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Life Estates and Trusts--Allocation of Stock Dividends

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LIFE ESTATES AND TRUSTS—ALLOCATION OF STOCK DIVIDENDS—Under a testamentary disposition to successive legatees “all dividends” were given expressly to the life tenant as income beneficiary. Three stock dividends, of 50%, 33 $\frac{1}{3}$ % and 25%, were declared on shares in a bank corporation so bequeathed. In proceedings between the remaindermen and the assignees of life tenant, the lower court held that all of the 25 $\frac{1}{2}$ shares paid to the assignees as stock dividends should be allocated to the life tenant as income. This holding followed past Kentucky decisions, but on appeal the Kentucky Court of Appeals reversed, and adopted the so-called “Massachusetts” rule for allocating such dividends. This rule awards the entire extraordinary dividend from earnings to principal if it is essentially a stock dividend, and to income if it is essentially a cash dividend. *Bowles v. Stilley's Ex'r*, 267 S.W. 2d 707 (Ky. 1954).

It should be noted at the outset that the successive estates of ownership here were legal, but the principles governing the proper division of stock dividends are substantially the same where the property is held in trust. In the authorities, these principles are usually classified as “trust” principles and this terminology is followed in this comment.¹

In a trust for successive beneficiaries the trustee is obligated to perform his fiduciary duties with equal loyalty to the income beneficiary and the principal beneficiary. The receipt of a stock dividend creates two problems for the trustee: First, the dividend must be *allocated* to the income account or to the principal account, depending on whether it is treated as an item of current receipts or as an increment to capital. Second, where it is treated as income, it may be necessary to *apportion* it between the life tenant and the remaindermen, depending on whether it was realized in whole or in part during the period of time when the life tenant is entitled to trust income. If it was realized before the commencement of the life estate, or after its end, the stock dividend, like any other dividend, cannot be distributed as income even though it is by nature a current receipt. Problems of allocation are resolved by the nature of the receipt, while problems of apportionment are concerned with time when the receipt was realized, regardless of its nature.^{1a} The instant case clearly involves

¹ 33 AM. JUR. 463, 900 (1941). The proper classification of the problem apparently created some difficulty in preparing the head note for this case, as the advance sheets report carried a *life estates* head note (key number 15.2), whereas the bound report bears a *trusts* headnote (key number 272.3).

^{1a} 2 SCOTT, TRUSTS secs. 232-233.1, 235 (1939). Of course, it should be emphasized that the intention of the testator will be followed by any jurisdiction, even contrary to the state's view. *Laurent v. Randolph*, 306 Ky. 134, 139, 206 S.W. 2d 480, 483 (1947).

only the problem of allocation, and is of interest primarily because the court seems to have ignored completely a statutory formula, adopted in 1950, for allocating stock dividends in Kentucky.

Prior to 1950, stock dividends were governed by the so-called "Kentucky" rule as to allocation of all extraordinary corporate dividends which awarded them in their entirety to the life tenant whether they were stock dividends or cash dividends.² The rule also "apportioned" all extraordinary dividends, including stock dividends, to income wholly after, or partly before or partly after, the commencement of dividends to the remaindermen if the earnings embraced by the extra-the life estate. This all inclusive and simple rule, followed by perhaps only one other state,³ looked only to the nature of the receipt and not to the time when it was realized. At the time of its adoption the court recognized that the then current of authority held that all dividends were non-apportionable whether payable in stock or in money. They were to be considered as accruing in their entirety as of the date when declared.⁴ In *Hite v. Hite*,⁵ the court reasoned that where a stock dividend was declared on *earnings*, it was profit and therefore had to be income. The court also pointed out that ". . . really a corporation has no right to declare a dividend, either in cash or stock, except from its earnings. . . ."⁶

Besides the old "Kentucky" rule and the "Massachusetts" rule adopted by the Court of Appeals in the instant case, there is the "Pennsylvania" rule, which seems to reach the apportionment problem only, avoiding the allocation problem directly. This rule gives stock dividends to the remaindermen if the earnings embraced by the extraordinary distribution were earned before the commencement of the life estate. If earned after that time, the dividends go to the life tenant as income,⁷ although by nature they might represent an increment to

² *Laurent v. Randolph*, *supra* note 1; *Huble's Guardian v. Wolfe*, 259 Ky. 574, 82 S.W. 2d 830 (1935); *Robinson v. Robinson's Ex'r*, 221 Ky. 245, 298 S.W. 701 (1927); *Cox v. Gaulbert's Trustee*, 148 Ky. 407, 147 S.W. 25 (1912); *Hite v. Hite*, 93 Ky. 257, 20 S.W. 778 (1892). See also *Ball's Ex'r v. Woodford Bank and Trust Co.*, 311 Ky. 474, 224 S.W. 2d 678 (1949) (dictum).

³ *Ortiz v. Fidelity-Philadelphia Trust Co.*, 159 Atl. 376 (Del. 1931); *Bryan v. Aiken*, 10 Del. Ch. 446, 86 Atl. 674, 685 (1913), where the "American" rule is stated: ". . . all net earnings, however they may have been treated or used by the corporation during their accumulation, and regardless of the period during which they have accumulated, if declared as dividends out of net profits during the life tenancy, are given to the life tenant when declared, whether such dividends are made in cash or capital stock, provided that the principal of the trust is not diminished thereby."

⁴ *Hite v. Hite*, *supra* note 2, at 265, 20 S.W. at 779.

⁵ *Id.* at 266, 20 S.W. at 780. "If it be really profit, then he should have it, whether paid in stock or money."

⁶ *Ibid.*

⁷ *Lindau v. Community Fund of Baltimore*, 53 A. 2d 409 (Md. 1947); *Earp's Appeal*, 28 Pa. 368 (1857); 2 *SCOTT*, *supra* note 1a, sec. 236.3; 4 *BOGERT, TRUSTS*

principal. This rule sometimes is praised because it achieves "ideal justice" between the life tenant and the remaindermen,⁸ but it presents very practical difficulties of application to the trustee and the courts because it requires a detailed analysis of the financial records of the corporation to fix the time when the earnings were realized.⁹

The "Massachusetts" rule, now followed by a majority of the states, awards the dividend to the remaindermen if essentially a stock dividend, and to the life tenant if essentially a cash dividend, without inquiry in either case as to the time covered by the earnings.¹⁰ This rule, like Kentucky's old one, *implies* that allocation according to nature of the receipt solves any problems of apportionment that may be involved. As the court in the instant case put it: "A stock dividend does not distribute property but simply dilutes the shares as they existed before."¹¹ This view rests on the theory that stock dividends are merely bookkeeping processes of corporations, or are only readjustments of the corporate structure, and therefore do not represent a division of income from capital.¹² This rule is thought to be fairer than the old Kentucky rule in that both the life tenant and the remaindermen will benefit from the stock dividend, since the life tenant will draw income from the stock once it is assigned to principal.¹³ In adopting the Massachusetts rule in the instant case, the Kentucky court emphasized this point by providing specifically that all cash dividends declared on the stock issued as a result of a stock dividend during the continuance of the life interest shall be payable to the life beneficiary.¹⁴ The principal weakness in this rule is the fact that it does not indicate the legal criteria for determining whether the dividend is "essentially" cash or whether it is "essentially" stock.¹⁵

AND TRUSTEES, sec. 848 (1935). The pertinent statute in Pennsylvania now reads: "(1) All dividends on shares of a corporation, forming a part of the principal, which are payable in the shares of the corporation itself of the same kind and rank as the shares on which such dividend is paid shall be deemed principal" 20 PURDON PA. sec. 3470.5 (1953).

⁸ 4 BOGERT, *supra* note 7, sec. 857.

⁹ *Ibid.* 2 SCOTT, *supra* note 1a, sec. 236.3. But see 5 WASH. & LEE L. REV. 288, 293 (1948).

¹⁰ *Gibbons v. Mahon*, 136 U.S. 549 (1890); *First National Bank of Tuskalooza v. Hill*, 241 Ala. 606, 4 So. 2d 170 (1941); *United States Trust Co. v. Cowin*, 121 Neb. 427, 237 N.W. 284 (1931); *Minot v. Paine*, 99 Mass. 101 (1868); 2 SCOTT, *supra* note 1a, sec. 236.3; 4 BOGERT, *supra* note 7, sec. 851.

¹¹ *Bowles v. Stille's Ex'r*, 267 S.W. 2d 707, 708 (Ky. 1954).

¹² *Gibbons v. Mahon*, *supra* note 10, at 569; *First Nat'l Bank Tuskalooza v. Hill*, *supra* note 10, 4 So. 2d at 172.

¹³ 4 BOGERT, *supra* note 7, sec. 857, unless, of course, the stock dividend is granted as part of the liquidation process. See *Laurent v. Randolph*, *supra* note 2, and 5 WASH. & LEE L. REV. 288, 293 (1948).

¹⁴ *Bowles v. Stille's Ex'r*, *supra* note 11, at 709.

¹⁵ One may imply that the ultimate criteria is the source of the funds from which the dividend is paid. If paid from the earnings or surplus, it is clearly a cash dividend. If paid from capital for the purpose of splitting ownership shares, it is clearly a stock dividend.

The Kentucky court's renunciation of the old rule is commendable,¹⁶ but it has confused the Kentucky law by ignoring the legislative solution to the problem which was enacted in 1950. Kentucky Revised Statutes section 386.020(4) provides this formula for the allocation problem presented in the instant case:

All dividends on shares of a corporation forming a part of the principal of an estate or trust which are payable in shares of the same class of the corporation and which are payable at a rate of ten per cent or more of the corporation's outstanding shares of such class before such dividend, shall be deemed principal of the estate or trust, and all such dividends payable at a rate less than ten per cent of the corporation's outstanding shares of such class before such dividend, shall be deemed income of the estate or trust. . . . (Note that the statute applies to both legal and equitable divisions of the property interest.)

Although the allocation made in the instant case would have been the same under the statute, the Court of Appeals made it for an entirely different reason. The court allocated the extraordinary dividend to principal because it was essentially a stock rather than a cash dividend. This is not the basis of the statutory allocation at all. The statute merely declares, without rationalization, that stock dividends, payable at the rate of ten percent or more, as in the instant case, shall be deemed principal, and all such dividends payable at a rate less than ten percent shall be deemed income. Thus, it can be seen that although the Kentucky rule based on this decision looks to the nature of the dividend, the applicable Kentucky statute looks to the amount of the dividend. Although the statutory formula fails to distinguish the problems of allocation and apportionment, it nevertheless does express the will of the legislature, and it is submitted that the Court of Appeals at least should have referred to it in overruling the old Kentucky rule. In failing to do so the court lost a good opportunity to relate the statutory formula to the case law governing the problem.

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¹⁶ It should be pointed out that disagreement with the old Kentucky rule was voiced by the court some time ago. *Laurent v. Randolph*, *supra* note 2, at 138, 206 S.W. 2d at 483; *Huble's Guardian v. Wolfe*, *supra* note 2, at 584, 82 S.W. 2d at 835. See the prediction in 5 WASH. & LEE L. REV. 283 at 294 (1948).