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Principal and Income Allocation of Stock Distributions--The Six Per Cent Rule

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A productive trust is usually dynamic in two ways: the principal assets appreciate in value, and their use produces income. When the beneficial interests in such a trust are successively divided between income recipients and principal remaindermen, every payment to the trust must be characterized either as income or as an addition to principal. The most difficult categorization problems arise when the receipt is of corporate stock.[1]

I. Introduction

Until recently, the two most important methods of categorization were specified by the Pennsylvania and Massachusetts rules.[2] The Pennsylvania rule allocates to income that portion of a stock dividend attributable to earnings accruing to the corporation during the period of the trust, and to principal that portion of the dividend arising out of earnings accruing prior to the creation of the trust.[3] Although designed to be a rule of fairness, this rule often requires a detailed analysis of corporate accounting practices, and has consequently proved unwieldy.[4] The Massachusetts rule, on the other hand, was designed for administrative convenience. For all practical purposes stock distributions[5] under this rule are allocable entirely to principal.[6] Although the weight of authority originally favored

1. See generally Bogert, Trusts & Trustees §§ 841-59 (2d ed. 1962); 3 Scott, Trusts § 236 (2d ed. 1956). For some interesting statistics on the growing popularity of common stock as a trust investment, see Barclay, *Bank Trust Investments Surveyed*, 103 Trusts & Estates 682 (1964).

2. The Kentucky rule allocated all extraordinary stock dividends to the life tenant, regardless of their source. Hite's Devisees v. Hite's Ex'r, 93 Ky. 257, 20 S.W. 778 (1892). The rule was rejected by the Kentucky court in Bowles v. Stilley's Ex'r, 267 S.W.2d 707 (Ky. 1954), and does not appear to be currently in effect in any jurisdiction.

3. 3 Scott, Trusts § 236.3, at 1813 (2d ed. 1956). See generally Brigham, *Pennsylvania Rules Governing the Allocation of Receipts Derived by Trustees From Shares of Stock*, 85 U. Pa. L. Rev. 358 (1937); 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).

4. See Matter of Payne, 7 N.Y.2d 1, 194 N.Y.S.2d 465, 163 N.E.2d 301 (1959); Catherwood Trust, 405 Pa. 61, 173 A.2d 86 (1961); Browning, *Extraordinary Corporate Distributions Under the New York Law of Trusts*, 4 Syracuse L. Rev. 293 (1953); Grossman, *Mechanics of Apportionment of Receipts From Shares of Stock*, 65 Dick. L. Rev. 179 (1961); Machen, *The Apportionment of Stock Distributions in Trust Accounting Practice*, 20 Md. L. Rev. 89 (1960); Tenney, *Stock Splits—The Trustee's Dilemma*, Proceedings of Banking Law Section, N.Y. State Bar Ass'n, 1 (1959).

5. For present purposes the phrase "stock distribution" refers only to a corporation's distribution of its own shares. The Revised Uniform Act and the New York act both allocate distributions of another corporation's stock to income. In addition, the phrase refers only to stock dividends and stock splits. Shares received in a merger or reorganization, rights to subscribe to stock, and liquidation distributions are excluded. There is now basic agreement on the treatment to be given these items. See note 17 *infra*.

6. See Minot v. Paine, 99 Mass. 101 (1868). See generally Bogert, Trusts & Trustees § 850 (2d ed. 1962). Although extraordinary stock dividends and all stock splits are

the Pennsylvania approach, the Massachusetts rule has become predominant in later years. The experiences of Pennsylvania and New York are illustrative of the problems created by this historical evolution. Pennsylvania originated its rule of apportionment in 1857.[7] The rule remained in full effect in Pennsylvania until the Uniform Principal and Income Act, which incorporated the Massachusetts rule, was adopted in 1945[8] and given retroactive effect by judicial decision in 1961.[9] In New York, early decisions held that all stock dividends declared out of earnings were income, without regard to when the earnings were accumulated.[10] The Pennsylvania rule was adopted in 1913,[11] however, and until 1963 governed the allocation of stock distributions to trusts created prior to 1926. Trusts created subsequent to 1926 were governed by the Massachusetts rule, adopted by statute in that year.[12] In 1963 both New York and Pennsylvania enacted legislation rejecting their Massachusetts rules and adopting versions of what has come to be called the "six per cent rule."[13] New

allocable to principal, it has never been clear how the Massachusetts rule would treat an ordinary stock dividend, but because of the rarity of such a device the classification problem is not serious. In any event, there is authority that such distributions would be allocated to principal. See Eastman v. State Bank, 259 Ill. App. 607 (1931); Rhode Island Hosp. Trust Co. v. Tucker, 51 R.I. 507, 155 Atl. 661 (1931).

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

8. Laws of Pa. 1945, P.L. 416, as amended, P.L. 1283 (1947).

9. See Catherwood Trust, 405 Pa. 61, 173 A.2d 86 (1961). The constitutionality of giving principal and income statutes retroactive effect has been questioned. In Crawford Estate, 362 Pa. 458, 67 A.2d 124 (1949), the Pennsylvania Principal and Income Act was denied retroactive effect. However, *Catherwood* overruled *Crawford* and two cases which had followed it: Warden Trust, 382 Pa. 311, 115 A.2d 159 (1955); Pew Trust, 362 Pa. 468, 67 A.2d 129 (1949). New Jersey followed the *Crawford* decision and denied its Principal and Income Act retroactive effect in *In re* Fera, 26 N.J. 131, 139 A.2d 23 (1958). However, all constitutional objection to specific legislative retroactivity in New Jersey was removed by *In re* Arens, 41 N.J. 364, 197 A.2d 1 (1964), and within the year the legislature gave the Principal and Income Act retroactive effect. N.J. Rev. Stat. § 3A:14A-9 (Supp. 1965). Other states have had less trouble with retroactivity, and it now seems fair to conclude that the constitutionality of such provisions will be upheld. See Farmers Bank & Capital Trust Co. v. Hulette, 293 S.W.2d 458 (Ky. 1956); *In re* Warner's Trust, 263 Minn. 449, 117 N.W.2d 224 (1962); *In re* Estate of Valiquette, 122 Vt. 350, 173 A.2d 832 (1961); Will of Allis, 6 Wis. 2d 1, 94 N.W.2d 226 (1959). These state cases rely, in good part, upon Tidal Oil Co. v. Flanagan, 263 U.S. 444 (1924). See generally New York Comm'n on Estates, 2d Report (Legis. Doc. 1963 No. 19) 196-99; Ives, *Allocating Stock Dividends*, 91 Trusts & Estates 851 (1952).

10. See Lowry v. Farmers' Loan & Trust Co., 172 N.Y. 137, 64 N.E. 796 (1902); McLouth v. Hunt, 154 N.Y. 179, 48 N.E. 548 (1897); Riggs v. Cragg, 89 N.Y. 479 (1882).

11. In the Matter of Osborne, 209 N.Y. 450, 103 N.E. 723 (1913).

12. N.Y. Sess. Laws 1926, ch. 843.

13. N.Y. Sess. Laws 1963, ch. 1005, § 2, as amended, ch. 336, § 2 (1965); Pa. Stat. Ann. tit. 20, § 3470.5(1) (1964). The Pennsylvania enactment was apparently preceded by judicial adoption of a similar 6% rule, although a footnote inserted at the conclusion of the majority opinion casts some doubt upon the prospective effect of the rule. Catherwood Trust, 405 Pa. 61, 173 A.2d 86 (1961). However, the judicial version ordered a computation on the basis of total distributions in the current year, rather than upon a distribution-by-distribution basis.

The New Jersey Legislature, following a suggestion of the state's supreme court, *In re* Arens, 41 N.J. 364, 384, 197 A.2d 1, 12 (1964), adopted in 1964 a small-stock-dividend allocation rule similar to those currently in effect in New York and Pennsylvania, but with a 4% cutoff rather than 6%. N.J. Rev. Stat. § 3A:14A-4 (Supp. 1965).

York's comprehensive Principal and Income Act,[14] adopted two years later, retained the six per cent rule, but with modifications.[15] Under the 1965 formulation, a stock distribution which does not exceed six per cent of the shares upon which the distribution is made is allocated exclusively to income. Otherwise the distribution in its entirety is an addition to principal. The Commissioners on Uniform State Laws, after considering the six per cent rule, promulgated in 1962 a Revised Uniform Principal and Income Act[16] which retains the previously adopted Massachusetts rule.[17]

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14. N.Y. PERS. PROP. LAW, art. 2A. See generally NEW YORK COMM'N ON ESTATES, 3D REPORT (Legis. Doc. 1964 No. 19) 300; Barclay, *Legislation in Aid of Administration*, 104 TRUSTS & ESTATES 728 (1965).

15. "A distribution by a corporation or association made to a trustee in the shares of the distributing corporation or association held in such trust, whether in the form of a stock split or stock dividend, at the rate of six per cent or less of the shares upon which the distribution is made, shall be income. Any such distribution at a greater rate shall be principal." N.Y. PERS. PROP. LAW § 27-e-2. Like the New York law, the Pennsylvania and New Jersey statutes allocate each stock distribution individually. That is, if a particular distribution, in and of itself, does not exceed the cutoff percentage it is immediately allocable to income, without regard to the existence or timing of any other distributions made by that corporation. There were two forerunners to this form of the 6% rule. The third tentative draft of the Revised Uniform Act, which was ultimately rejected by the Commissioners, made an allocation based upon the total amount of all distributions received from a corporation in the corporate fiscal year; it did not deal with each distribution individually. If the total amount exceeded 6% it was fully allocable to principal; otherwise it belonged entirely to income. The 1963 amendment to § 17(a) of the N.Y. Personal Property Law, N.Y. Sess. Laws 1963, ch. 1005, § 2, repealed by the 1965 Principal and Income Act, N.Y. Sess. Laws 1965, ch. 336, § 2, allocated stock distributions received in the trust year to principal to the extent they exceeded 6% of the number of shares of that stock held in the trust.

It seems clear that the form of the rule now in effect in New York, Pennsylvania, and New Jersey is the best of the three approaches. In the first place, it is the most easily administered. Under the New York 1963 amendment an apportionment was required, in that all stock distributions received in the trust year were to be allocated to income to the extent of 6%. Although the third draft made a total allocation to one account or the other, thus eliminating any need to apportion, all distributions received in the corporate fiscal year were to be totalled before the allocation could be made. This appears unsatisfactory, as it causes a delay and quite possibly superimposes upon the trust year several staggered corporate fiscal years.

In addition to the administrative preferability of the present form of the rule, it does not appear that it will be arbitrary in practical effect when compared with the 1963 amendment, which incorporated the fairness of an apportionment. Statistics indicate that the overwhelming percentage of small stock distributions do not exceed 6%. See Niles, *The New 6% Stock Distribution Rule*, 102 TRUSTS & ESTATES 648 (1963). As few dividends of 7-9% are declared, the incongruous situation where an income beneficiary receives all of a 6% and none of a 7% distribution may be considered a rarity. New Jersey's 4% rule may be subject to some criticism in this respect, however.

16. "Corporate distributions of shares of the distributing corporation, including distributions in the form of a stock split or stock dividend, are principal." REVISED UNIFORM PRINCIPAL AND INCOME ACT § 6(a). See generally Commissioners' Prefatory Note, 9B UNIFORM LAWS ANN. 176 (Supp. 1964).

17. The Uniform Act and the New York Act are in basic agreement upon most of the problems dealt with under the "principal and income" rubric. It is important to consider the present discussion in light of this general agreement, because this comment, centering upon one narrow, although important, aspect of the broad scheme, can give the impression that New York has completely rejected the values which can be recognized from national statutory uniformity. This is not so; there is significant diver-

Although the eventual disappearance of the original Pennsylvania rule of apportionment now seems virtually assured, the challenge presented to the Massachusetts view by the six per cent rule may prove far more formidable.[18] It is anticipated, therefore, that a num-

gence between the acts only with regard to the allocation of a corporation's distribution of its own stock to its own shareholders. A brief, section by section, comparison of the acts will illustrate the general correspondence. (a) The definitional sections are virtually identical. *Compare* UPIA §§ 1, 3 *with* NYPIA §§ 27-b, 27-q. (b) The administrative duty sections are generally identical, differing only in the phrasing of the scope of trustee discretion. *Compare* UPIA § 2 *with* NYPIA § 27-a. (c) The sections pertaining to the date upon which the right to income arises are identical in substance, with minor differences in wording. *Compare* UPIA § 4 *with* NYPIA § 27-c. (d) The sections on income earned during the administration of a decedent's estate are alike except that the New York act makes special provision for a situation that arose in Matter of Shubert, 10 N.Y.2d 461, 180 N.E.2d 410 (1962). *Compare* UPIA § 5 *with* NYPIA § 27-d. (e) The bond premium and discount sections are identical, except that the New York act employs a broader phraseology, similar to that of several other states adopting the Uniform Act, which enlarges the section's scope. *Compare* UPIA § 7 *with* NYPIA § 27-f. (f) New York omits the section on farm operations, UPIA § 8(b), but the sections on business operations are identical. *Compare* UPIA § 8(a) *with* NYPIA § 27-g. (g) The natural resource sections are identical in wording and substance. *Compare* UPIA § 9 *with* NYPIA § 27-h. (h) The sale-of-timber sections are identical. *Compare* UPIA § 10 *with* NYPIA § 27-i. (i) The sections on other depletable property differ; the Uniform Act allocates 5% to income, see UPIA § 11, whereas New York uses a prudent-man standard, see NYPIA § 27-j. (j) The underproductive-property sections are similar in basic wording but differ in two important respects. New York specifically excludes marketable securities and sets no time limitation upon the non-apportionment of land acquired by mortgage foreclosure. *Compare* UPIA § 12 *with* NYPIA § 27-k. (k) The sections on charges against income and principal differ significantly because of certain unique features of established New York practice, but there is no fundamental disagreement. *Compare* UPIA § 13 *with* NYPIA § 27-*l*. (l) The important sections on retroactive application are identical. *Compare* UPIA § 14 *with* NYPIA § 27-m; see note 9 *supra*. In conclusion, the New York act adopts verbatim the statement in the Uniform Act to the effect that its general purpose is uniformity. *Compare* UPIA § 15 *with* NYPIA § 27-n.

See Barclay, *New York's Proposed Principal and Income Act*, 102 TRUSTS & ESTATES 689 (1963); Bogert, *Uniform Principal and Income Act Revised*, 101 TRUSTS & ESTATES 787 (1962); Dunham, *Revised Uniform Principal and Income Act*, 102 TRUSTS & ESTATES 210 (1963); Note, 1963 U. ILL. L.F. 473. For a discussion of the specific points of departure between the acts, see Barclay, *supra* note 14.

There are several substantively identical provisions within the corporate distributions sections of the two acts. (a) Subscription rights are principal. UPIA § 6(a); NYPIA § 27-e-4. (b) Distributions stemming from the call of shares, mergers, and liquidations by corporate decision or court decree are principal. UPIA § 6(b); NYPIA §§ 27-e-5, 6. (c) The sections differentiating between various distributions of regulated investment companies are identical. *Compare* UPIA § 6(c) *with* NYPIA § 27-e-7. (d) Options to receive in cash or stock are income. UPIA § 6(d); NYPIA § 27-e-8. (e) Each act has a general provision that all other distributions are income. UPIA § 6(d); NYPIA § 27-e-10.

In addition, the New York act covers certain items which are not mentioned in the Uniform Act. For instance, it is made clear that the settlor's specificaton is binding, see § 27-e-1, and that the trustee shall not be liable if he retains in principal an item about which he is uncertain, though it turns out to be income. See § 27-e-12.

18. Two other resolutions of the problem of the allocation of stock distributions have recently been suggested. Neither is treated extensively in this comment because neither has attracted sufficient support to be considered a viable alternative to the 6% and Massachusetts rules.

(1) The "prudent man" rule. This approach has been adopted by statute in Delaware. Under the Delaware formulation, a trustee shall treat all property received as

ber of states will reevaluate their rules regulating the allocation of stock distributions between principal and income. It is hoped that the following discussion of the Massachusetts and six per cent rules and their ramifications will provide the necessary guidelines for legislators who must permanently resolve this issue in order to avoid a duplication of those problems with which trustees and draftsmen in Pennsylvania and New York have been forced to contend as a result of vacillating statutory framework.

II. Effectuating Settlor's Probable Intent Through Statutory Enactment

Rarely, if ever, does a settlor define "income" when he provides that "income" or "net income" be paid to one person, while "principal" or "corpus" be held for another.[19] Thus, the initial inquiry in

a corporate distribution as income to the extent that, in the judgment of the trustee, it would be regarded by men of prudence, discretion, and intelligence in the management of their own affairs as income from the investment. DEL. CODE ANN. tit. 12, § 3526 (Supp. 1964). For criticisms of this rule, see NEW YORK COMM'N ON ESTATES, 2D REPORT (Legis. Doc. 1963 No. 19) 177; Dunham, *Uniform Revised Principal and Income Act*, 101 TRUSTS & ESTATES 894, 896 (1962).

(2) "Anticipatory apportionment." This plan provides for the periodic invasion of corpus to maintain the income beneficiary's rate of return. The trustee would multiply the market value of the stock at the beginning of the year by the bond yield, and then, at the end of the year, distribute sufficient corpus to make up the amount by which this figure exceeded the dividends received. See text accompanying notes 24-26 *infra;* Aronstein, *Common Stocks in Trust*, 113 U. PA. L. REV. 228, 253 (1964); Aronstein, *Toward Growth With Fair Return*, 104 TRUSTS & ESTATES 788 (1965). For a critical view of this suggestion, see Barclay, *The Lot of the Income Beneficiary* (pts. 1 & 2), 104 TRUSTS & ESTATES 144, 277 (1965).

For an approach which seems to represent a combination of the "prudent man" and "anticipatory apportionment" proposals, see Wells, *Pity the Poor Income Beneficiary*, 103 TRUSTS & ESTATES 119 (1964), suggesting anticipatory apportionment on a prudent man basis, rather than through the application of a specific formula.

19. The meaning of "income" differs according to its context. To the corporation, the excess of revenues over expenses may be considered income. However, for tax purposes that excess is not income to the individual shareholder because he must part with some of his proportionate interest in the corporation in order to realize any tangible benefit. See Eisner v. Macomber, 252 U.S. 189 (1920); note 47 *infra* and accompanying text. Yet, if this same shareholder is the income beneficiary of a trust, it may be argued that for allocation purposes corporate earnings should be considered income.

Both the Uniform Act and the New York act begin with the same definition: "Income is the return in money or property derived from the use of principal . . . ." REVISED UNIFORM PRINCIPAL AND INCOME ACT § 3(a); N.Y. PERS. PROP. LAW § 27-b-1. However, the acts proceed to modify this definition, in opposite ways, in their sections concerning corporate distributions.

The question of what significance the usual settlor ascribes to the source of the distributed property is of course essential to any discussion of allocation rules in general. For example, should cash or stock dividends from paid-in surplus be considered income? Should cash or stock dividends from earned surplus acquired prior to the trust's purchase of the shares be income? However, for the purposes of the present discussion this problem is not really relevant, as neither the 6% rule nor the Massachusetts rule distinguishes between stock splits and stock dividends, and neither can be preferred on the ground that it does or does not give weight to the source of the distribution. It will therefore be assumed that all increased book value and all capitalized distributions derive from operational earnings. There is an obvious caveat here, however. Inherent interpreting the trust instrument is necessarily directed to determining the settlor's intent.[20] Likewise, it would seem that legislators, when analyzing the merits of the Massachusetts and six per cent rules, should be initially concerned with adopting a statute most closely incorporating the settlor's probable intent. It becomes immediately apparent in the context of the allocation of stock distributions, however, that a settlor could, if he considered the problem, adopt any one of several constructions for "income."

If it is the conclusion of the legislature that the settlor would generally construe "income" in light of the nature of corporate ownership, the Massachusetts rule should be adopted. Common stock is not evidence of a debt, but rather of participation in the success or failure of a business enterprise. Given the discretion of the board of directors in distributing or retaining earnings,[21] the settlor would, upon considering the question in this light, probably intend his term "income" to encompass only actual distributions of corporate assets.[22] Under such a construction of the settlor's intent, all stock dividends would be allocated to principal, for the distribution of a stock dividend does not alter corporate net worth. Previously withheld earnings remain in the hands of the corporation. Before a trustee can be said to have realized tangible value, he must sell the stock received as a dividend, thus surrendering a portion of the trust's participation in future earnings and diluting whatever control may have been possessed. Since the same amount of money could have been received through a sale of the same proportionate share of the trust's holdings before the dividend, the distribution of the dividend does not in any way facilitate the trustee's realization of tangible assets, and thus cannot be considered income.

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in the reasoning supporting the 6% rule is an assumption, with some empirical basis, that small stock distributions generally have their source in the capitalization of earned surplus, and that the rule is not therefore subject to the criticism that it allocates to income that which the settlor would never consider to be income: unearned surplus. See Shapleigh, *How Fair Is the Six Percent Rule on Stock Distributions?*, 104 TRUSTS & ESTATES 908 (1965).

20. Although it is clear that the settlor's intention is the ultimate allocation determinant, there has been some question whether a direction in a will to allocate stock distributions to principal would constitute an invalid accumulation of income in those states where the law would otherwise assign part of the distribution to the income account. It was so held in Maris's Estate, 301 Pa. 20, 151 Atl. 577 (1930). However, New York is to the contrary, Equitable Trust Co. v. Prentice, 250 N.Y. 1, 164 N.E. 723 (1928); and the Pennsylvania holding has subsequently been changed by statute, PA. STAT. ANN. tit. 20, § 301.6 (Supp. 1965).

21. See Moskowitz v. Bantrell, 190 A.2d 749 (Del. 1963); 11 FLETCHER, PRIVATE CORPORATIONS § 5325 n.72 (perm. ed. rev. repl. 1958). Two cases in New York suggest an exception for corporations controlled by trustees. In the Matter of Adler, 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937); In the Matter of McLaughlin, 164 Misc. 539, 299 N.Y. Supp. 559 (Surr. Ct. 1937).

22. Any possible distinctions that might be developed between the treatment of preferred and common stock, or between varying classes of common, are not considered in the present discussion, since little or no sentiment for the making of such distinctions exists. Simplicity is the admitted goal of both rules.

If, however, the legislature concludes that the settlor would generally construe "income" in light of the practical consequences to the income beneficiary, then it might find merit in the six per cent rule. Certainly a settlor might reason that although a share of stock does not entitle the holder to any more than a proportionate participation in actual distributions, the holder may realize the value of the retained earnings, or some part thereof, through increased market value of the stock. Theoretically, the increased book value which derives from the retention of earnings will be reflected by the price of the stock, and the price may even increase to a disproportionate extent in response to the anticipation of the future growth suggested by such retention. Thus, the settlor might equate the term "income" with the full amount of corporate earnings, or some fixed portion thereof, expecting that the earnings will be tangibly realized by the income beneficiaries through periodic sales of shares held by the trustee in the principal account. The timing of the sales and the computation of the number of shares to be sold present problems[23] probably best solved by a device called "anticipatory apportionment."[24] This means of apportionment calls for distribution to income beneficiaries from the trust corpus whenever the pure income yield on the corpus falls below the current bond yield, as determined by an acceptable national index. However, a definition which equates income with some fixed portion of corporate earnings, whether or not actually distributed, and which quite logically compels some type of periodic apportionment is an extreme definition which supporters of the six per cent rule are not forced to accept. Rather, they may more moderately conclude that the typical settlor uses the term "income" to mean simply a return to the income beneficiaries larger than that provided by cash dividends, at least in those cases where, because of the retention of earnings, the yield from cash dividends is significantly lower than the bond yield.[25] Periodic apportionment would accomplish a full-scale effectuation of such an intention. However, it presents some danger of stunting the growth of the corpus, and thus in the long run might adversely affect both income beneficiaries and remaindermen.[26] This danger, coupled with the revo-

23. Such problems include the questions of when there has been a sufficient increase in book value and market price to warrant a sale, whether a rise in market price has been caused by the retention of earnings or by some combination of speculation and inflation, and what treatment should be accorded decreases in market value.

24. See note 18 *supra.*

25. This conclusion is supported by the fact that most of the anti-inflationary benefit from holding common stock accrues to the remainderman. While the market price of the stock will tend to rise with the cost of living, accompanying increases in an initially deflated cash dividend will provide little protection for the income beneficiary.

26. Without attempting a comprehensive criticism, it might be suggested that in developing his theory of anticipatory apportionment Aronstein, *Common Stocks in Trust,* 113 U. PA. L. REV. 228 (1964), overemphasizes the income beneficiary's predicament, and is consequently driven to this rather drastic solution. He assumes that the

lutionary nature of periodic apportionment, indicates that it is not a viable alternative solution. Nevertheless, it is clear that the six per cent rule is a closer approximation than the Massachusetts rule to the intent of a settlor wishing to provide the income beneficiaries with an amount greater than that of the cash dividends alone.

The differences in yield between stock and debt securities are significant. Since 1962 the average yield on long-term taxable Treasury bonds has fluctuated between 3.8% and 4.25%, and the average yield on Aaa and Aa corporate bonds has varied between 4.25% and 4.6%. In the same time period, the average yield upon industrial common stocks has never exceeded 3.8% and has gone as low as 2.8%.[27] Thus, trust assets in the form of common stock produce about one per cent less current income than do debt securities.[28] The allocation of small stock dividends to income cannot completely correct this situation. Not every corporation whose stock yields less than four per cent makes recurring stock distributions in an amount sufficient to compensate for the depressed cash yield. In addition, stock distributions which *are* made may exceed six per cent and thus be of no benefit to the income beneficiary.[29] On the other hand, the distributing corporation may be one which already returns a sufficient

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common stock corpus will yield only 3½% in cash dividends and that the value of the corpus will appreciate only about 5% per year, while the bond yield is assumed to be a constant 4½%. As a result, he concludes that the common stock yield does not reach the level of the bond yield until the tenth year. However, the following figures indicate that this may be somewhat pessimistic, and that the yields may become comparable within four or five years. The income and growth stocks listed here were among the most popular with trustees in 1964 and 1965. See *A Good Investment Year*, 104 TRUSTS & ESTATES 29 (1965). The figures are derived from 1965 volumes of STANDARD & POOR'S, STANDARD CORPORATION DESCRIPTIONS.

Income Stocks	1954 yield	1964 yield*	Growth Stocks	1954 yield	1964 yield*
GM	4.5	17.0	GE	3.6	5.2
AT & T	5.4	7.0	Texaco	5.2	10.3
Stand. N.J.	5.0	9.9	DuPont	4.0	5.3
Socony	5.1	8.0	Union Carb.	3.2	4.6
Phillips	4.1	6.3	Sears-Roeb.	4.5	8.4
Amer. Cyan.	4.1	8.2	Gen. Foods	4.0	11.8
Int. Paper	4.2	4.9	East. Kodak	3.4	8.8
Amer. Can	3.7	4.8	Gulf Oil	3.6	9.1
CIT Fin.	5.9	8.4	Dow Chem.	2.5	4.4
Cont. Ins.	3.4	5.3	Caterpillar	3.1	14.1
United Gas	4.2	5.5	Merck	4.0	14.0
Average	4.5	7.8	Average	3.7	8.7
	Combined Average		4.1	8.2	

* Based on 1954 price.

27. See *Moody's Investors Yield Table*, 104 TRUSTS & ESTATES 796 (1965).

28. See authorities cited note 18 *supra*; Niles, *The New 6% Stock Distribution Rule*, 102 TRUSTS & ESTATES 648 (1963); Shapleigh, *supra* note 19.

29. *But see* note 15 *supra*.

cash yield, so that the stock distribution will result in an excessive allocation to the income beneficiary. However, in contradistinction to the Massachusetts rule, which necessarily aggravates any unfairness to the income beneficiary, the six per cent rule does provide some measure of alleviation, and there is empirical evidence which indicates that the impact may be significant.[30] Recent trends also suggest that the number of small stock dividends declared will rise in years to come, increasing the impact of the method of allocation employed. Although in the period from 1949 to 1954 there were only 686 stock dividends and splits declared by corporations listed on the New York Stock Exchange,[31] there were 1549 declared between 1959 and 1964.[32]

Thus, the essence of the argument for the six per cent rule, which allocates small stock distributions to income, is not that such distributions are in fact the equivalent of ordinary cash dividends, but rather that the term "income" encompasses more than cash distributions, because retained earnings may be realized upon through the increased market value of the stock. It is not argued by proponents of the six per cent rule that the shares received as the result of a stock dividend represent a valuable distribution of corporate property. Such a dividend is simply viewed as a convenient mechanism for the partial alleviation of what is felt to be an imbalance between the trust's principal and income accounts—a workable means of reallocating part of what may rightfully belong to income, given the difference in yield between equity and debt securities.

Yet the Uniform Act rejects the six per cent rule.[33] Several reasons have been put forth to explain the rejection. The first is an extension of the definitional argument discussed previously.[34] It was suggested that the settlor might equate "income" from common stock with total corporate earnings because the stockholder is an owner of the enterprise and, although he cannot force a distribution of the

30. See generally Shapleigh, *supra* note 19.

31. See 1965 NEW YORK STOCK EXCHANGE FACT BOOK 38.

32. *Ibid.* Three factors account for the present popularity of stock dividends. Retained earnings are an inexpensive source of new capital, avoiding the selling costs of a public offering. There can be benefit to the shareholder, as the declaration of an extra stock dividend may precipitate a somewhat illogical rise in market price, which can be converted into cash at capital gains rates. In addition, it is often said that a stock dividend conserves cash for the corporation. See Corey, *Cash Plus Stock Dividends*, 98 TRUSTS & ESTATES 339 (1959). For a critical view of this assertion, see Barclay, *Stock Dividends Belong to Principal*, 103 TRUSTS & ESTATES 482 (1964).

33. The third tentative draft of the Uniform Act revision adopted a form of the 6% rule, in preference to the Massachusetts rule, but the 6% rule was rejected in the final draft. See note 15 *supra*; Dunham, *supra* note 18. It is interesting to trace a change of position by George C. Barclay. *Compare* articles favoring the 6% rule, written as late as March 1964, *Third Draft of Revised Principal and Income Act*, 101 TRUSTS & ESTATES 505 (1962), *The Revised Uniform Principal and Income Act*, 101 *id.* 833 (1962), *Supervision of Trust Powers to Comptroller?*, 101 *id.* 833 (1962), and *Dividend Allocation Powers*, 103 *id.* 272 (1964), *with.* Barclay, *Stock Dividends Belong to Principal*, 103 *id.* 482 (1964).

34. See Barclay, *supra* note 32.

earnings,[35] he can realize upon these earnings by selling part of his ownership interest, which the retention has caused to appreciate in value. However, this reasoning can be carried a step further. Common stock is an interest in a business enterprise, the management of which is entrusted to a board of directors. Cash dividends are the only return from this interest. A stock dividend or split, which is not a distribution of earnings and does not alter the proportionate interest of the shareholder, cannot be considered income in and of itself. Furthermore, there is no persuasive reason why the income beneficiary should have any claim to retained earnings. The board of directors decides upon this immediate reinvestment with the expectation that it will result in increased future earnings, which will permit increased cash dividends.[36] These will of course accrue to the income beneficiary. Thus, it might be concluded that the typical settlor contemplating trust ownership of stock would rely upon the judgment of the board of directors regarding the long-run advisability of distributing or retaining earnings, and would expect his income beneficiary to receive only those earnings distributed as cash dividends, rather than the greater amount with which proponents of the six per cent rule seek to effectuate what they view as the intent of the settlor.[37] In addition, it must be remembered that if a retention of earnings is successful it may well cause the cash yield to surpass comparable bond yield in a very few years.[38]

III. Effectuating Settlor's Intent Through Trustee's Discretion

In light of the variety of views a settlor could reasonably take with respect to the meaning of the ambiguous term "income," it is apparent that any attempt to develop a generalized conception of the typical settlor's intention through manipulation of the legal attributes of stock and stock dividends is fruitless. Since the actual intention of the settlor is as varied as the family situation, it would seem that, rather than attempting to anticipate intention by statute, the construction and effectuation of the settlor's purpose is best relegated to the discretion of the trustee, with the usual judicial supervision and remedial sanctions. There are several channels through which this discretion may operate. First, the trustee may fashion the trust portfolio to accomplish the purposes which he feels the settlor intended. If the primary concern is for the remaindermen, as, for example, when the income beneficiary is otherwise well provided for, the bulk of the corpus may be invested in growth stocks show-

35. See note 21 *supra*.
36. See note 26 *supra*.
37. See text accompanying note 25 *supra*.
38. See note 26 *supra*.

ing low cash yields. On the other hand, if the income beneficiary has pressing needs and the remaindermen are remote or unascertained secondary recipients, a more substantial return may be achieved by purchasing debt securities and income-oriented stocks showing significant cash yields. Such portfolio manipulation can reduce potential unfairness under the Massachusetts rule. However, it is asserted by proponents of the six per cent rule that the six per cent rule allows the trustee to hold reliable low-yield growth stocks even when the primary trust purpose is the production of income. This argument assumes, however, that the corporations whose shares are considered a desirable growth stock regularly distribute small stock dividends, which does not at present appear to be the case,[39] and that good income stocks do not appreciate in value, which also appears not to be the case.[40] Furthermore, even under the six per cent rule the trustee must rely heavily upon high-yield securities when income is the primary goal.

The second, and probably more desirable, mechanism for effecting the settlor's intention is the power of invasion. The trustee is not required to make any income distributions, but is authorized, in his discretion, to distribute as much from both principal and income as he feels to be appropriate.[41] Such an authorization liberates the trustee's investment policy. Rather than structure the portfolio for the immediate production of income, he may choose those securities which promise the best return in terms of a combination of cash yield and market appreciation. Ultimately this is the most favorable course for the income beneficiaries as well as for the remaindermen, because the absolute cash income, even without exercise of the power to invade, will tend to increase as the securities grow in market value. But the most important aspect of a power to invade is that it provides a complete remedy for any undervaluation of the income beneficiary's share. Unlike the six per cent rule, the remedy is not dependent for its effectiveness upon the vagaries of corporate financial decisions. The power to invade eliminates the danger that, in any given trust year, there may be too few or too many small stock distributions to provide a fair return for the income beneficiary. However, the six per cent rule may create some pitfalls for the draftsman who seeks to use the power to invade to accomplish this more complete solution. That is, not only is the six per cent rule a less effective remedy, but it may also make employment of the better solution hazardous. The statutory characterization of small stock distributions as income, coupled with powers to accumulate income or to allocate stock dividends, or coupled with a direction that stock dividends be al-

39. See Aronstein, *Common Stocks in Trust*, 113 U. PA. L. REV. 228, 244 (1964); *A Good Investment Year*, 104 TRUSTS & ESTATES 29 (1965).

40. See note 26 *supra*; Barclay, *supra* note 32, at 484.

41. See generally 2 SCOTT, TRUSTS §§ 187.2, .3 (2d ed. 1956).

located to principal,[42] can create interpretative problems where legal consequences depend upon whether the settlor has allocated "all of the income" to the income beneficiary. For example, valid use of the federal estate tax marital deduction may require that the surviving spouse be entitled, for life, to "all the income" from certain of the decedent's property.[43] Of greater interest in New York is the possibility that the surviving spouse's limited right of election will not be effectively foreclosed by a trust which allows the reallocation of small stock distributions. It has been held that the full income of the trust must, on the face of the will, be given to the surviving spouse in order to pre-empt an election.[44] Certainly these hurdles are not insurmountable, but they do suggest that the six per cent rule can have unexpected side effects which are most troublesome for the more careful draftsmen.

Nevertheless, it must be conceded that the six per cent rule is not without practical merit. If the settlor has not given the trustee adequate powers for the diversification of investment and the discretionary distribution of corpus, the six per cent rule may well provide an important measure of relief for the income beneficiary. It is, of course, in these cases, where careful planning is absent, that the statutory rules of allocation are most important. Of course, if the legislature concludes that trust law should facilitate the legitimate and careful planning of experienced draftsmen rather than catering to and relieving the inadvertent and inexpert, the primary emphasis of the six per cent rule, directed as it is at alleviating the consequences of inadequate planning, is fundamentally suspect.

IV. Nonsubjective Considerations

A number of other grounds for rejection of the six per cent rule have been suggested. First, through the receipt of stock dividends the income beneficiary is able to acquire part of the basis of the trust assets and thus, upon sale, to reduce his tax burden at the expense of the

42. It might be suggested that a power of invasion can be effective without these concomitant powers of accumulation, and thus without contravening the 6% rule. However, it is often thought desirable that the trustee be able to redirect stock dividends to facilitate administration. Certainly, the textual discussion is less appropriate when administrative facility is not felt to necessitate such powers.

It might also be suggested that the trustee be given the power to allocate, in the first instance, between principal and income. In such cases, when receipts are classified as principal from the outset rather than being income originally and then redirected through the trustee's administrative power of appointment, it is less likely that problems concerning the marital deduction and the New York right of election stemming from the phrase "all the income" will be encountered. *But see* Blish, *Discretionary Allocation Provisions*, 45 Trust Bull. 35 (1965).

43. Int. Rev. Code of 1954, § 2056(b)(5). *But see* Treas. Reg. § 20.2056(b)-5(f)(3), (4) (1954).

44. See In the Matter of Kunc, 43 Misc. 2d 387, 251 N.Y.S.2d 112 (Surr. Ct. 1964). *But see* In the Matter of Baileson, 16 N.Y.2d 757, 262 N.Y.S.2d 487, 209 N.E.2d 810 (1965); In the Matter of Edwards, 2 Misc. 2d 564, 152 N.Y.S.2d 7 (Surr. Ct. 1956).

remaindermen.[45] Although it is arguable that such a windfall to the income beneficiary is consonant with the purposes of the six per cent rule, since that rule augments the depressed return which the income beneficiary may be receiving, it is more in keeping with the presumed intention of the settlor and the assumptions inherent in the Internal Revenue Code's conduit theory of taxation of trust income[46] to expect that the remainderman will have the full benefit of the basis. If small stock distributions are to be treated as income for trust purposes because it is assumed that the settlor would desire some supplement to income when stock is held, they should also be treated as income for tax purposes. It may be suggested, in response, that this is a flaw in the tax law, rather than in the six per cent rule, and that the criticism is therefore misdirected. This argument, however, raises a second problem. It is conceivable that remedial activity in the tax laws could extend beyond a mere provision preserving basis for the principal account and precipitate a reevaluation of *Eisner v. Macomber*,[47] the foundation of the present nontaxable status of stock dividends.[48] The reasoning of *Macomber* is sound when applied to the individual shareholder-taxpayer, since the nature and extent of his interest in the corporation are not changed by the dividend, but are simply represented by a greater number of shares. Accumulated earnings are not paid out and thus are not realized. However, when the shareholder is a trust, and local law commands that six per cent stock dividends be distributed as income, there is clearly a realization from the income beneficiary's standpoint. Such a stock dividend may possess sufficient independent significance to be considered an appropriate taxable event. Indeed, Mr. Justice Brandeis, who, along with Mr. Justice Holmes, dissented in *Macomber*, made specific reference to the Pennsylvania rule of apportionment to support his contention that stock dividends may be considered income.[49] However, a reexamination of *Macomber* is certainly unlikely at this late date. Although apparently near rejection following *Helvering v. Griffiths*,[50] the *Macomber* doctrine was reaffirmed and given specific legislative approval with the enactment of section 305(a) of the 1954 Internal Revenue Code, and could probably weather any storm created by investigation into the present provisions concerning allocation of basis.

Difficulty in administration has been suggested, apparently by analogy to the discredited Pennsylvania rule of apportionment, as a

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45. See INT. REV. CODE OF 1954, § 307(a).
46. See Subchapter J.
47. 252 U.S. 189 (1920). See Dunham, *supra* note 18, at 895.
48. INT. REV. CODE OF 1954, § 305.
49. Eisner v. Macomber, 252 U.S. 189, 233-37 (1920). See Lowndes, *The Taxation of Stock Dividends and Stock Rights*, 96 U. PA. L. REV. 147 (1947).
50. 318 U.S. 371 (1943).

third collateral criticism of the six per cent rule.[51] An immediate reallocation of basis will be required following all distributions of six per cent or less. In addition, the volume of small distributions which will have to be processed may increase as corporations returning low yields seek to make their stock more attractive for trust investment. On the other hand, under the six per cent rule as it is now worded, a trustee need only determine the distribution ratio to know whether to allocate entirely to income or entirely to principal. The former problems of differentiating stock splits and stock dividends, of distinguishing ordinary and extraordinary distributions, of computing "intact value," and of determining the source of the assets capitalized are all eliminated. Therefore, although experience with the six per cent rule may ultimately dictate a different conclusion, it would appear that the administrative problems are not burdensome.

Finally, it has been suggested that in the interests of uniformity the Massachusetts rule embodied in the Uniform Act is preferable to the six per cent rule.[52] Although there is some merit in this suggestion, uniformity is not as pressing here as in other areas of the law, and a possibly inferior provision should clearly not be accepted simply to promote uniformity.

These collateral criticisms of the six per cent rule thus appear to be little more than makeweights. None is of sufficient substance by itself to support acceptance or rejection of either the six per cent rule or the Massachusetts rule. However, since legislative opinion on this matter must rest upon a balance of individually insignificant factors, the criticisms are worth considering.

V. Conclusion

The Pennsylvania rule of apportionment can be considered a rule of fairness only upon the assumption that the term "income," as used in the trust instrument, is to be fully equated with current corporate earnings. Such an equation is at best tenuous; "income" expresses the settlor's intention, which in all likelihood embodies an expectation that some earnings will be retained. Even if "income" is construed to be a term of art, any definition formulated with a clear understanding of the nature of corporate ownership would allocate stock dividends to principal. Thus the six per cent rule must rely upon the undervaluation of the income beneficiary's share caused by the growing trust investment in low-yield stock to maintain its case of unfairness against the Massachusetts rule. Yet there is a more satisfac-

51. See Dunham, *supra* note 18, at 895.

52. See Niles, *supra* note 28. The author also suggests that, because of precedent and reliance by draftsmen, the Massachusetts rule should be retained in New York. It does not seem likely, however, that a settlor wishing to have the Massachusetts rule applied would do so by silent reliance, rather than simply directing that all stock distributions be allocated to principal.

tory method of dealing with this undervaluation. Responsible drafting and careful investment can provide adequately for the income beneficiary. Power in the trustee to accumulate and invade can provide a flexible means—a means far more complete and workable than the six per cent rule—of balancing the successive interests in a trust. Although the six per cent rule may alleviate harshness in restrictively drawn trusts, the possible pitfalls which it poses for careful draftsmen, under federal income and estate tax law as well as local decedent estate law, coupled with the danger of its causing increased administrative burdens for the trustee, would appear to outweigh its beneficial effects.

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