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As a result of these distinctions any far-reaching conclusions about lines of liability would be ill-advised.²⁴ The case is a valuable insight into the court's attempt to chart a path in the virtually unmapped land of implied warranty. The decision, however, sets up true lines of demarcation for implied warranty in only an extremely limited area and even in that area only on a very temporary basis.

Malcolm J. Gross

TRUST ADMINISTRATION—PRINCIPAL AND INCOME ACT APPLIES RETROACTIVELY TO EXTRAORDINARY BUT NOT TO ORDINARY STOCK DIVIDENDS.

Pew Trust (Pa. 1963)

In 1932 settlor created an irrevocable spendthrift trust, the sole asset being 40,000 shares of common stock of the Sun Oil Company. By the terms of the trust, the trustee was to hold one half of the corpus to pay the net income to the appellant for life, and upon his death to pay the net income for the support, maintenance, and education of his children.¹ In 1961 Sun Oil Company declared a six per cent stock dividend which the life tenant claimed as income and guardians ad litem for his minor children claimed as principal. Relying on *Catherwood Trust*,² the Orphans' Court of Montgomery County entered a final order awarding all the shares to principal. On appeal, the Pennsylvania Supreme Court reversed, and awarded the stock dividend to the life tenant, *holding* that the Principal and Income Act³ does not apply retroactively to ordinary dividends, the *Catherwood* decision being limited in application to extraordinary stock dividends. *Pew Trust*, 411 Pa. 96, 191 A.2d 399 (1963).

Before the enactment of uniform statutory authority, three major rules had developed concerning distribution of dividends on corporate stock between income and principal: the Massachusetts Rule,⁴ the Kentucky

1962); *Payne v. Valley Motor Sales Inc.*, 124 S.E.2d 622 (W.Va. 1962). It is intriguing to imagine airplane passengers being told the plane's makers would not be responsible for their injuries in the event of a crash.

24. The Uniform Commercial Code is effective in New York in April, 1964. Although such legislation will not affect the airlines industry in cases similar to the instant decision, no sale of goods being involved, it will definitely govern problems similar to that confronted in the *Greenman* case in the food sales area. See UNIFORM COMMERCIAL CODE § 2-318.

1. The remaining half of the stock was to be held under identical provisions for the appellant's brother.

2. 405 Pa. 61, 173 A.2d 86 (1961).

3. PA. STAT. ANN. tit. 20, §§ 3470.1-.15 (Supp. 1962).

4. Under this rule all stock dividends go to principal and all cash dividends to income. Thus, distribution depends entirely on the character of the dividend. *Minot v. Paine*, 99 Mass. 101 (1868).

Rule⁵ and the Rule of Apportionment, which was adopted by Pennsylvania and became known as the Pennsylvania Rule.⁶ The Rule of Apportionment was operative if an apportionable event occurred,⁷ such as an extraordinary stock dividend. In this situation, the life tenant would receive as income that part of the dividend which represented earnings accumulated by the corporation after the inception of the trust, and the remainderman would be entitled to an amount sufficient to keep the corpus value intact.⁸ A cash dividend or a small ordinary stock dividend presented no problem of apportionment, each being awarded to the life tenant whether paid out of earnings accumulated prior to or subsequent to the creation of the trust.⁹ This Rule, though admittedly fair to the interests of both the life tenant and the remainderman, placed emphasis on corporate bookkeeping techniques and became increasingly difficult to apply.¹⁰ Since it had originated at a time when corporations declared few stock dividends, it failed to envision the problems faced by a trustee today.¹¹ Therefore in 1945, Pennsylvania adopted the Uniform Principal and Income Act,¹² later substantially re-enacted as the Principal and Income Act of 1947, which applies, in the absence of a clear expression of intent by the settlor,¹³ to all trusts created both prior to and following its enactment,¹⁴ awarding all stock dividends in shares of the declaring corporation to principal.¹⁵ The Act attempted to alleviate the difficulty in administering trusts under the com-

5. This rule awards the dividend to the beneficiary entitled to receive the income at the time the dividend is declared, without regard to whether it is a cash or stock dividend or when the fund out of which it is payable was earned. *Cox v. Gaubert's Estate*, 148 Ky. 407, 147 S.W. 25 (1912).

6. See *Earp's Appeal*, 28 Pa. 368 (1848).

7. The following Pennsylvania cases have held these events apportionable: *Barnes' Estate*, 338 Pa. 555, 12 A.2d 912 (1940) (extraordinary stock dividends in shares of another corporation); *Hotstetter's Trust*, 319 Pa. 572, 181 Atl. 567 (1935) (rights to subscribe to stock); *Nirdlinger's Estate*, 290 Pa. 457, 139 Atl. 200 (1927) (sale of stock); *Flaccus' Estate*, 283 Pa. 185, 129 Atl. 74 (1925) (extraordinary cash dividend); *McKeown's Estate*, 263 Pa. 78, 106 Atl. 189 (1919) (corporate liquidation); *Earp's Appeal*, *supra* note 6 (stock dividend). In the *Earp* case, it was stated that when dealing with stock dividends, where the issuance of new stock is supported by a capitalization of earnings, the apportionable event is the extent of the capitalization of earnings. See generally *Cohan & Dean, Legal, Tax and Accounting Aspects of Fiduciary Apportionment of Stock Proceeds—The Non-Statutory Pennsylvania Rules*, 106 U. PA. L. REV. 157 (1957).

8. The "intact value" of the corpus is the book value of the stock at the inception of the trust, adjusted by considering capital losses. *Cunningham Estate*, 395 Pa. 1, 149 A.2d 72 (1959).

9. See *Nirdlinger's Estate*, 290 Pa. 457, 463, 139 Atl. 200, 202 (1927).

10. The Rule's application requires that the trustee determine the source from which a distribution was made, and whether it consists of actual earnings or profits of the corporation; he also must determine how much of the earnings have accumulated since the trust was created, which is often contingent upon the character of the surplus capitalized to support newly issued stock. *Cunningham Estate*, 395 Pa. 1, 149 A.2d 72 (1959).

11. Due to the broadening of markets for stock and the tax problems of a modern corporation, much transferring of accounts occurs. See generally 4 *BOCER, TRUSTS AND TRUSTEES* § 824 (1948).

12. PA. STAT. ANN. tit. 20, §§ 3471-85 (1945), as amended PA. STAT. ANN. tit. 20, §§ 3470.1-.15 (Supp. 1962).

13. PA. STAT. ANN. tit. 20, § 3470.2 (Supp. 1962).

14. PA. STAT. ANN. tit. 20, § 3470.15 (Supp. 1962).

15. PA. STAT. ANN. tit. 20, § 3470.5 (Supp. 1962).

plexities of the old Rule of Apportionment by abandoning it in favor of the convenience afforded by the Massachusetts Rule.¹⁶ There was, however, a major question challenging successful operation of the Act: could the Act be retroactively applied to trusts created prior to its enactment?

Pennsylvania cases¹⁷ decided in the negative, holding that the life tenant under a trust created prior to the Act had a vested right, protected by the Constitution,¹⁸ to income distributed under the Rule of Apportionment. The leading case of *Crawford Estate*,¹⁹ in dealing with an extraordinary stock dividend, declared, ". . . no vested property right exists in a rule of law . . . except where such rule of law has established a vested property interest. Where a decision of the Supreme Court of Pennsylvania declares an interest to be vested, no retroactive statutory enactment may modify or extinguish it. . . ."²⁰ In 1961, *Catherwood Trust*, also dealing with an extraordinary stock dividend, overruled this case.²¹ The court admitted that the life tenant had a vested right to income, but argued that the Rule only dictated a method of ascertaining income; until a dividend was declared, no income existed and no vested rights could attach.²²

In adopting the Principal and Income Act, the legislature found it necessary to balance the convenience in administration afforded by the Act with its two basic inequities, both of which were illustrated in the instant case. The first inequity was its failure to permit an exception when current earnings were distributed in the form of small ordinary stock dividends. If a corporation paid little or nothing in cash dividends, but poured all earnings back into capital, the income beneficiary would receive nothing.²³ The *Pew* case questioned the wisdom of the legislature in not awarding small ordinary stock dividends to income, arguing that these dividends had always been considered income under the Rule of Apportionment.²⁴ However, the *Catherwood* decision had removed all constitutional barriers to the retroactive application of the Act by arguing that vested rights, conferred by a rule of law such as the Rule of Apportionment, are conditioned by withdrawal of the rule.²⁵ By not overruling, but merely limiting *Catherwood*, the instant case acknowledged the right of the legislature to apply the Act to small ordinary dividends declared on

16. See authorities cited *supra* note 4.

17. See, e.g., *Cunningham Estate*, 395 Pa. 1, 149 A.2d 72 (1959); *Warden Trust*, 382 Pa. 311, 115 A.2d 159 (1955); *Jones Estate*, 377 Pa. 473, 105 A.2d 353 (1954); *Steele Estate*, 377 Pa. 250, 103 A.2d 409 (1954); *Crawford Estate*, 362 Pa. 458, 67 A.2d 124 (1949).

18. U.S. CONST. amend. XIV, § 1; PA. CONST. art. 1, §§ 1, 9.

19. 362 Pa. 458, 67 A.2d 124 (1949).

20. *Id.* at 467, 67 A.2d at 129.

21. 405 Pa. 61, 77, 173 A.2d 86, 93 (1961).

22. *Accord*, *Gardner's Trust*, 123 N.W.2d 69 (Minn. 1963); *Will of Allis*, 6 Wis.2d 1, 94 N.W.2d 226 (1959). See also *Bookstaver, Estates and Trusts*, 23 U. PRR. L. REV. 409, 417-20 (1961).

23. See discussion in *Scott, Principal or Income?*, 100 TRUSTS & ESTATES 180 (1961).

24. *Pew Trust*, 411 Pa. 96, 102, 191 A.2d 399, 403 (1963).

25. *Catherwood Trust*, 405 Pa. 61, 72, 173 A.2d 86, 91 (1961).

stock held in a trust created prior to 1945. Yet, by restricting *Catherwood* to its facts, the court has attempted to limit the retroactive application of the Act to extraordinary dividends. Such court action appears to encroach upon the province of the legislature.²⁶ Indeed, recent legislation has shown that the legislature is not unaware of the possible unfairness of awarding all stock dividends to principal. In a 1963 amendment to the Principal and Income Act, stock dividends of six per cent or less are awarded to income and all other stock dividends to principal.²⁷ This amendment does not apply, however, to trusts created before September 1, 1963,²⁸ and thus will not affect administration of prior trusts.

The second inequity of the Act was that its retroactive application necessarily interfered with the settlor's intent insofar as it affected the plan of distribution for the trust. The instant case relied on this point as an alternative basis for its decision. The settlor merely directed that "net income" be distributed to the life tenant. He did this fully cognizant that the Rule of Apportionment made all ordinary stock dividends income. The court treated this as an intent sufficient to remove the case from the operation of the Act because the settlor had "directed otherwise" in the trust instrument. In so doing, the instant case has defeated all retroactive application of the provisions of the Act, since every settlor creating a trust prior to the Act would designate the distribution intended by the words "net income" and the like, relying on the Rule to supply the specifics. If this designation eliminated consideration of the Act, it could in no case apply retroactively. *Catherwood* was compelled by necessity,²⁹ since the efforts of the Principal and Income Act to aid the problems of trust administration would have been seriously hampered if trusts created prior to the Act had to be treated under the Rule of Apportionment, while those created subsequently were handled under the Act.³⁰ By virtue of the *Pew* case, however, trustees must look to the Principal and Income Act when dealing with an extraordinary dividend, but when dealing with an ordinary dividend must resort to the Rule of Apportionment if the trust was created before 1945.

In exempting ordinary dividends from the Act, even though other jurisdictions have had no inclination to do so,³¹ Pennsylvania remains the only state to have adopted the Principal and Income Act which has not

26. See *Gardner's Trust*, 123 N.W.2d 69, 75 (Minn. 1963), stating that ". . . it is permissible for the legislature to make an act of this kind retroactive in effect, absent a constitutional barrier. Finding no constitutional objection, we are bound to give it the effect which the legislature intended."

27. Pa. Laws 1963, act 233.

28. Pa. Laws 1963, act 233, § 5.

29. See generally RESTATEMENT, TRUSTS § 236 (1959); 3 SCOTT, TRUSTS § 236.3 (2d ed. 1956).

30. All trusts created prior to the Act would be handled by the Rule; all those created subsequently would follow the Act. Since there are a great number of trusts which were created before the statute, its efforts at convenience for trustees could have no effect on them.

31. See *Gardner's Trust*, 123 N.W.2d 69 (Minn. 1963) and *Will of Allis*, 6 Wis.2d 1, 94 N.W.2d 226 (1959), both of which applied the Act retroactively to ordinary dividends of 6% or less.

applied it in all cases to trusts created prior to its effective date.³² Also, in its efforts to avoid a retroactive application of the Act, the instant case has failed to require a clear expression that stock dividends should go to the life tenant in order to take the case from the scope of the Act.³³ In thus further complicating the administration problems of the trustee, the case relied on arguments of policy based on the unfairness of the Act. In fact, the unfairness has been recognized by the legislature in amending the Principal and Income Act by directing the distribution of small ordinary stock dividends to income. This appears to be a wise amendment and would seem to be precipitated by the same difficulties the *Pew* court encountered with the Act. But the legislature, after balancing the relevant considerations, had decided in favor of administration convenience; any compromise in favor of fairness to the parties involved should come from that source rather than from judicial decree.

Thomas F. Schilpp

32. *Catherwood Trust*, 405 Pa. 61, 76, 173 A.2d 86, 93 (1961).

33. When the term "income" is used, construe in favor of the remainderman. *Ferguson's Trust*, 354 Pa. 367, 47 A.2d 245 (1946).