Case Western Reserve Law Review

Volume 2 | Issue 2

1950

Income from Testate Estates and Express Private Trusts

Harry L. Deibel

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IN ADMINISTRATION of decedent's testate estates and in administration of express private trusts where the testator or settlor has not clearly outlined his purposes, recurs the twofold query, always practical, sometimes puzzling and often confusing:

WHAT IS TO BE REGARDED AS INCOME, AND WHO IS ENTITLED TO IT?

It is here proposed to comment briefly on some applicable rules without too much indulging in legal theory.

HARRY L. DEIBEL (A.B., 1911, Denison University; LL.B., 1914, Western Reserve University) is a practicing attorney in Cleveland and Professor of Trusts at Cleveland-Marshall Law School. He is the author of DEIBEL'S OHIO PROBATE CODE (1948), and has annotated the RESTATEMENT OF TRUSTS for Ohio.

1. *What of income accruing from a decedent's estate during executorial Administration?*

Davidson v. The Miners and Mechanics Savings and Trust Co.[1] offers a suitable point of departure. There the decedent bequeathed his entire net estate to the trust company in perpetual trust, directing one half of all the income derived from the net estate to be paid to a named brother for and during his life, and after his decease such income to the Westminster Presbyterian Church in perpetuity; and the other half of the income from the net estate to a lady friend of the testator-settlor, whom he designated by name for and during her life, and after her death such income to The Ohio Valley Hospital in perpetuity. After execution of the will the testator-settlor and the same lady friend were married, and he died leaving her surviving him as his widow, without, however, revoking the will or executing a new will or a codicil. The deceased left no lineal descendants.

The widow elected to renounce the will. She did so because by such election she took one half of the net estate outright under the existing Ohio election statute.[2] And she was entitled to maximum exemptions of $2,500[3] and was awarded a year's support of $3,600.

Needless to say, exemptions and a year's support are to be and were

[1] 129 Ohio St. 418, 195 N.E. 845 (1935).

[2] OHIO GEN. CODE §§ 10504-55, 10503-4.

[3] OHIO GEN. CODE § 10509-54.

there treated as debts of the estate. After the election the trust provisions of the will continued to operate on the remaining half of the net estate; hence one half of the income from the trust estate (the trust estate being now one half of the net estate) went to the brother for life, then to the church, the other half of the income from the trust estate accelerating to the hospital.

It is to be noted parenthetically that the half of the net estate acquired by the widow on her election was free from all powers of sale and other restraints created by the will; she took exactly as if her husband had died intestate, except that the present Ohio election statute limited her election avails to one half of the net estate.[4]

On the widow's election by which she rejected one half of the income from the entire net estate for and during her life and took one half of the net estate outright, the right of the hospital to one half of the income derived from the trust estate accelerated to the hospital. On such election the equitable doctrine of *acceleration* applied in the absence of a contrary intent expressed in the will.[5]

Since the widow by her election became absolute owner of one half of the net estate outright, she was necessarily entitled to the income from that half.

By the weight of authority and by logical considerations the statutory election of the spouse relates back to the time of the testator's death.[6] In necessary consequence she was entitled to the income derived from such half, from and after the date of the testator's death.

The query then arose: Are the trust income beneficiaries also entitled to income from the time of the testator's death?

The rule which the court followed in the *Davidson* case is well settled, namely, that income beneficiaries of a testamentary trust are entitled to the income arising from the trust property, from the date of the death of the testator-settlor.[7] That is, from the inception of the trust.

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[4] Barlow v. Winters Nat. Bank & Trust Co., 145 Ohio St. 270, 61 N.E. 2d 603 (1945); OHIO GEN. CODE § 10504-55.

[5] Stevens v. Stevens, 121 Ohio St. 490, 169 N.E. 570 (1929); Holdren v. Holdren, 78 Ohio St. 276, 85 N.E. 537 (1908). In the *Stevens* case the remainders were held contingent on the named remaindermen surviving the first taker. Even when remainders are contingent on survivorship, some authorities, regarding the election as equivalent to actual death, accelerate the remainders, unless, of course, the will in express terms withholds vesting until the actual physical death of the prior taker: so to defer vesting would, it is submitted, usually run counter to the primary testamentary intent. Nelson v. Meade, 129 Me. 61, 149 Atl. 626 (1930); Safe Deposit & Trust Co. v. Gunther, 142 Md. 644, 121 Atl. 479 (1923); Schulz's Estate, 113 Mich. 592, 71 N.W. 1079 (1897); American Nat. Bank v. Chapin, 130 Va. 1, 107 S.E. 636 (1921).

[6] Watrous v. Watrous, 180 Iowa 884, 163 N.W. 439 (1917); Fitzgibbon's Estate, 276 Pa. 105, 119 Atl. 837 (1923); 2 PAGE, WILLS § 671 (3rd ed. 1941); 4 *Id.* § 1383.

All such income received during the executorial administration, which was derived from *trust property,* goes to the income beneficiaries of the trust. Income remains income and is not incorporated with principal. The income definitely cannot be added to the principal of the estate by the executor and then be paid out by him along with the principal to creditors or to legatees.[8]

Moreover, the great weight of authority is that this rule means *actual* income. If there was no actual income, the income beneficiary receives none; if it is abnormally large, he nevertheless receives all of it.[9]

By a minority rule, it may be observed, such trust income beneficiary does not normally take the actual income from the trust estate but receives what is known as equitable income, arrived at on the theory of constructive conversion of the trust estate.[10]

Equitable income for any year is determined by adding the *actual* income, if there was any, to the principal, and dividing the resulting sum by the figure representing 100 plus the current normal rate of trust income; the quotient will be regarded as principal, and the difference between the sum and the quotient is income. Thus, if the principal of the trust property be $50,000, the administration of the estate continues one year, the actual income received by the executor from the trust property during the year is $750, and the current trust income rate, let us say is 4 per cent, then the sum of $50,750 is divided by 104, the quotient is $48,798.08, and the *equitable* income $1,951.92, in contrast to $750, the *actual* income.

It does not appear that this minority rule of equitable income has been given wide application in such cases.

The majority rule of *actual* income quite obviously would apply whenever the trust consists of specific legacies, as, for example, my A. T. and T. stock; but it also applies in the cases where the trust property consists of a general legacy, as, the sum of $50,000, or residuary legacies, as one third of the residue.[11]

That is, in trust cases the *actual* income derived by the executor *from the trust property,* whatever it may be, during the period of administration is allocated to the income beneficiary; yet it is well recognized that a *general* legatee is not entitled to interest or other income on his general legacy for the period of administration, unless the period of administration

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[7] Davidson v. Miners and Mechanics Savings & Trust Co., 129 Ohio St. 418, 195 N.E. 845 (1935); Hegner v. Hegner, 9 Ohio App. 147 (1917); Central Nat. Bank v. Coyle, 40 Ohio L. Abs. 441 (Probate 1943); 4 BOGERT, TRUSTS (part 1) § 811 (1948); 2 SCOTT, TRUSTS § 234.3 (1939); RESTATEMENT, TRUSTS § 234 (1935).

[8] See note 7 *supra.*

[9] See note 7 *supra.*

[10] Equitable Trust Co. v. Kent, 11 Del. Ch. 334, 101 Atl. 875 (Ch. 1917).

[11] RESTATEMENT, TRUSTS § 234, comments *b, c, f* (1935).

exceeds one year; when the administration is not completed within one year from the testator's death, the legal rate of interest is allowed on a general legacy after one year, if the executor cannot show good cause for delay.[12]

The question then is, Who is entitled to the income on the property of the estate which has to be used to pay debts, state succession taxes, federal estate taxes, costs, expenses and legacies, which, but for such paying out, would be trust property? This income may be considerable. There may be delay due to litigation or otherwise, before such payment can be made, and income accumulates.

The rule is that such income does not go to the trust income beneficiaries, because the property from which it is derived is paid out and is not itself trust property. The income so received by the executor from such property before he so pays out the principal, he is duty-bound to allocate as follows: (1) Pay interest, if any, on debts and legacies; and (2) Incorporate the balance into the principal of the trust assets.[13] Here is a situation where income is in law actually converted into principal.

Referring again to the *Davidson* case,[14] it will be noted that the court, without assigning reasons, first awarded one half of the income received by the executor to the widow (necessarily so, since by her election she became owner of one half of the net estate); the other half of the estate income (trust income) was again halved: (1) One half of the trust income was apportioned to the brother up to the time of the election, and after the election to the hospital; (2) The other half necessarily went to the brother (the election did not affect him). The court appears in error in postponing the hospital's income. Its rights were to accrue in possession and use on the lady friend's death. Since the election surely relates back to the testator's death, the hospital was entitled by acceleration to one half of the trust income from the testator's death, and not so much importance attaches to the date of election as was given it. The court should in later case correct the error. With this one exception the majority opinion in the *Davidson* case is commendable.

2. *Who takes trust income in excess of income annuities?*

The settlor's mind is focused on the immediate beneficiaries and he often forgets, and the scrivener likewise not infrequently fails to realize, that the trust may produce income in excess of specified annuities directed to be

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[12] Gray v. Case School of Applied Science, 62 Ohio St. 1, 56 N.E. 484 (1900); 34 C.J.S., *Executors and Administrators* § 508 (1942).

[13] 4 BOGERT, TRUSTS (part 1) § 811, p. 2344, n. 3 (1946); 2 SCOTT, TRUSTS § 234.4 (1939); RESTATEMENT, TRUSTS § 811, p. 2344, n. 3 (1946); 2 SCOTT, TRUSTS § 234.4 (1939); RESTATEMENT, TRUSTS § 234, comment *g* (1935).

[14] 129 Ohio St. 418, 195 N.E. 845 (1935).

paid out of income, and no disposition is made of such excess or surplus income. What is to be done with it?

Assume the following fact frame—

The trust estate consists of stocks and real property; the trust instrument, a will, directs the trustee to pay to the widow out of income an annuity of $5,000, to each of three daughters out of income $3,000, and to each of two sons out of income $2,000; the ultimate remainder of the estate is over to grandchildren. The annuities aggregate $18,000. The annual income fluctuates, but averages $25,000. The average surplus is $7,000. Is the surplus to be allocated to the remainder or principal, or may it be apportioned among the annuitants on a pro rata basis as additional income, or is it intestate? Assume further that the will has no residuary clause which embraces such excess income.

The better rule is that such excess income is *intestate* and will fall, until the trust terminates, to those inheriting under the statutes of descent and distribution.[15]

Since the excess income is intestate, the widow will in such case take an intestate share—in Ohio one third under the present election statutes.[16]

The lineal descendants take the balance. If no lineal descendants, the widow takes one half.

It appears, too, that the surplus income is payable annually.[17]

And such surplus income is assignable, descendable and devisable.[18] When the trust ends, the surplus is necessarily extinguished too.

Where, however, the annuity is one expressly for support, it has been held that the beneficiary is entitled to the surplus income.[19]

3. *When is Income not Income?*

As shown above, income received by the executor from such part of the principal estate as is consumed in paying debts, et cetera, is not income to the trust income beneficiary, but is allocated to the principal of the trust estate.[20] It is not income to the income beneficiary, but falls to the remainderman.

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[15] New Haven Bank v. Hubinger, 117 Conn. 417, 167 Atl. 914 (1933); Abbott v. Williams, 268 Mass. 275, 167 N.E. 357 (1929); Phelps v. Pond, 23 N. Y. 69 (1861); Shapiro's Estate, 134 Misc. 363, 236 N. Y. Supp. 280 (Surr. Ct. 1929); *aff'd mem.*, 229 App. Div. 867, 243 N.Y. Supp. 813 (1st Dept. 1934); Kenworthy's Estate, 230 Pa. 606, 79 Atl. 803 (1911).

[16] OHIO GEN. CODE § 10504-61.

[17] See note 14 *supra.*

[18] *Ibid.*

[19] Adrian v. Koch, 83 N.J.Eq. 484, 91 Atl. 123 (Ch.), *aff'd mem.*, 84 N.J.Eq 195, 93 Atl. 1083 (Ct. Err. & App. 1914); 4 BOGERT, TRUSTS (part 1) § 811 p. 2349 (1948).

[20] See note 12 *supra.*

Where the trust income beneficiary is a life beneficiary, and he dies between periodical payments, or a trust is then otherwise terminated, the question arises, How is trust income to be apportioned at the time of his death or other termination of the trust? The familiar question is, Is the Income apportioned?

As a general rule, all trust income is apportioned or prorated; at the beneficiary's death, or such other termination, the amount earned up to that time is payable to his estate; three exceptions to the rule are recognized: rents on land, annuities, and dividends on corporate stock, he taking who owns at accrual or vesting in each instance.

The same principles apply at the inception of the trust.

Interest on loans, and other similar claims, are apportioned as to time, being regarded as accruing from day to day.

It has been held that interest on bank deposits is not to be apportioned.[21] But where the bank has agreed to pay interest, and deposits as a matter of law are held, as they generally are, to be loans to the bank,[22] it must be obivious that interest on deposits should be apportionable.

However, as to rents on land, the quite uniform rule in England and this country is that rents are not apportionable as to time. He receives the rent who owns the reversion at the moment the rent is payable.[23]

And this country also follows the English rule that annuities will not be apportioned as to time.[24]

As to dividends on corporate stocks considerable confusion prevails.

It appears clear, however, that the general formula is that referred to as the "Massachusetts Rule." By this formula all *cash* dividends, whether ordinary or extraordinary, are income, unless, indeed, they have been declared out of capital.[25]

But *stock dividends* are held to be principal or capital, not income, without regard to the time when the earnings were made against which they were issued or the time when declared or issued.[26]

Moreover, cash dividends are payable when declared, even when ex-

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[21] Greene v. Huntington, 73 Conn. 106, 46 Atl. 883 (1900).

[22] Bank v. Brewing Co., 50 Ohio St. 151, 33 N.E. 1054 (1893).

[23] Dexter v. Phillips, 121 Mass. 178 (1876); *In re* Rosenstein, 152 Misc. 777, 274 N.Y. Supp. 126 (Surr. Ct. 1934). In Barbour v. Gallagher, 2 Ohio App. 205 (1913), the court recognized the rule but derived a contrary intent from the will.

[24] Kearney v. Cruikshank, 117 N.Y. 95, 22 N.E. 580 (1889); Barbour v. Gallagher, 2 Ohio App. 205 (1913).

[25] 2 SCOTT, TRUSTS § 236.5 (1939).

[26] Gibbons v. Mahon, 136 U.S. 549, 10 Sup. Ct. 1057 (1890); Minot v. Paine, 99 Mass. 101 (1868); Hayes v. St. Louis Union Trust Co., 317 Mo. 1028, 298 S.W. 91 (1927); Lamb v. Lehman, 110 Ohio St. 59, 143 N.E. 276 (1924); 2 SCOTT, TRUSTS §§ 236.3, 236.4 (1939).

pressly made payable at a future date. However, the prevailing practice of large corporations is to declare a cash dividend made payable at a future designated time to the shareholders of record on a specified intermediate date. In such cases it is the *date of record* which is the time of vesting, the right to the dividend then accruing, and not on the date of declaration or specified date of payment. A good case on the subject is *Estate of Wuichet.*[27] Judge Williams well outlines the applicable rules.

Thus, if the corporation declares a *cash* dividend on January 10, payable on March 10, to the shareholders of record on February 10, and the income-beneficiary of the stock dies on February 9, his estate is not entitled to any part of the cash dividend; he was not living on vesting. But if he dies on February 11, or any other time after the record date before time of payment, his estate is entitled to the entire dividend. The beneficiary's estate gets it if he was living at the record date; if he died before, no; if afterwards during the trust period, yes.

However, the foregoing rules are by no means universally followed.[28]

By the so-called "Pennsylvania Rule" the time during which the dividend was earned, and keeping the intrinsic value of the stock intact as it was at the inception of the trust, are the crucial considerations. No difference is made between cash and stock dividends. If the dividend was earned before the trust began, it is principal; if after, during the trust period, it is income.[29] The Restatement of the Law of Trusts has approved this rule.[30] The rule is logical, but comparatively difficult of application. And in the interest of simplicity the pronounced tendency among the jurisdictions is to receive the Massachusetts rule with favor.

Another, known as the "Kentucky Rule," is followed in a a few states.[31] By this rule merely the time of declaration of the dividend, without regard to the time when earned, or whether cash or stock, or ordinary or extraordinary, is the criterion. The owner at the time of declaration is entitled to the dividend. This is simplicity itself.

Ohio courts have not decided all phases of the Massachusetts rule but are committed to the doctrine that stock dividends are normally principal. It appears desirable that this rule should be followed in all its bearings and aspects.

Endless arguments over the respective merits of these rules fill the books, and no useful purpose appears likely to be served by prolonging

[27] 138 Ohio St. 97, 32 N.E. 2d 15 (1941).

[28] 18 C.J.S., *Corporations* § 470, p. 1120 (1939).

[29] Earp's Appeal, 28 Pa. 368 (1857); 2 SCOTT, TRUSTS § 236.3. (1939).

[30] RESTATEMENT, TRUSTS § 236 (Supp. 1948).

[31] Hite v. Hite, 93 Ky. 257, 20 S.W. 778 (1892); Oritz v. Fidelity-Philadelphia Trust Co., 18 Del. Ch. 439, 159 Atl. 376 (Ch. 1931).

this comment here. It is enough to say that holding all cash dividends to be income and all stock dividends principal does have the virtue of relative simplicity without too much outraging of a sense of fairness and justice.

4. *When is Income Chargeable with Expenses?*

Take this set of facts: At the inception of the trust the trust property is encumbered by mortgage; the testator-settlor dies March 1; interest on the mortagage is payable on January 1 and on July 1 each year; the trustee pays the interest for six months on July 1, which interest represents four months of the trust period, that is, the trust covers two thirds of the interest period. Hence, two thirds of the interest is held to be chargeable against income, and one third against principal.[32]

Current expenses in administration of a trust are to be allocated to income. Such expenses include trustees' compensation, recurring annual taxes, water rents, fire insurance premiums, premiums for trustees' bonds, ordinary repairs.[33]

To the extent, however, that compensation of the trustees is properly attributable to benefit of the principal, the compensation is chargeable to principal, but only to that extent.[34]

Expenses, including counsel fees, incurred in good faith in defending the validity of the trust, or in defending the trust property, are chargeable to principal, whether the trustee defends successfully or not.[35] Expense of recovery of income, for example rent, is chargeable to income.[36]

The cost of capital improvements on real property is allocated according to benefits inuring to income beneficiary and remainderman, respectively.[37]

Depreciation in value and obsolescence of improvements on *real property* are held not chargeable to income; and the trustee is not only not under a duty to set aside a reserve for these purposes, but also is held to incur a liability for doing so.[38]

On the other hand, where the depreciation results from consumption of the trust property itself, or where the trust property is perishable, the remainder is required to be kept intact by amortizing enough of the income derived from the so-called "wasting asset" to do so.

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[32] RESTATEMENT, TRUSTS § 237, comment *b* (1935).

[33] Butler v. Builders Trust Co., 203 Minn. 555, 282 N.W. 462 (1938); RESTATEMENT, TRUSTS § 233, comment *e* (1935).

[34] RESTATEMENT, TRUSTS § 233, comment *b* (1935).

[35] LORING, A TRUSTEE'S HANDBOOK § 69 (5th ed. 1940).

[36] RESTATEMENT, TRUSTS § 233, comment *g* (1935).

[37] Estate of Matthews, 210 Wis. 109, 245 N.W. 122 (1932); 4 BOGERT, TRUSTS (part 1) § 842 (1948); 2 SCOTT, TRUSTS § 239.4 (1939), and cases cited.

[38] *Ibid.*

Good examples of "wasting assets" because of consumption of the property itself are patents and coal mines. During its limited life a patent, for example, may produce a substantial income. On its termination it has no value. If it be the subject of a trust where income falls to immediate beneficiaries and a remainder goes over to others it is only fair that the remaindermen receive consideration.

Thus, assume the patent has a value of $25,000 at the inception of the trust and has fifteen years to run; the patentee's widow is life beneficiary and has an expectancy of twelve years; and the income is $2,000 per year. As time goes on the initial value of the patent itself gradually diminishes; in fifteen years it is zero.

Obviously just treatment of the remaindermen requires that they receive something of value.

In such cases the depreciation is amortized out of income. If the normal trust return be 4 per cent, that is all the income beneficiary is justly entitled to; the balance of the actual income is allocated to remainder. In the above illustration the normal income at 4 per cent would be $1,000; the actual income, however, is $2,000.00. One half of the latter should, in general, be reserved for the remaindermen.[39]

Thus the formula for each year would be the following: Add the value of the asset to the actual income derived from it, and divide the result by 100 plus the usual and normal trust income rate. The quotient is regarded as principal. The difference between the result of addition and the quotient is the amount to which the income beneficiary is entitled. The balance of the actual income is reserved for the remaindermen. In the foregoing example the quotient on the basis of 4 per cent is $25,960; the income would be $1,040 and $960 would be reserved.[40]

A like formula is applied in delayed income cases, as where the trust assets are unproductive for a time and are then sold and proceeds reinvested.

Of course a "wasting asset" may be sold by the trustee and a new investment made. But the trustee may apply the foregoing formula. This formula is labeled *constructive conversion.* It is akin to *equitable income* mentioned earlier. The formula has been applied to a variety of cases.[41]

Profits made on sale of assets are principal and not income; unless, of course, the trustee is running a business for profit, as for instance, a retail hardware store.[42]

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[39] RESTATEMENT, TRUSTS §§ 239, 241 (1935).

[40] RESTATEMENT, TRUSTS § 241 (1935).

[41] Gay v. Focke, 291 Fed. 721 (9th Cir. 1923) (leaseholds); *In re* Elsner's Will, 210 App. Div. 575, 206 N.Y. Supp. 765 (4th Dept. 1924) (royalties); Housman's Estate, 4 Dem. Surr. 404 (N.Y. 1886) (furniture); Industrial Trust Co. v. Parks, 57 R.I. 363, 190 Atl. 32 (1937) (commissions); RESTATEMENT, TRUSTS § 239 (1935) (machinery).

Where securities are bought by the trustee below par, redeemable at par, the discount is principal and not income. And where such securities are purchased by the trustee at a premium, the par value is required to be restored by amortization out of income.[43]

On the other hand, where the trustee took over the securities from the settlor, whether they are quoted below or above par, no amortization is held required.[44]

Discount bonds issued by the U. S. Government pay no interest but gradually increase in value to maturity. Meanwhile they are unproductive. By the foregoing rules the discount would appear to be principal and not income. But at least one decision takes a contrary view, holding that the increment on such bonds is income.[45]

The logic of the latter view appears unimpeachable. For the increase in value is not an increase in the intrinsic value of the basic asset, but derives from income increment. Therefore it possesses the attribute of income.

The reasoning supporting the rule that the increase in value of a security which was purchased at a discount is to be regarded as principal, is said not to apply. Such reasoning appears twofold: (1) The interest rate does not necessarily determine the discounted value; factors of credit may contribute. (2) There is no certainty of redemption at par.

These reasons are plausibly asserted not to apply to discount bonds because, first, they are issued by the government, whose credit is unquestioned, and the only factor fixing value is the interest rate; and, second, the bonds will be redeemed at the value nominated in the bond.[46]

Of course, all the foregoing rules yield to the intention of the testator or settlor and serve as chart and compass only when he has failed to provide them. In all cases his express purpose is paramount.

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[42] 2 SCOTT, TRUSTS § 233.1 (1939).

[43] Old Colony Trust Co. v. Comstock, 290 Mass. 377, 195 N.E. 389 (1935); *In re* Brewster's Estate, 163 Misc. 820, 298 N.Y. Supp. 761 (Surr. Ct. 1937); RESTATEMENT, TRUSTS §§ 239, 240 (1935).

[44] Boston Safe Deposit & Trust Co. v. Williams, 290 Mass. 385, 195 N.E. 393 (1935).

[45] *In re* Wehner's Will, 238 Wis. 557, 300 N.W. 241 (1941).

[46] 40 MICH. L. REV. 1113 (1942).