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Trust Administration--Principal and Income-Allocation of Income from Properties Disposed of by the Executor to the Income Beneficiary

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approval. Even if the immunity ever existed, as the New York court reasoned in the *Rozell* case, "it is not necessarily the function of a court to refuse to declare a rule of conduct until the economic and social order of the day forces its declaration by the state."[14] This is sound reasoning in light of the history of our judicial system in which the courts have seldom waited for legislative action on matters that could be solved by the courts themselves. Courts are always subject to legislative command, but they do not have to wait for it.

When the problem arises in those jurisdictions which have not yet decided the question, it is probable that disposition favorable to suit will be made as it has so far in every jurisdiction which has considered it. Reason and justice point in this direction.[15]

Philip Taliaferro, III

TRUST ADMINISTRATION—PRINCIPAL AND INCOME—ALLOCATION OF INCOME FROM PROPERTIES DISPOSED OF BY THE EXECUTOR TO THE INCOME BENEFICIARY—Testatrix, leaving a probate estate of $480,000, provided for payments of taxes, debts, legacies, and expenses out of her "general estate" in items I-V of her will. In item VI she bequeathed to a trustee "all the rest, residue and remainder" of her estate in two equal trusts for the benefit of her niece and nephew. During the administration period $3,500 was earned on properties which were subsequently disposed of by the executor to cover debts, taxes, legacies and other administrative costs. Unable to determine whether this particular income should be allocated to the income beneficiaries or added to corpus, the executor instituted an action for declaration of rights to the specified income. The trial court found for the income beneficiaries. *Held*: Affirmed. Absent a contrary manifestation of intent, the income beneficiary of the residuary trust is entitled to the whole income derived from the residuary estate,

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[14] Rozell v. Rozell, 281 N.Y. 106, —, 22 N.E.2d 254, 257 (1939).

[15] If the problem should arise in Kentucky, the *Rozell* doctrine should be accepted. This would be a natural development in the favorable climate created by Brown v. Gosser, 262 S.W.2d 480 (Ky. 1953), which held that a wife could sue her husband for damages for personal injuries. Before that case, Kentucky was one of the great majority of courts which steadfastly followed the common-law rule of husband-wife immunity. The remaining intra-family immunity, parent-child, has just recently been stricken down in Kentucky. Harlan Nat'l Bank, Adm'r v. Gross, —S.W.2d—, (Ky. 1961), overruling Harralson v. Thomas, 269 S.W.2d 276 (Ky. 1954). It is hoped that Kentucky will continue the liberalizing trend in family-relationship cases by following the unanimous line of decisions rejecting the creation of an immunity between unemancipated minors of the same family.

including income earned on properties disposed of by the executor in payment of the legal charges against the estate. *Whitman v. Lincoln Bank & Trust Co.*, 340 S.W.2d 608 (Ky. 1960).

Proper allocation of probate income earned on properties sold by an executor to meet the various charges against the estate is a recurring, unsettled problem in the administration of trusts for successive beneficiaries.[1] According to generally accepted authority an income beneficiary of a residuary trust is entitled to income from the *residue* beginning at testator's death, because the testator is presumed to have intended this result.[2] The precise question here is whether "residue" comprises the entire estate before being diminished by proper charges against it, or whether it is that which remains after all claims against the gross estate have been paid.

The answer, unfortunately, is not found in the Uniform Principal and Income Act.[3] The act which governs the allocation of receipts and expenses between income and principal in trusts for successive beneficiaries makes no mention of estates in administration. For this reason the act has been held (by at least one court) not to apply to allocation problems arising in probate estates.[4]

In some jurisdictions allocation is governed by statute,[5] but in the majority of states the solution to the problem has been left to the courts. Three methods of allocation based on two diametrically opposed definitions of "residue" are found in the cases and statutes. The methods may be identified as (1) the Massachusetts Rule, (2) the Old New York Rule, and (3) the English Rule. Because of the similarity in theory of the latter two rules, many courts,[6] includ-

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1 Abernathy, "Is It Income or Principal," 95 Trusts and Estates 412 (1956).

2 Grainger's Ex'rs & Trustees v. Pennebaker, 247 Ky. 324, 56 S.W.2d 1007 (1932); Folsom v. Strain, 138 Neb. 497, 293 N.W. 357 (1940); Restatement (Second), Trusts § 234, comment *g* (1959). See generally 4 Bogert, Trusts and Trustees § 811 (1948) and III Scott, Trusts § 234.3 (2d ed. 1956). Historically, no income was received by the life beneficiary during administration unless specifically bequeathed by the testator, because the residue was not ascertained until settlement of the estate. Proctor v. American Security & Trust Co., 69 App. D.C. 70, 98 F.2d 599 (1938); Tilghman v. Frazer, 199 Md. 620, 87 A.2d 811 (1952).

3 9B Uniform Laws Annot. 365 (1931); Ky. Rev. Stat. §§ 386.190-.340 (1960).

4 *In re* Freehely's Estate, 179 Ore. 250, 170 P.2d 757 (1946).

5 See Cal. Probate Code § 162.5 (1960 Supp.); Conn. Gen. Stat. (Rev. 1958) § 45-192; Ill. Rev. Stat. ch. 30, § 163 (1954); Md. Ann. Code art. 93, § 391 (1957); N.Y. Personal Property Law § 17-b; Pa. Stat. Ann. tit. 20, § 320.753(D) (1950). In all of the above statutes the Massachusetts Rule was enacted—the same as adopted by the court in the principal case.

6 American Security & Trust Co. v. Frost, 73 App. D.C. 75, 117 F.2d 283 (1940), *cert. denied*, 312 U.S. 707 (1941); Proctor v. American Security & Trust Co., 69 App. D.C. 70, 98 F.2d 599 (1938); First Nat'l Bank v. Allen, 86 F. Supp. 918 (M.D. Ga. 1949); Folsom v. Strain, 138 Neb. 497, 293 N.W. 357

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ing the Kentucky Court of Appeals,[7] in approaching the problem entirely from a theoretical viewpoint have grouped them under the heading "general rule." Often under such an approach, the court fails to perceive the practical differences resulting from each of the three distinct methods of computing "residue."

The Massachusetts Rule gives all income earned by the probate estate to the income beneficiary, including income from properties used to pay debts, legacies, taxes and expenses.[8] "Residue" is determined as of the testator's death and, as defined by the Massachusetts court in *Old Colony Trust Co. v. Smith*,[9] it "comprehends the whole of the estate . . . left by the testator subject to all deductions required by operation of law or by direction of the testator."[10] The testator is presumed to have intended this result, since the income beneficiary is generally the principal object of his bounty.[11]

Under the Old New York Rule[12] the income beneficiary receives only the income derived from that part of the estate which is not disposed of by the executor in settlement of the estate.[13] The income from property used in settlement is added to corpus.[14] The rule is predicated on a definition of "residue" more closely approximating

(Footnote continued from preceding page)
(1940); American Nat'l Bank v. Embry, 181 Tenn. 392, 181 S.W.2d 356 (1944); Rosenberger v. Rosenberger, 184 Va. 1024, 37 S.E.2d 55 (1946).

[7] Whitman v. Lincoln Bank & Trust Co., 340 S.W.2d 608 (Ky. 1960).

[8] Old Colony Trust Co. v. Smith, 266 Mass. 500, 165 N.E. 657 (1929). The Massachusetts Rule is the most recent in origin. Although the issue was raised as dictum in Treadwell v. Cordis, 71 Mass. (5 Gray) 341 (1855), and again in McDonough v. Montague, 259 Mass. 602, 157 N.E. 159 (1927), it did not become holding until the *Old Colony Trust Co.* case, *supra*, where the court relied on its earlier dicta as authority.

[9] 266 Mass. 500, 165 N.E. 657 (1929).

[10] *Id.* at —, 165 N.E. at 658. Again relying on McDonough v. Montague, 259 Mass. 602, 157 N.E. 159 (1927), the court found "nothing in the will which indicates an intention to make a change from the accepted rule that a tenant for life is entitled to the income from the time of testator's death." Old Colony Trust Co. v. Smith, 266 Mass. 500, —, 165 N.E. 657, 658 (1929). Thus the court considers the generally accepted rule as to income from residuary estates to apply to income from properties disposed of in settlement unless a contrary intention is expressed. See Whitman v. Lincoln Bank & Trust Co., 340 S.W.2d 608 (Ky. 1960).

[11] *In re* Schiffman's Estate, 86 Cal. App. 2d 638, 195 P.2d 484 (1948); Grainger's Ex'rs & Trustees v. Pennebaker, 247 Ky. 324, 56 S.W.2d 1007 (1932); Wachovia Bank & Trust Co. v. Jones, 210 N.C. 339, 186 S.E. 335 (1936). For a listing of cases following the Massachusetts Rule, see Restatement (Second), Trusts, Appendix § 234 (1959).

[12] The rule was specifically repudiated by statute in favor of the Massachusetts Rule. N.Y. Personal Prop. Law § 17-b.

[13] Matter of Benson, 96 N.Y. 499 (1884); Williamson v. Williamson 3 N.Y. Ch. R. Ann. (6 Paige) 298 (1837). For a listing of cases see Restatement (Second), Trusts, Appendix § 234 (1959).

[14] See cases in Restatement (Second), Trusts, Appendix § 234 (1959).

its common meaning.[15] The Connecticut court, a former proponent of the rule,[16] has stated the definition as follows:

> The residue is that portion of an estate that remains after the payment of debts, legacies, and administration charges. . . . [It includes] income and accretions of the estate which are . . . not otherwise disposed of by the will.[17]

The testator, it is assumed, intended to provide as large an income as possible during the beneficiary's tenure. By an all-inclusive definition of residue, a larger corpus is provided making available increased income in subsequent years.

The English courts, under the leading case of *Allhusen v. Whittel*,[18] follow still a third rule. While committed to the theory of the Old New York Rule that the income beneficiary is only entitled to income from properties comprising the clear net residuary estate, the computation of "residue" is completely different. "Residue" is derived by reducing the probate estate by a sum which, with interest thereon at the rate earned by the entire estate, will be sufficient to satisfy the various charges against the estate.[19] This sum by which the probate estate is reduced, referred to as the "deduction fund," is computed by use of the standard capitalization formula, $x = P (r + 1) t$, the same as used when an estate includes unproductive or wasting

[15] Residue is defined in Black, Law Dictionary 1474 (4th ed. 1951), as "the surplus of a testator's estate remaining after all the debts and particular legacies have been discharged." In Ballentine, The Self-Pronouncing Law Dictionary 733 (2d stud. ed. 1949), conflicting definitions are found for "residuary" and "residue." Residuary is defined to be "that which remains of a decedent's estate after the specific legacies have been paid." Residue, on the other hand, is "all of that portion of the estate of a testator of which no effectual disposition has been made by his will, otherwise than by the residuary clause."

[16] Connecticut, like New York, adopted the Massachusetts Rule by statute. Conn. Gen. Stat. (Rev. 1958) § 45-192.

[17] Stanley v. Stanley, 108 Conn. 100, –, 142 Atl. 851, 855 (1928). This definition approximates that formerly given by the Kentucky court. Harlan Nat'l Bank v. Brown, 317 S.W.2d 903 (Ky. 1958); McLeod v. Andrews, 303 Ky. 46, 196 S.W.2d 473 (1946).

[18] L.R. 4 Eq. 295 (1867).

[19] *In re* Oldham (1927) W.N. 113; *In re* Wills (1915) 1 Ch. 769; Allhusen v. Whittel, L.R. 4 Eq. 295 (1867). After the *Allhusen* rule was announced, various modifications were made causing the English Rule to closely approximate the Old New York Rule. See *In re* McEuen (1913) 2 Ch. 704; Lambert v. Lambert, L.R. 16 Eq. 320 (1873). But the rule was revived with additional vigor in *In re* Wills, *supra*, which held that the true principle of *Allhusen* was to deprive the tenant for life of income derived from a fund equivalent to the present worth of a sum sufficient to satisfy the liabilities of the estate. Although there was little American authority for the rule, it was adopted by the American Law Institute in the Restatement, Trusts § 234, comment *g* (1935). However, the *Second Restatement of Trusts* adopted the Massachusetts Rule. Restatement (Second), Trusts § 234, comment *g* (1959).

assets.[20] Instead of discounting the estate by the total sum of all charges against the estate as under the Old New York Rule, it is reduced only by the present worth of these various charges against the estate.[21]

The practical differences resulting under each of the three rules are demonstrated by the following illustration. Assume as in the principal case a probate estate of $480,000, earnings at 4% and debts, taxes, legacies and expenses totaling $87,500. Income from the entire estate is $19,200 of which $3,500 is attributable to property sold by the exe̓cutor in payment of the $87,500.

Rule	Allocation to income beneficiary 1st year	Corpus after settlement	Income at 4% available in successive years
Massachusetts	$19,200	$392,500	$15,700
Old New York	15,700	396,000	15,840
English	15,835	395,865	15,835[22]

The Massachusetts Rule is undoubtedly the most advantageous to the income beneficiary. Although the additional income received during administration necessarily results in a smaller trust income in future years, by investing the additional income received during administration the income beneficiary can secure an income in future years equivalent to that which would be received under the Old New York Rule.[23] Under both the New York and English Rules the income beneficiary shares part of the burden of administrative ex-

[20] III Scott, Trusts § 234.4 (2d ed. 1956). "x" is the total debts, legacies, taxes, and other administrative expenses; "r" is the rate of earnings on the entire estate; "P" is the deductible fund, and "t" is the period in years in which the estate was administered. Since the deductible fund is the unknown, transposed the formula becomes $P = \frac{x}{(r + 1)t}$.

[21] Tilghman v. Frazer, 199 Md. 620, 87 A. 2d 811 (1952).

[22] Under the Massachusetts Rule the entire $19,200 income is paid to the income beneficiary the first year leaving the corpus at $392,500 ($480,000—$87,500). Income from this sum at 4% is $15,700 which represents the anticipated income in each future year. Under the Old New York Rule, only the income earned on properties not sold by the executor, $15,700 ($19,200—$3,500), is awarded the income beneficiary. The $3,500 is added to corpus after the deduction of the $87,500, leaving $396,000 which at 4% will net $15,840 in future years. The computation under the English Rule is $P = \frac{87{,}500}{(1 + .04)1}$. "P," the deductible fund, equals $84,135, and subtracted from the gross estate leaves $395,865. Earnings at 4% in the first year and in future years will net an income of $15,835.

[23] Sir William Pendler illustrated this point in his commentaries following a note in 30 Law Q. Rev. 481, 489 (1914). By investing the $3,500 at 4% interest the income beneficiary would receive $140 annually. Added to her trust return of $15,700 the beneficiary would then receive $15,840, the same as under the Old New York Rule.

penses preventing further depletion of corpus. The English Rule, although somewhat more difficult to apply, results in what may be referred to as a "refined apportionment." By computing residue as of the testator's death, but not subject to reduction by charges against the estate, the same amount of income is made available in subsequent years as during administration.[24]

Although courts of many states have cited Kentucky as committed to the "general rule"[25] under the holding in *Grainger's Ex'rs and Trustees v. Pennebaker*,[26] the Court of Appeals in the principal case did not consider itself so bound. Limiting the *Pennebaker* case to "the peculiarities of the will and testamentary trusts there involved,"[27] the court adopted the Massachusetts Rule in no uncertain terms. Despite a number of cases in which "residue" was said to be that portion of the estate which is left after discharging all legal and testamentary claims,[28] a definition consistent with the "general rule," the court redefined "residue" as "the entire estate undiminished until the proper charges against it . . . are satisfied."[29] Primary reliance was placed on section 234, comment g of the *Second Restatement of Trusts* as stating the prevailing law on the subject. Particular attention was drawn to the *Second Restatement's* reversal of the position taken by the 1935 *Restatement*, indicating the modern trend in favor of the Massachusetts Rule.

The Massachusetts Rule has prevailed, not because the average testator would have intended this result, but because practical necessity demands a rule that is simple to explain and easy to apply.[30] Neither complex accounting procedures nor algebraic formulas are required.[31] Even though the income beneficiary receives what is referred to by some as a "windfall benefit during the administration period" at the expense of the principal beneficiaries, the rule has found the approval of executors, trustees and now the courts.

If the rule is not applied cautiously, the testator's plan may be

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[24] Based on a misconception that all debts, taxes, legacies, etc., are paid upon settlement date, the English Rule becomes quite complex in reality since the formula must be applied for each payment. Note, 30 Law Q. Rev. 481 (1914).

[25] Proctor v. American Security & Trust Co., 69 App. D.C. 70, 98 F.2d 599 (1938); Tilghman v. Frazer, 199 Md. 620, 87 A.2d 811 (1952); Rosenberger v. Rosenberger, 184 Va. 1024, 37 S.E.2d 55 (1946).

[26] 247 Ky. 324, 56 S.W.2d 1007 (1932). Both parties in the principal case cited *Pennebaker* as authority for their view.

[27] Whitman v. Lincoln Bank & Trust Co., 340 S.W.2d 608, 610 (1960).

[28] Harlan Nat'l Bank v. Brown, 317 S.W.2d 903 (Ky. 1958); McLeod v. Andrews, 303 Ky. 46, 196 S.W.2d 473 (1946); Grainger's Ex'rs & Trustees v. Pennebaker, 247 Ky. 324, 56 S.W.2d 1007 (1932).

[29] Whitman v. Lincoln Bank & Trust Co., 340 S.W.2d 608, 610 (1960).

[30] Abernathy, *supra* note 1.

[31] III Scott, Trusts, § 234.4 (2d ed. 1956).

destroyed.[32] For example, if the testator left a heavily indebted estate which, due to financial complexities, required an extended period of administration, the interest and administration expenses borne solely by principal could conceivably deplete the entire corpus. Meantime, the income beneficiary would enjoy the full income from the properties which were subsequently sold to pay the indebtedness and other charges against the estate. Thus an attempt to establish a residuary trust for successive beneficiaries would be converted into a specific bequest of probate income. In dealing with such a problem, the court need only remember that the rule which it has adopted is a rule of construction, not a rule of law. The court should not limit itself to the four corners of the will as suggested in the principal case, but the trustees, executors and court should consider the financial circumstances surrounding the estate before making a conclusive determination of the testator's intent. In some cases the court may find an application under one of the other rules to be more consistent with testator's intent.

The court in the *Whitman* case not only solves the allocation problem by adopting the Massachusetts Rule, it vividly reminds the practitioner and testator to specifically consider the subject of probate income in drafting the testator's will.

K. Sidney Neuman

WORKMEN'S COMPENSATION—OCCUPATIONAL DISEASE—INJURIOUS EXPOSURE—Claimant was employed as a mine motor car operator for twenty-three months by the defendant from whom he sought compensation for total permanent disability resulting from silicosis. Medical testimony established that he had some degree of silicosis prior to this employment, but that it had not reached the disabling stage. There was evidence that in this employment claimant was exposed for several hours a day to dust from sand used for wheel traction. Some nine months after beginning work the claimant experienced shortness of breath. Then over a year later a medical examination revealed silicosis which had progressed to the disabling stage.

Claimant thereafter applied to the Workmen's Compensation Board for an award of compensation. The referee's report recommending such an award was set aside by the board, three members of the five-member board sitting, one of the three dissenting. Compensation was denied on the ground that claimant had not sufficiently proved

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[32] See examples in Tilghman v. Frazer, 199 Md. 620, 87 A.2d 811 (1952); *In re* Freehely's Estate, 179 Ore. 250, 170 P.2d 757 (1946).