willing's Estate, 288 Pa. 337, 343, 135 Atl. 751, 752 (1927). The act of 1840 does not apply to retrials of questions of fact. Priestly's Appeal, 127 Pa. 420, 17 Atl. 1084 (1889). A failure to claim apportionable items at prior accountings and the award thereof to corpus can bar the life tenant under the doctrine of res judicata where such items have become part of the "warp and woof of the corpus. . . ." Jordan Estate, 83 Pa. D. & C. 1, 14 (Orphans' Ct. 1952); see also Bullitt's Estate, *supra* note 247; Kellerman's Estate, *supra* note 247.

statutory limitation, above referred to, will also bar further inquiry into the earlier accounting.[249]

The choice between these three remedies depends somewhat upon the type of error involved. A review to rectify errors of law can be obtained most easily by an objection in the next accounting. However, much can happen in the operation of a trust before another account is filed, and a petition for review under the Fiduciaries Act of 1949 provides the more efficient remedy before the errors are compounded and time dulls the edge of husbandry.[250]

III. Federal Tax Consequences of Apportionments

A. *Federal Income Tax Consequences*

The 1954 Internal Revenue Code has resolved some but not all of the basic conflicts between judicial and administrative rules of federal income taxation of apportioned distributions to income beneficiaries. The new code follows the prior administrative rule in adopting, in substantial part, the conduit theory[251] under which the beneficiary

249. Brown's Estate, 343 Pa. 19, 29, 21 A.2d 898, 903 (1941); Neafie's Estate, 325 Pa. 561, 564-65, 191 Atl. 56, 58 (1937); see Daub's Estate, 313 Pa. 35, 39-40, 169 Atl. 379, 381 (1933).

250. Grounds for granting review include the following: (1) an error of law on the face of the record. Stotesbury Estate, 387 Pa. 591, 128 A.2d 587 (1957). *But see* Cassatt's Estate, 45 Pa. D. & C. 185 (Orphans' Ct. 1942), where a change in substantive law was said not to be an error of law apparent on the face of the record. *But cf.* Frantz v. Philadelphia, 333 Pa. 220, 3 A.2d 917 (1939); (2) new matter. Estate of Turnbull, 88 Pa. Super. 482 (1932). *But see* Priestly's Appeal, 127 Pa. 420, 17 Atl. 1084 (1889), denying review of trustee's commissions later discovered to be unearned; Mershon Estate, 364 Pa. 549, 73 A.2d 686 (1950), denying review when knowledge was available to the petitioners and the public at large; *cf.* Graham's Estate, 28 Pa. Dist. 1023 (1919); (3) that the matter was not raised or decided in the prior adjudication. Reamer's Estate, 331 Pa. 117, 200 Atl. 35 (1938); Bullitt's Estate, 308 Pa. 413, 162 Atl. 288 (1932); Willing's Estate, 288 Pa. 337, 135 Atl. 751 (1927); Kellerman's Estate, 242 Pa. 3, 88 Atl. 865 (1913). *But see* Brown's Estate, 343 Pa. 19, 21 A.2d 898 (1941), refusing review where parties had an opportunity to raise their objection at prior proceeding; (4) fraud. *But see* Thorne's Estate, 344 Pa. 503, 25 A.2d 811 (1942), denying review where the party had waited an unreasonable time to disaffirm a contract made by him while in an alcoholic condition (elaborate dictum): Daub's Estate, 313 Pa. 35, 169 Atl. 379 (1933), holding no fraud although the executor did not disclose the full amount of assets which were distributable; see also Kinter v. Commonwealth Trust Co., 274 Pa. 436, 118 Atl. 392 (1922); Netter Estate, 68 Pa. D. & C. 309 (Orphans' Ct. 1949), in which laches barred a review: (5) change in the law. Reamer's Estate; Estate of Mereto, 39 Montg. Co. L. Rep. 679 (Pa. 1929); (6) misconduct of a fiduciary. See Wilford's Estate, 70 Montg. Co. L. Rep. 83 (Pa. 1953), granting review despite inconvenience and burdensome calculations imposed on trustee. *But see* Nixon's Estate, 239 Pa. 270, 86 Atl. 849 (1913), impliedly finding no misconduct by a fiduciary who was officer of corporation in which the trust held shares; Millikan's Appeal, 227 Pa. 502, 76 Atl. 248 (1910), refusing review when the party had neglected earlier to raise objection to excess commissions; Scott's Appeal, 112 Pa. 427, 5 Atl. 671 (1886), denying review when the claimant did not raise the issue solely because he lived in Ireland.

251. S. Rep. No. 1622, 83d Cong., 2d Sess. 343 (1954): "In effect, the concept of distributable net income gives statutory expression to the principle underlying the taxation of estates and trusts, that is, that these separate taxable entities are only conduits through which income flows to the beneficiaries. . . ."

generally is taxed only to the extent that the trustee would have been taxed had no apportionment been made.

The pre-1954 judicial rule had denied the need or desirability of correlating the incomes of the trustee and the income beneficiaries.[252] While this was perhaps a proper result where the effect was merely to deny the income beneficiary the benefit of losses and expenses chargeable to corpus, the doctrine was extended to the point where it enlarged the created income in the apportionment situation.[253] And in so doing the courts created conflict and confusion as to when and how much of the apportioned distribution was taxed.

The decisions uniformly created income by adopting the superficial rule that what an *income* beneficiary receives for trust accounting purposes must, without other reason, be income for federal tax purposes. In *Kathryn E. T. Horn*[254] the income beneficiary had received a distribution of principal in 1940 as reimbursement, under the Pennsylvania apportionment rule of *Levy's Estate,*[255] for loss of income during earlier years when so-called salvage expenses exceeded rental income. The principal distribution was taxed as income at the beneficiary level although there was in fact no income at the trustee level. This type of arbitrary creation of taxable income runs the gamut of most apportionment situations. In *Plunkett v. Commissioner*[256] the beneficiary was taxed on a surcharge receipt apportioned under Massachusetts law as replacement of hypothetical income which "might have been" had there been no breach of trust by the surcharged trustee. In *Johnston v. Helvering,*[257] tax was imposed upon an apportionment under New York law of a part of the sales proceeds of foreclosed property although the trustee had incurred a loss; and a similar apportionment under Pennsylvania law was similarly taxed in *John F. Nixon.*[258]

This judicial approach defined taxable income not by its character but by the character or status of the recipient. In the *Johnston* decision the court stated the rule as follows:

252. In denying the income beneficiary's right to deduct a loss realized by the trust, a conceptualistic approach was established in Anderson v. Wilson, 289 U.S. 20 (1933): "In so ruling, we do not forget that the trust is an abstraction, and that the economic pinch is felt by men of flesh and blood. Even so, the law has seen fit to deal with this abstraction for income tax purposes as a separate existence, making its own return under the hand of the fiduciary and claiming and receiving its own appropriate deductions." *Id.* at 27.

253. KENNEDY, FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES § 2.15A (1948).

254. 5 T.C. 597 (1945).

255. 333 Pa. 440, 5 A.2d 98 (1939).

256. 118 F.2d 644 (1st Cir. 1941). But there is substantial basis for treating a surcharge receipt as distributable income. Cornelius J. Ryan, 8 CCH Tax Ct. Mem. 804 (1949).

257. 141 F.2d 208 (2d Cir.), *cert. denied,* 323 U.S. 715 (1944).

258. 4 CCH Tax Ct. Mem. 741 (1945).

". . . [T]he amount of the proceeds apportioned to petitioners under this rule must, as far as petitioners, the life income beneficiaries, are concerned, be considered as 'income' received by them, *since under the instrument creating the trusts petitioners were only entitled to receive 'income' and nothing else.*" (Emphasis added.) [259]

But if the trust instrument *stipulates* that principal be invaded for distribution to the beneficiary, it is conceded that the distribution could not be taxed as income; and this should be the result even though the instrument stipulates that a prospective principal distribution shall depend upon an apportionable event. Why, then, should a different result obtain simply because the instrument is silent and, in its stead, the local law speaks and requires the apportionment of a principal sum?

Nevertheless, the judicial rule persisted and, having thus created taxable income in cases involving cash distributions, the extreme extension of the doctrine, however erroneous, was eventually exemplified in *McCullough v. Commissioner.*[260] In that case the court held the life tenant taxable upon an apportioned stock dividend which had been received tax-free by the trustee. By special ruling,[261] the Treasury Department refused to follow the *McCullough* decision and thereby continued its prior administrative rule[262] that "income of a trust, which is currently distributable, retains in the hands of the beneficiary the identity which it possesses in the hands of the trustee." This administrative rule was curiously and inconsistently used as precedent in that the beneficiary was not taxed when the trustee sold the tax-free stock dividend and distributed cash in lieu of stock,[263] but tax was imposed upon cash distributions resulting from apportionments due to surcharge and salvage receipts of the kind dealt with in the *Johnston* case.

259. Robert W. Johnston, 1 T.C. 228, 237 (1942); followed in John F. Nixon, *supra* note 258, at 742. But where the income beneficiary did not claim the apportionment, and there was some doubt under local Pennsylvania law that an apportionment would have been granted if claimed, the beneficiary was not taxed on his hypothetical right to the apportionment. Marjorie V. L. Hudson, 8 T.C. 950 (1947).

260. 153 F.2d 345 (2d Cir. 1946). The decision benefited the taxpayer who had been apportioned and had later sold stock dividend stock, and who then claimed a high cost equal to its fair market value at the dividend distribution date. The result was contrary to I.T. 1622, II-1 CUM. BULL. 135 (1923) which ruled that the beneficiary was not taxable on a stock dividend which was tax-free in the hands of the trustee.

261. P-H 1948 FED. TAX SERV. ¶ 76225.

262. I.T. 1622, II-1 CUM. BULL. 135 (1923); G.C.M. 21532, 1939—2 CUM. BULL. 231.

263. Rev. Rul. 24, 1953-1 CUM. BULL. 263, imposed tax only on the gain, if any, from the sale of the stock. If the stock was not sold but distributed in kind to the beneficiary, he also received the benefit of the cost basis of the stock apportioned to him. Special Ruling, I.T. 1622, II-1 CUM. BULL. 135 (1923). Special Ruling, 5 CCH 1952 STAND. FED. TAX REP. ¶ 6157.

It is apparent that the administrative rule rendered only lip service to its expressed philosophy that income "retains in the hands of the beneficiary the identity which it possesses in the hands of the trustee." If this language meant what it said, salvage sales proceeds of the *Johnston* type surely would have had the "identity" of non-taxable principal in the hands of the trustee; nevertheless, apportioned proceeds of this type were treated as ordinary income in the hands of the beneficiary.[264] However, if the apportionment was directly traceable to a transaction which *itself* produced not only the apportionable event but also capital gain, the beneficiary would be taxed on the apportionable distribution as capital gain, at least in part.[265]

A further perplexing problem under the pre-1954 law was that of determining *when* the beneficiary was taxable in the case where he received the distribution in a year subsequent to the apportionable event. The answer depended upon whether the apportionment decree spoke as of the date of the apportionable event so that the apportionment could be said to be an income item which was currently distributable by the trustee. In *Kathryn E. T. Horn*[266] the tax court held that the beneficiary was taxable in the later year of distribution because the issue lay within the discretion of the court, which was not exercised until its decree was handed down.[267] This conclusion was contrary to the prior holding in *Johnston v. Helvering*[268] and to subsequent decisions by the district court, tax court and the circuit court.[269] The conflicting tax court rule appears to have been laid at rest in the light of the principle that, in determining what is currently distributable,

264. Carrie A. Kolb, 6 CCH Tax Ct. Mem. 1184 (1947), involved the usual apportionment situation in which salvage sales produced a loss. The court concluded that "Since no capital gain was realized by either the trust or the life beneficiary, nothing can be taxed as capital gain." *Id.* at 1186. If capital gain was realized to some extent, who would receive the resulting tax benefit: beneficiary, trustee, or both in allocable shares?

265. Rev. Rul. 24, 1953-1 CUM. BULL. 263. *Cf.* Commissioner v. Hopkinson, 126 F.2d 406 (2d Cir. 1942); Arthur Letts, Jr., 30 B.T.A. 800 (1934), *aff'd,* 84 F.2d 760 (9th Cir. 1936); McNaghten v. United States, 17 F. Supp. 509 (Ct. Cl. 1937). But if trustee and beneficiary are apportioned equal portions of $1,000 of sales proceeds that produced $600 capital gain, who pays the tax on the $600 gain: (a) trustee on $600; (b) trustee on $500 and beneficiary on $100; (c) trustee on $100 and beneficiary on $500 gain? Alternative (c) would apply if the presumption be that gain is first distributed.

266. 5 T.C. 597 (1945).

267. See also Emily B. Harrison, 7 T.C. 1 (1946); A. Douglas Russel, 7 CCH Tax Ct. Mem. 627 (1948); Mary deF. H. Geary, 9 T.C. 8 (1947). Marjorie V. L. Hudson, 8 T.C. 950 (1947), reaches the same result but emphasizes the unsettled condition of the Pennsylvania apportionment law as inconsistent with the concept of currently distributable income.

268. 141 F.2d 208 (2d Cir.), *cert. denied,* 323 U.S. 715 (1944); note holding of tax court in Johnston v. Commissioner, 1 T.C. 228, 240 (1942).

269. Cope v. United States, 80 F. Supp. 534 (E.D. Pa. 1948); Thomas B. Wanamaker, Jr., 14 CCH Tax Ct. Mem. 203 (1955); Polt (Estate of Robert L. Dula) v. Commissioner, 23 T.C. 646 (1955), *aff'd,* 233 F.2d 893 (2d Cir. 1956).

"tax consequences to the beneficiaries cannot be determined by the timing of payment over by the trustee, even though he may be guided by an honest, if doubtful, interpretation of the state law." [270]

1. The Conduit Concept of the 1954 Code

The 1954 code now establishes the conduit rule with the result that the beneficiary is taxed on no greater amount of income than was received by the trustee. This is accomplished principally by the new concept of "distributable net income," defined as the taxable income at the trustee level which (subject to certain statutory adjustments) operates as the maximum amount taxable to the beneficiary.[271] The Report of the Senate Finance Committee leaves no doubt but that apportionments currently distributable to the beneficiaries are taxed only if and to the extent that they are taxable to the trustee, regardless of whether the source of the apportionment be a stock dividend as in the *McCullough* case, the proceeds of salvage sales as in the *Johnston* case, or any other apportionable event.[272]

"Distributable net income" is computed by excluding from taxable income, insofar as concerns apportionment distributions, (1) those capital gains which are "allocated to corpus and . . . not paid, credited or required to be distributed to any beneficiary during the taxable year," and (2) those extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law.[273] Since the starting point is "taxable

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270. Polt v. Commissioner, *supra* note 269, at 896.

271. INT. REV. CODE OF 1954, §§ 643, 652, 662; S. REP. No. 1622, 83d Cong., 2d Sess. 82 (1954).

272. S. REP. No. 1622, 83d Cong., 2d Sess. 346 (1954) states that the new § 652 ". . . provides that the beneficiaries of a trust which is required to distribute all of its income currently are taxed on the amounts of income required to be distributed to them, whether distributed or not; however, if such amount exceeds the distributable net income of the trust, each beneficiary is taxed only on his proportionate share of the distributable net income. . . . The effect of this limitation . . . insures that the beneficiary will not be taxed on certain distributions to him that represent income under the local law applicable to trusts but that are not regarded as income to the trust for Federal income tax purposes. Under certain decisions of existing law, a beneficiary has been held taxable on his distributable share of proceeds received by a trust from a defaulted mortgage even though the total proceeds were less than the principal of the mortgage debt, and the trust thus realized no gross income. . . . Similarly, the receipt by a beneficiary of a stock dividend that was not taxable in the hands of the trust was determined to be a taxable distribution in McCullough v. Commissioner. . . . Although similar results may or may not be reached in other cases, the limitation of this section should insure that such a construction will not arise in cases where the new provisions of this part are applicable and will preserve the conduit principle in this area."

273. INT. REV. CODE OF 1954, § 643. This provision rounds out the conduit principle by passing through the tax-free income items as well. Subsections (5), (6) and (7) respectively provide for inclusion in distributable net income of tax-free interest, for-

income," there is automatically excluded from "distributable net income" not only the capital gain and extraordinary dividend items already mentioned but also items of receipt which fall outside the "taxable income" area because, under general taxation principles, they are tax-free.[274] Examples are the receipt of principal payments or of non-taxable stock dividends.

The relationship between trustee and beneficiary is further refined by subpart B in the case of "Simple Trusts," and by subpart C in the case of "Complex Trusts,"[275] which require the trustee to deduct and the beneficiary to pay tax upon the amount of *trust accounting income* required to be distributed currently; but the amount so taxable to the beneficiary cannot exceed the amount of "distributable net income." Thus, an apportionment will be taxed to the beneficiary only if in the first instance it is a taxable item in the trustee's hands, and if so taxable, it must be a sum which is "required to be distributed currently."

Assuming that the apportioned item is taxable in the trustee's hands, and that it is taxable currently to the trustee because it need not be, and in fact is not, distributed to the beneficiary, a subsequent distribution of the item may be taxed to the beneficiary under the new "throw-back" rule which would entitle the beneficiary to take credit for any tax previously paid by the trustee.[276] However, even the delayed taxation of the beneficiary under the throw-back rule is limited to income which was initially taxable as such in the hands of the trustee.[277]

Finally, the conduit concept is rounded out by the rule that the amount of distributable net income taxable to the beneficiaries shall have the same character in the hands of the beneficiary as in the hands of the trust.[278] While this statement of the rules of taxation of fiduciary income is undoubtedly oversimplified, it is sufficient as background against which to test the income tax consequences of apportionment distributions.

eign source income of a foreign trust, and dividends otherwise excludible under section 116. These items are thus included, passed through and then excluded at the beneficiary level under rules of limitation pertaining to pro-rating tax-exempt income, deductibility of expenses, etc.

274. The approach adopted by the bill eliminates the necessity, in determining the taxability of distributions, of tracing such distributions to the income of the estate or trust for the current taxable year. S. REP. No. 1622, 83d Cong., 2d Sess. 83 (1954).

275. INT. REV. CODE OF 1954, §§ 651, 652 (Subpart B) applies only to trusts which are required to distribute all income currently to non-charitable beneficiaries. INT. REV. CODE OF 1954, §§ 661, 662, 663 (Subpart C), applies to trusts and estates which, in addition to the first tier of income "required to be distributed currently," have other income, which is paid, credited or required to be distributed.

276. INT. REV. CODE OF 1954, §§ 665-68.

277. INT. REV. CODE OF 1954, § 668(a), provides that the delayed distribution is taxable to the beneficiary only "to the extent that such total would have been included in the income of such beneficiary . . . if [it] . . . had been paid to such beneficiary . . . in the preceding taxable year."

278. INT. REV. CODE OF 1954, §§ 652(b), 661(b).

As already indicated, all *non-taxable* receipts of the trustee are, by definition, excludible from distributable income. Since the beneficiary cannot be taxed upon any amount greater than the distributable net income, it follows that apportionment distributions of non-taxable stock dividends, and of salvage sale proceeds which are not productive of gain, are non-taxable in the hands of the beneficiary.[279]

But many apportionments are from a source productive of capital gain, as where they arise from the sale of stock of a corporation with accumulated earnings during the trust period, or from the sale of a non-taxable stock dividend. The question will then arise: if but part of the proceeds are apportioned and distributed to the beneficiary, is he taxable on only a pro rata share of the gain or is he taxable on all of the gain to the extent of the distribution received by him?[280] The commissioner's regulations suggest that the beneficiary is taxable on the whole gain only if that gain is "utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed." This rule is apparently applicable where the full gain is included in the apportioned distribution because the trust instrument expressly so provides, or in a unique traceable situation such as under New Jersey law where a stock dividend is apportionable in the limited sense that the trustee is required to sell the stock and distribute the proceeds represented by capitalized earnings.[281] In either case the gain is utilized and traceable *in toto* to the apportioned distribution and, therefore, is fully taxable to the beneficiary.[282]

The more common case is where the sale proceeds are apportioned between trustee and beneficiary and neither the trust instrument nor the factual situation indicates how the related gain is to be apportioned. In such case, and assuming the apportionment is "distributable" or is in fact distributed in the year the gain is realized, there are several possibilities. The lone Pennsylvania decision, *Francis R. Dravo Trust*,[283] holds that the amount apportionable to the income beneficiary must be regarded as a distribution of capital gain up to but not exceed-

279. See note 272 *supra*.

280. Note, 12 TAX L. REV. 99, 102 (1956), suggests that the beneficiary is taxable on capital gains "only in the relatively rare cases where the governing instrument specifically requires distribution of the proceeds or the facts clearly reveal an intent to make available to the beneficiary the proceeds of a sale or exchange as such."

281. The life tenant is said to have merely a charge on the stock dividend insofar as earnings were capitalized. McCracken v. Gulick, 92 N.J. Eq. 214, 112 Atl. 317 (Ch. 1920); Hagedorn v. Arens, 106 N.J. Eq. 377, 150 Atl. 4 (Ch. 1930).

282. Other situations in which the whole gain is taxed to the beneficiary are where it is regular practice to distribute the net proceeds of sale, or if the gain is allocated to corpus which itself is distributed in the year of realization of the gain. U.S. Treas. Reg. 1.643(a)-3.

283. 99 PITT. L.J. 397 (1951).

ing the amount of such gain.[284] A contrary result is indicated by the regulations which, although ambiguous, state that "gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income, and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary. . . ."[285] But apart from this extreme view which can only be implied from the regulations, the Internal Revenue Service generally has taken the middle road of apportioning gain between trustee and beneficiary in the same ratio that the sales proceeds are apportioned between them. Thus, where a stock dividend is apportioned and distributed in kind, it has been ruled that the beneficiary also receives the allocated cost basis attached to the stock with the result that upon a later sale only the excess of proceeds over basis (*i.e.*, the apportioned gain) will be taxable to him.[286] Moreover, if the trustee first sells the stock dividend and then apportions the proceeds, the beneficiary will be regarded as receiving a portion equal to the allocated cost basis as a tax-free distribution of principal.[287]

While at first sight this middle road appears to offer the more equitable rule, the more logical rule is that of the *Dravo Trust* which, to the extent possible, apportions the entire gain to the beneficiary. It is only this rule which is consistent with the dual concepts that the beneficiary receives only the equivalent of retained corporate earnings, and that intact value must be preserved in all events. Consider the case of stock purchased at, and having an intact value of, $1,000; accumulated earnings are $200; the stock is sold for $1,200. The beneficiary will be apportioned $200 and the trustee will retain $1,000 as intact value; but *any* tax on the gain, apportioned to the trustee, will invade and reduce intact value. In this situation, to preserve intact value it is necessary that the beneficiary be presumed to have received (and be taxable upon) the entire gain.

The date of distribution to the income beneficiary usually occurs in a year subsequent to the apportionable event. This deferment may be due to the careful fiduciary practice of withholding any unusual distribution until it has been included in an account and schedule of distribution which has been judicially approved; or perhaps the distribution was deferred pending the outcome of conflicting claims of life tenant and remaindermen. If the apportionment (including its

284. This rule is comparable to the statutory presumption that dividends are paid out of the most recent profits. See note, 12 TAX L. REV. 99, 101 (1956). *Cf.* Irish v. Commissioner, 129 F.2d 468 (3d Cir. 1942). This result is consistent with the concept of apportionment which entitles the income beneficiary to accumulated earnings; hence, the gain should be fully taxed to him if his distribution is in lieu of earnings.

285. U.S. Treas. Reg. 1.643(a)—3.

286. G.C.M. 21532, 1939—2 CUM. BULL. 231.

287. Rev. Rul. 24, 1953—1 CUM. BULL. 263.

taxable portion) is an item which "is required to be distributed currently," it is taxable to the income beneficiary as a part of the "distributable net income" in the year of realization by the trustee; but if the apportionment is regarded as a *non*-distributable item, the trustee is taxable in the year of realization since he will have allocated the income item to corpus.[288]

It may be significant that section 643(a)(4), applicable solely to "extraordinary dividends and taxable stock dividends," permits the trustee "acting in good faith" to allocate such income items to corpus, which thereby results in taxation of the trustee rather than the beneficiary. But the "good faith" words are absent in the preceding subsection (3) which deals with capital gains and which reduces the "distributable net income" by capital gains only "to the extent that such gains *are* allocated to corpus." It can be argued that in the capital gain situation the trustee has no discretion (not even that which he might exercise in "good faith"); that irrespective of his "good faith" in allocating the capital gain item to principal, the tax result depends upon the final determination under state law, and if it is decided in a later year that the item "is required to be distributed currently," it will be taxed to the beneficiary in the earlier year of receipt by the trustee.

The weight of pre-1954 code law is to the effect that "currently distributable" income includes the capital gain component of an apportionment even though the beneficiary's claim was contested and finally upheld only in a year subsequent to the year of receipt by the trustee.[289] This "currently distributable" concept found in section 162(b) of the 1939 code required only that the beneficiary have a recognized present right, under the instrument or local law, which is legally enforceable apart from judicial discretion or judicial review of the trustee's reasonable discretion.[290] It has been generally assumed that this pre-1954 definition applies with equal force to the 1954 code phrase "required to be distributed currently." But there is some reason to question this assumption.

Consider these three factors in conjunction with each other: First, the statute states that the trust income must be *"required* to be

288. INT. REV. CODE OF 1954, §§ 651(a), 652(a), 661(a), 662(a). If the income item is allocated to corpus, it follows that it is excluded from "distributable net income." INT. REV. CODE OF 1954, §§ 643(a) (3), (4). Its later distribution to the beneficiary will not be taxed to him under the "throw-back rule," INT. REV. CODE OF 1954, §§ 665-68, because it is only trustees' accumulations of "distributable net income" which come within that rule. S. REP. No. 1622, 83d Cong., 2d Sess. 358 (1954).

289. See note 265 *supra*.

290. KENNEDY, FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES § 2.05G (1948).

distributed currently," thereby suggesting that the result depends on a duty which is "required" of the trustee. Second, the emphasis upon the trustee's affirmative and personal duty is confirmed by the Senate Finance Committee Report which states that, "The fiduciary must be under a *duty to distribute* the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trustee's taxable year." [291] Third, in regard to the specific item of capital gain, the foregoing report indicates that it is intended "to tax capital gains to the estate or trust where the gains must be *or* are added to principal," [292] *i.e.*, although not mandatory in the "must" sense, it was contemplated that gains might be diverted from the income beneficiary to corpus in the trustee's discretion. In the case of apportionments under Pennsylvania law it is considered the duty of the trustee to act as a stakeholder [293] and withhold any distribution until the claimant has carried the burden of proof to require it. If it be his duty to withhold in the first instance, it follows that the trustee can hardly be under a duty to distribute; and lacking such a duty, the apportionment item could not be one which is "*required* to be distributed currently." It is suggested that this is the correct result from the administrative standpoint as well, for it eliminates the senseless problem of determining who is taxable during a period of litigation (often concluded many years after the taxable event) when there are several possible claimants including those not yet born.[294]

B. *Federal Estate and Gift Tax Consequences*

The right to an apportionment distribution has been held to be a property right which is includible in the taxable estate of a deceased life tenant although, whether through inadvertence or intention,[295] he has not claimed that to which he was entitled.[296] While as a general rule the existence of such a property right is determined by local law,[297]

291. S. Rep. No. 1622, 83d Cong., 2d Sess. 345 (1954).

292. *Id.* 343.

293. King Estate, 355 Pa. 64, 78, 48 A.2d 858, 866 (1946); Buist's Estate, 297 Pa. 537, 542, 147 Atl. 606, 608 (1929); Thompson's Estate, 262 Pa. 278, 281, 105 Atl. 273, 274 (1918).

294. Moore & Sorlien, *Homeless Income,* 8 Tax L. Rev. 425, 440-43 (1953). The "requirement" for distribution surely has not arrived if the trustee is duty bound to withhold apportionment until the beneficiaries have ascertained and established (1) the identity of the beneficiaries entitled and (2) the facts necessary to determine the amount of the apportionment.

295. The income beneficiary frequently will prefer that a claimable apportionment remain a part of principal in the hope that it may thereby pass to his children, as remaindermen, without reduction by federal estate tax.

296. Soles v. Granger, 174 F.2d 407 (3d Cir. 1949).

297. Blair v. Commissioner, 300 U.S. 5 (1937); Freuler v. Helvering, 291 U.S. 35 (1933).

the federal court will itself determine that question in the absence of a state court decree,[298] and it may disregard an *ex parte* decree or award which conflicts with the local law.[299]

The most effective and perhaps the only sure method of avoiding this estate tax result is an assignment of the life tenant's entire interest in the trust estate. The more limited assignment or release to the trustee of only the apportionment right, while retaining the income right, is in effect the creation of a trust in which the beneficiary, in this limited sense acting as a grantor, has reserved an interest in the income.[300]

However, it is possible that relief may also be found in the rule, more commonly applied in the case of a power of appointment, that a disclaimer or renunciation of an otherwise taxable power "within a reasonable time after learning of its existence" will eliminate it from estate and gift taxation.[301] Both the estate and the gift tax regulations recognize that one need not accept a property interest, and that affirmative non-acceptance will insulate the reluctant donee from tax consequences which otherwise would follow from ownership of an apportionment right. While the pertinent rules are set forth only in those parts of the regulations dealing with powers of appointment, that area itself is sufficiently broad to include the power or right to invade principal or to demand a distribution which, if not made, would become a part of principal.[302]

Thus, the right of the life tenant to demand an apportionment from principal is the substantial equivalent of a power which in a real

298. Estate of George M. Henderson, 45 B.T.A. 1080 (1941); Estate of Amy H. DuPuy, 9 T.C. 276 (1947).

299. Sharpe v. Commissioner, 107 F.2d 13 (3d Cir. 1939). In holding that the trust interest was taxable in the parent's estate, even though such interest passed directly to children in default of a claim made by the parent's executors, the court noted that "the practice of short-cutting through to the final beneficiary is not uncommon." To the same effect, see Earle v. Commissioner, 157 F.2d 501 (6th Cir. 1946).

300. Hence the interest so released continues to be includible in the taxable estate of the beneficiary. INT. REV. CODE OF 1954, § 2036. In Commissioner v. Henry's Estate, 161 F.2d 574 (3d Cir. 1947), the parties and both sides of the divided court agreed that if the apportionment right had been released after March 3, 1931 (the effective date of the predecessor provision to § 2036), estate tax would have resulted. *Cf.* U.S. Treas. Reg. 20.2041-3(d)(3), holding that the lapse of an annual withdrawal right is treated as a transfer, subject to a reserved interest, which is includible in the estate of the holder of the power.

301. A disclaimer or renunciation, as distinguished from a release or assignment, of a general power will effectively divorce the donee from the appointive property so that he will not be subject to gift or estate tax in respect of such property. But if such disclaimer is to be effective under local law, it must occur prior to acceptance and within a reasonable time from the date the donee learned of the existence of the power, and the power must be disclaimed fully and not merely in part. U.S. Treas. Reg. 20.2041-3(d)(6), 25.2514-3(c)(5); Edith Evelyn Clark, 47 B.T.A. 865 (1942), permitted a tax-free "relinquishment" of a power over principal after it had existed for over a year.

302. "The term 'power of appointment' includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations." U. S. Treas. Regs. 20.2041-1(b)(1), 25.2514-1(b)(1).

sense is separate and distinct from the right to income; and being a separate and distinct power, the life tenant *may* be able to renounce and disclaim the apportionable amount without tax consequences. The importance of the words "separate and distinct" follows from the definitive statement in the estate tax regulations:[303]

> "A disclaimer is a *complete* and unqualified refusal to accept the rights to which one is entitled. Such rights refer to the incidents of the power and *not to other interests* of the decedent (or, as used in the Gift Tax Regulations, the possessor of the power) in the property." (Emphasis added.)

Thus, if the apportionment right which accrues only occasionally is regarded as a separate power, distinct from the recurring income right, it might be "completely" disclaimed in order to avoid both estate and gift taxes.

But it is arguable that, while the apportionment right is indeed "separate and distinct" in many ways, it could exist only in conjunction with the recurring right to income. In other words, the chief justification for an apportionment is that it replaces a prior loss or reduction of the recurring income rights. In this sense, the apportionment right and the income right have the same source and are so integrated that *both* may be required to be disclaimed in order to meet the requirement of the regulations that there be "a *complete* and unqualified refusal to accept the rights to which one is entitled."

Nevertheless, it is significant that non-taxable apportionment distributions are generally regarded for federal income tax purposes as separate from those recurring income items which are includible in "distributable net income." It is also significant that under local law many apportionment distributions are made out of principal, in the trust accounting sense. In fact, the apportionment right itself represents an exception to the general rules governing trust income and, in its status as an "exception," the apportionment can be rationally treated as a separate right or power which *alone* may be disclaimed without tax consequences. This was essentially the conclusion reached in *Commissioner v. Henry's Estate*[304] in which the life tenant had, pursuant to a prior family settlement agreement, executed contemporary approvals and waivers which permitted apportionable stock dividends to be retained by the trustee. In holding that such stock dividends were not a part of the deceased life tenant's taxable estate, the court in effect acknowledged the right of disclaimer of the apportionable interest.

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303. See note 301 *supra*.
304. 161 F.2d 574 (3d Cir. 1947).

In the absence of an effective disclaimer or renouncement, existing and future apportionable interests may be disposed of by a blanket release or assignment which constitutes a taxable gift[305] (unless adequate consideration is received). But if there be such a prior transfer of apportionment rights *in futuro,* does the gift occur when the apportionable event occurs, or when the trust account is audited and approved by judicial decree?[306] Ordinarily, the gift occurs at the latter date since until then the release of the apportionment right remains "inchoate and imperfect"; not until then has there been a "change of legal rights and . . . shifting of economic benefits."[307]

In regard to both federal estate and gift taxes, therefore, the person entitled to an apportionment right has a very narrow area of action to avoid tax consequences. He can only disclaim or renounce the right; and in doing so, he must act promptly. Moreover, if he retains the recurring income interest, he runs the risk that his disclaimer is ineffective because it is not a "complete and unqualified refusal to accept the rights to which one is entitled."

One would assume that the state inheritance tax rule would be the same as the federal estate tax rule and, if the apportionment right is properly claimable by the life tenant or his executor, it is difficult to support anything but a taxable result. But at least one Pennsylvania decision avoids the tax in the limited situation where a stock dividend is declared after the life tenant's death. While the life tenant's estate was entitled to an apportioned share of the stock dividend (as representing income accumulated during the trust term while the life tenant lived), nevertheless, it was concluded in *Belmont Estate*[308] that such stock could not be "inherited" from the life tenant because it was issued after her death. In other words, at date of death the stock was non-existent and thus could not constitute property of which the life tenant was then "seized or possessed." While at first glance this decision seems to ignore the taxability of the "claim" as a property item separate from its subject matter, nevertheless it has the merit of laying at rest the potential inheritance tax liability which otherwise would hover over the trusteed stock of any corporation which has accumulated earnings during the trust term.

305. *Cf.* Cerf v. Commissioner, 141 F.2d 564 3d Cir. (1944); Edith Evelyn Clark, 47 B.T.A. 865, 867 (1942) (dissenting opinion).

306. Perhaps even the decree date is not sufficiently definitive inasmuch as within five years thereof the income beneficiary may petition to open the decree.

307. Burnet v. Guggenheim, 288 U.S. 280 (1933); Commissioner v. Allen, 108 F.2d 961 (3d Cir. 1939).

308. P-H INH. & TRANS. TAX SERV. ¶ 1017 (Orphans' Ct. Montg. Co., Pa. 1954).

IV. Observations and Suggestions

A. *Historical Changes*

Until recently Pennsylvania apportionment decisions have given the impression of protecting life tenants as the proximate objects of the testator's bounty. Many of the cases arose during depression years when there was an understandable desire to allocate income to the hard pressed life tenant. Perhaps it is the improved economic status of the community that has reversed the trend in favor of the remainderman.

The trend away from the life tenant is more fully expressed by the adoption of the Uniform Principal and Income Act, and the trend in other states also seems to be away from the Pennsylvania judicial rule of apportionment.[309] This doubtless reflects the effect of increasing complexities, of an accounting as well as of a corporate nature, which have become a Pandora's box as life tenants have probed more deeply into the opportunities for apportionment. Fiduciaries are not in agreement as to the simplest kind of calculations, much less the more complicated ones.

Although the Pennsylvania rule was founded as an equitable doctrine, it often tends to be illogical, inconsistent and sometimes unfair.[310] Inflation has caused changes in corporate profits, dividends and security values which are so extreme as to justify a searching inquiry as to the equitable effect of the apportionment rules. In a sense, the application of the rules is founded in capriciousness due to the fact that, in the case of an apportionment based on sale, it is contingent upon an act of the trustee and not upon any coordinated managerial decision. The fiduciary's decision as to the sale of one stock and the retention of another, is often arbitrary and perhaps influenced by the desire to make an apportionment or the fear of making one. Sales may be made or withheld for other than investment reasons and beneficiaries may bring pressure for sales at profits when investment reasons would dictate otherwise. Moreover, the rule fails to consider that corporate management may have reinvested earnings for the benefit of the life tenant in order to provide a consistently higher income.

There is a serious question as to whether corporate earned surplus should have the sacred meaning ascribed to it by the great mass of apportionment decisions. Instead, there should be room for the concept that accumulated surplus is less an income retention than it is a vehicle

309. See note 267 *supra*.

310. See expert testimony in Ketterlinus Estate, Civil No. 2223, Orphans' Ct., Phila. Co., 1952.

to replace capital equipment at constantly increasing costs, thereby assuring future income which otherwise might be lost to the life tenant.[311]

B. *Accounting Problems*

Book values, as used to compute intact value and as an aid in computing retained earnings, should be stated to the date nearest the intact value and apportionable event dates. Generally, interim statements will be adequate, but the claimant to the apportionment can, and sometimes should, insist upon a reasonable per diem adjustment.

Occasionally the earned surplus has been reduced by an arbitrary reserve such as one labeled for inventory depreciation or, more generally, for contingencies of an unexplained character. These reserves should be eliminated if, and to the extent that, they are unreasonable as to the contingency or the amount retained. Although the trustee should be able to rely upon the stated corporate book value, where these values are not realistic a guide in this area may be found in the accounting procedure required by the Securities and Exchange Commission. Earnings should include contingency reserves which are clearly segregations of earned surplus and not genuine reserves set aside against probable losses or decreases in values. Depreciation reserves are proper; but where the company revalues annually there seems to be no reason why book value, disregarding these reserves for revaluation, cannot be considered intact value. In any event, any interested party has the right to delve into the corporate accounting procedures which were used.

In the case of apportioning proceeds of a sale or similar disposition of shares in the same corporation, purchased at different times by the trustee, it seems advisable that intact value should be the weighted average purchase price.[312] To do otherwise would make the apportionment result contingent on which shares the trustee may wish to sell where only a portion of the holdings are to be sold. In the case of an apportionment resulting from a corporate distribution, however, a share-for-share approach is entirely appropriate.

Intact value in the case of a revocable inter vivos trust should be based on book value as of the date of the settlor's death, for the settlor

311. Indeed, the lower court in Vinton's Appeal, 99 Pa. 434, 438 (1882), stated that "Everything which is necessary to carry into effect the purposes of the company is capital. Even when profits assume this character they become capital, and cannot be treated as profits, nor can they cease to be capital." *But see* Nirdlinger's Estate, 290 Pa. 457, 470, 139 Atl. 200, 205 (1927).

312. *But see* King Estate, 355 Pa. 64, 48 Atl. 858 (1946). "Each individual share of stock possesses an intact value." *Id.* at 69, 48 Atl. at 861.

retains control over the property until his death and can withdraw or substitute at will.

Where the trust benefits successive life tenants, the original intact value continues and is not adjusted by reason of a different book value at the death of the first life tenant; if this were not so, the apportionment rights which vest in the deceased and succeeding life tenants would be improperly limited. Life tenants are, of course, limited to the accruals of earnings during their respective tenancies, but they should not be required to sustain an intact value in excess of that at the time the trust became irrevocable.

Usually the trustee will have purchased shares at market value, but if a trustee had the opportunity to buy shares at less than market,[313] the amount expended for the purchase, and not the actual or the book value, would probably control intact value. However, in the case of trustee-purchased shares having an intact value equal to market value, a reasonable case can be presented for limiting an apportionable distribution to an extent which assures the corpus having a fair market value at the apportionment date of not less than such intact value. Often book value has limited analytical meaning, particularly where there is a sharp disparity between it and market value.[314] The important factors to be compared should be the cost or charge values of marketable securities and their ultimate value in a distribution or sale.

Despite the fact that accounting problems in computing an apportionment may be extremely complex in even the simplest case, it would be well for the accountant to detect and adjust for intangible values, valuation write-ups, allowances for gain or loss on the sale of capital assets, and the like. There is a double check in this situation due to the fact that the calculation of retained earnings on one hand may be compared with increase in the book value; and if the increase in book value and retained earnings calculated from the profit and loss statement appear to be similar, then intermediate surplus adjustments would generally have little if any significance. On the other hand, if these quantums are dissimilar, the corporate accounting must be re-examined minutely in order to limit the apportionment distribution to a proper amount.

It seems unfortunate that there is no present practice supporting an equitable adjustment to intact value where apportioned stock dividends have "captured" a part of the tax cost basis so that, on a later

313. As where the estate of a deceased employee exercises an option to acquire stock of the employer corporation pursuant to the present regulations. See INT. REV. CODE OF 1954, § 421.

314. For example, on December 31, 1956, the book value of Pennsylvania Railroad shares was $107, while the market value was only $22.

sale, the corpus may be depleted by additional federal tax on capital gains. Although usually it is not wise to consider federal tax consequences as a criterion of apportionment, equitably there should be an adjustment in this situation.

C. *Trustee Judgment and Mechanical Problems*

The Pennsylvania law of apportionment has subjected the trustee to a multitude of stresses which include not only the extremely difficult apportionment calulations, but also pressure by various interested parties and the vagaries of an area of law with indefinite boundaries require the exercise of a combined fiduciary, legal and accounting judgment.

It is particularly important for the trustee to give appropriate notice of apportionment opportunities to all interested parties even though accountings may be infrequent and the resulting apportionment calculations intermittent. Where the mechanics of trustee reporting have been set up, such as by quarterly reports, the trustee should indicate the apportionment possibilities even though the presumption may favor the corpus and the life tenant may have the burden of proof. At the time of a court accounting, the trustee should indicate in the audit notice that the accounting includes items which may be apportionable, although there is a question as to whether the trustee is under a duty to perform the apportionment mechanics and leave to the interested parties any adjustments. However, it would not be inappropriate for the trustee to work out a suggested apportionment upon the filing of the accounting.[315]

However, as a stakeholder, the trustee is under no affirmative duty to compute and distribute an apportionable income item, and he should do so without court approval only when all parties are sui juris, have acquiesced and have given a release. It is probably true that constant accountings for the purpose of securing orphans' court approval will place substantial burdens on that court. If this be the result from an administrative standpoint, the judicial burden might be somewhat lessened by a special committee or knowledgeable masters to resolve the mechanics of the apportionments and to make the necessary recommen-

315. A conservative trustee would do well to place a notation upon the interim accounting, stating that certain items in the report may be subject to apportionment, but that they have been held in principal until the next court account, at which time they will be apportioned if requested. By so doing, the life beneficiary has been put on notice. If the trustee does not apportion at the time of the court accounting, there would then be an indication that the life tenant wished the apportionable amounts to remain in corpus.

dations to the court; or else to propound pragmatic rules for special accountings geared to this problem,[316] without the full burden of a complete accounting.

Although seldom used, Pennsylvania courts have a broad jurisdiction to grant declaratory judgments, including the determination of questions arising in the administration of estates or trusts and questions of construction of wills and other writings.[317] Such relief is available in "civil cases where an actual controversy exists between contending parties, or where the court is satisfied that antagonistic claims are present . . . which indicate imminent and inevitable litigation." [318] However, where "a statute provides a special form of remedy for a specific type of case, that statutory remedy must be followed." [319] And a petition for declaratory relief must allege facts sufficient to enable the court to decide.[320]

The major obstacle to declaratory relief in apportionment cases is not the requirements of controversy and of specification but the provision that special statutory remedies must be followed where applicable. Where apportionment is uncertain, controversy invariably will arise and there will always be facts within the control of the fiduciary to enable him to present a sufficiently specific case once the proceeds in question have been received. The question of the availability of a special statutory remedy, however, is not within the control of the fiduciary and possibly would be resolved against him, for, although the main purpose of the limitation appears to be to prevent by-passing of administrative agencies, it has barred declaratory judgments where relief could have

316. For example, see Orphans' Court Act of 1951, PA. STAT. ANN. tit. 20, § 80.702 (Purdon Supp. 1956): "The court may decide or dispose of any question relating to the administration or distribution of an estate or trust and exercise any of its powers in respect thereof upon the filing of an account or in any other appropriate proceedings. The account may be a complete accounting of the estate or trust or of only the transactions which raise the question to be determined." See also Cassatt's Estate, 105 Pa. Super. 14, 158 Atl. 586 (1932).

317. PA. STAT. ANN. tit. 12, §§ 831, 832, 834 (Purdon 1953).

318. PA. STAT. ANN. tit. 12, § 836 (Purdon 1953).

319. *Ibid.* This section provides further that "the mere fact that an actual or threatened controversy is susceptible of relief through a general common-law remedy, or an equitable remedy, or an extraordinary legal remedy, whether such remedy is recognized or regulated by statute or not, shall not debar a party from the privilege of obtaining a declaratory judgment or decree in any case where the other essentials to such relief are present."

320. Carwithen's Estate, 327 Pa. 490, 194 Atl. 743 (1937) (relief denied where trustee asked a determination as to his rights to invest in common stocks but did not indicate what issues he intended buying); Jones v. Integrity Trust Co., 292 Pa. 149, 140 Atl. 862 (1928) (relief denied where trustee asked determination as to apportionment of stock rights but did not allege their disposition); Rebmann's Estate, 35 Pa. D. & C. 33 (Orphans' Ct. 1939) (relief denied where trustee sought a determination as to retention of common stocks in trust where he did not specify the common stocks he intended to retain).

been had from the Register of Wills[321] or by an accounting in the orphans' court.[322]

But this reasoning need not be extended to apportionment cases. While a trustee may file a full[323] or partial[324] account at any time, he cannot do so without substantial effort and perhaps considerable hardship where there is a large and varied portfolio. In such a case, a fiduciary could argue quite plausibly that no satisfactory remedy is available except the provisions for declaratory relief.[325]

Frequently the beneficiary does not desire the distribution of apportionable items and he may so inform the trustee. This suggests that the trustee might, as a matter of routine administrative policy, discuss this matter with life tenants and, if appropriate, obtain from them their written renunciation of future apportionable income items.[326]

Some corporate trustees have regarded their duty fulfilled, and their fiduciary position safe from surcharge, if the apportionable item is retained in principal until claimed by the life tenant. This not uncommon view reflects the understandable attitude that dollar inflation has made the intact value calculation meaningless; that it is an anomaly that the life tenant should share in the gains but not in the losses; that there is confusion and an inherent risk in interpreting the apportionment rules; and that the tax uncertainties of an apportionment are to be avoided if at all possible. Nonetheless, these are invalid objections by a trustee who should deal fairly and impartially and not substitute his views of equity for those of the law of apportionment.

The authorities are in accord that a trustee is liable for an improper distribution of trust assets, whether of income or principal, made without court approval; and that this liability exists notwithstanding a reasonable mistake of fact or law made by the trustee.[327] However,

321. Gerety Estate, 349 Pa. 417, 37 A.2d 792 (1944).

322. Follweiler's Estate, 6 Pa. D. & C. 757 (Orphans' Ct. 1924); *cf.* Dempsey's Estate, 288 Pa. 458, 137 Atl. 170 (1927), where the court held that it would give a declaratory judgment on the question of the trustee's duty to account, but not as to the extent of the required accounting.

323. PA. STAT. ANN. tit. 20, § 320.981 (Purdon 1950).

324. See note 316 *supra*.

325. *Cf.* Berman Estate, 35 Del. Co. 90 (Pa. 1947) which holds that the availability of another remedy is not a bar to a declaratory judgment when the case is not ripe for relief by the other remedy.

326. But the trustee must carefully examine the proposed plan in the light of its tax consequences.

327. RESTATEMENT, TRUSTS § 227, comment *m*(9) (1935). "It [is] the duty of the trustee, before making any payments whatsoever, to thoroughly and carefully examine the provisions of the trust instrument. . . . A fiduciary cannot be relieved by a mistaken payment made in good faith to the wrong person." Blish Trust, 350 Pa. 311, 317, 38 A.2d 9, 12 (1944). See also Moyer v. Norristown Bank, 296 Pa. 26, 30, 145 Atl. 682, 683 (1929); Heaning v. Riddle, 343 Pa. 453, 23 A.2d 456 (1942)

to succeed in surcharging the trustee, the complainant must prove that the trustee failed in his duty of reasonable skill and prudence by failing to apportion. It will not be enough to show that the trustee did not apportion a stock dividend, for not all such proceeds are apportionable.[328] Moreover, even if apportionable, the complainant's acquiescence will prevent a surcharge,[329] as where the life tenant approved the retention "for the present" and had received semi-annual notice of the retention over a period of years through statements of trust income received.[330] If, however, the life tenant had no knowledge of the facts, his acquiescence will not protect the trustee from surcharge;[331] nor will the life tenant be barred by laches from holding a trustee liable where he had no reason to know of the breach of trust.[332] Thus, where there is no proof that the life tenants were furnished statements of trust income, "informing them of these . . . [stock dividends] or of the circumstances affecting them, their acceptance of income, without objection cannot be regarded as acquiescence in the absence of any evidence that they knew its source, or understood its nature."[333] In this respect, the Pennsylvania Supreme Court speaks in terms of a "duty as a fiduciary to inform the cestuis fully of all matters affecting their interests,"[334] although in the ordinary case the *Restatement of Trusts* would impose no such duty upon a trustee to furnish such information except upon his request.[335]

D. *A Suggested Apportionment Formula*

The following is suggested as a simple approach to apportionment in the normal situation: First, intact value must be determined; next, determine if intact value has been impaired and, if not, then determine

(cases involving payment to the wrong beneficiary but not involving apportionable situations). The *Heaning* opinion states that "Fiduciaries who distribute funds in their hands without an accounting and an audit of their accounts do so at their own risk, and when they assume that risk they must be held responsible for payments made without the approval of the court which turn out to be improper." *Id.* at 457, 23 A.2d at 459.

328. Bard's Estate, 339 Pa. 433, 13 A.2d 711 (1940).

329. Clabby's Estate, 338 Pa. 305, 12 A.2d 71 (1940).

330. *Ibid.*

331. Bard's Estate, 339 Pa. 433, 13 A.2d 711 (1940); RESTATEMENT, TRUSTS § 216 (2) (1935).

332. RESTATEMENT, TRUSTS § 219(1), comment *c* (1935).

333. Fownes Trust, 3 Pa. D. & C.2d 637, 643 (Orphans' Ct. 1955).

334. Klein v. Dunn, 337 Pa. 480, 485, 12 A.2d 56, 58 (1940).

335. RESTATEMENT, TRUSTS § 173, comment *d* (1935).

what earnings have been retained and may be paid out; thereafter, determine how much of the retained earnings may be paid out without impairing intact value; and finally, when stock rather than cash is to be distributed to the life tenant, determine the number of shares of stock to be paid out. In these calculations, intact value should be computed as market value (cost) where the trustee purchased the stock and as book value where the trustee acquired the stock from a decedent or settlor.

In determining whether intact value has been impaired, it is important that the concept of market value (cost) be separate and distinct from the concept of book value. Comparing the unrelated quantums of initial market value and terminal book value to determine if intact value has been impaired, or to delineate the amount apportionable, appears to be as erroneous as the comparison of cabbages and kings. When considering the impairment of intact value, market value should be compared with market value of trustee-purchased stock, and book value should be compared only with book value of stock acquired by the trustee from a decedent or settlor. Unfortunately, trust accountants still adopt widely varying and inconsistent methods.

Having once determined that intact value is not impaired, retained earnings during the period the stock is held in trust are computed on the basis of recognized accounting principles and are checked by comparing original (at date of death or date of purchase) and terminal "adjusted" book values.

The result will be a distributable dollar amount which is traceable to earnings and which does not impair intact value. But if the distribution is to take the form of shares of stock, there remains the final problem of equating the predetermined dollar amount with the number of shares to be distributed, *i.e.*, should those shares be measured in book value or market value? Current practice leans toward the use of book value in the case of both trustee-purchased stock and stock acquired from a decedent or settlor. It is suggested that logic requires the use of market value in the case of trustee-purchased stock [336] and book value in the case of stock acquired from a decedent or settlor.[337]

336. Inasmuch as market value is used to determine intact value and, logically, as the test for impairment of that intact value, this rule avoids the practical incongruity of paying out shares at book value which in today's market may have a vastly greater real value.

337. Inasmuch as book value is used to determine intact value and as the test for impairment of that intact value, nonetheless it may be plausibly argued that market value of the distributable stock should be the measure of the number of shares to be distributed.

V. Conclusion

There is much that courts could still do in clarifying the basic rules by spelling out a basic apportionment formula; by restating what constitutes an apportionable event in areas such as corporate reorganization distributions where there is still much misunderstanding; by redefining intact value and earnings available for apportionment; and, finally, by more precisely defining the duties and mechanical operations of the trustee. Since the present apportionment rules are the result of developments based on statutory as well as judicial determinations, it is reasonable to suppose that the newer principles of the Uniform Principal and Income Act should and will affect the older judicial rules of apportionment.