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THE ILLINOIS PRINCIPAL AND INCOME ACT OF 1941

GEORGE G. BOGERT*

IN 1931 The National Conference of Commissioners on Uniform State Laws promulgated the Uniform Principal and Income Act and the American Bar Association approved it. The history of the preparation of the proposed statute may be found in the annual handbooks of the Conference from 1925 to 1931,¹ during which time a committee was considering the topic and several drafts prepared by Charles E. Clark, then Dean of the Yale Law School,² were being considered. These discussions and notes by committee and draftsman are of more than historical interest. They show its purpose and theory and may be used in construing the act, either in its original or modified form, wherever, as in Illinois, the members of the legislature knew the source of the statute when they adopted it.

During its preparation the act was subjected to criticism by corporate trustees and their counsel, and later was approved by the American Bankers' Association, Trust Division, in 1939.

The Uniform Act has now been adopted either intact or with some changes in eleven states, namely, Alabama (1939),³ Connecticut (1939),⁴ Florida (1937),⁵ Illinois (1941),⁶ Louisiana (1938),⁷ Maryland (1939),⁸

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¹ (1925), at 159-60; (1926), at 720-22; (1927), at 649; (1928), at 97, 99, 206; (1929), at 110, 112, 285; (1930), at 95, 96, 341; (1931), at 99, 115, 120, 325.

² Now Judge of the United States Circuit Court of Appeals, Second Circuit.

³ Alabama Code (1940) tit. 58, §§ 75-87.

⁴ Conn. Gen. Stat. (Supp. 1939) §§ 1292e-1301e. Connecticut omits parts of Section 12 and all of Sections 4, 11, 13-17.

⁵ Fla. Comp. Gen. Laws Ann. (Skillman, Supp. 1940) §§ 5671(2)-5671(20).

⁶ Ill. Rev. Stat. (1941) c. 30, §§ 159-76.

⁷ La. Gen. Stat. Ann. (Dart, 1939) §§ 9850.69-9850.78.

⁸ Md. Ann. Code (Flack, 1939) art. 75B, §§ 1-10. Maryland omits Sections 7-11 and Sections 12(4) and 13(2).

North Carolina (1937),⁹ Oklahoma (1941),¹⁰ Oregon (1931),¹¹ Utah (1939),¹² and Virginia (1936).¹³

Recently in several states local organizations of corporate trustees have subjected the Uniform Act to study and have modified it to some extent and either procured its passage, as in Louisiana and Oklahoma, or have prepared for presentation to their several legislatures drafts which have not yet been enacted into law, as in California¹⁴ and Minnesota.¹⁵ Other states have not yet adopted the Uniform Act or used it as a model, but have adopted piecemeal laws covering portions of the field.¹⁶

The Uniform Principal and Income Act was introduced in the 1939 session of the Illinois Legislature at the instance of the local Commission on Uniform Laws, but was withdrawn due to opposition by organizations of corporate trustees in Illinois who urged that they be given time to study the act, confer with the local Commissioners on Uniform Laws, and decide whether they could back the statute in its original or a modified form. During the autumn of 1940 and the winter and spring of 1941 conferences were held between the Illinois Commission on Uniform Laws and representatives of the Trust Division of the Illinois Bankers' Association and the Chicago Fiduciaries Association, and a modified form of the Uniform Principal and Income Act was agreed upon for introduction in the 1941 General Assembly. Representative Franklin U. Stransky of Savannah introduced the bill in the house. It was passed by the legislature and signed by Governor Green on July 17, 1941.¹⁷

The Illinois act applies only to estates and trusts created after the effective date of the act. If the estate or trust is created by deed *inter vivos*, it

⁹ N.C. Code Ann. (Michie, 1939) §§ 4035(1)-4035(15).

¹⁰ Okla. L. 1941, 505 et seq.

¹¹ Ore. Comp. Laws Ann. (1940) §§ 74-101-74-114.

¹² Utah L. 1939, c. 127.

¹³ Va. Code Ann. (Michie, 1936) §§ 5133c-5133r. Virginia provides that the act shall "apply to all estates heretofore or hereafter created."

¹⁴ Since this article was prepared, the writer has learned that this draft was enacted into law as c. 898 of the Laws of 1941, effective July 28, 1941. For the reasons for its adoption, see Nossaman, *The Uniform Principal and Income Act*, 28 Calif. L. Rev. 34 (1939).

¹⁵ The Minnesota draft has been printed. A copy might be obtained from Wm. J. Stevenson, Esq., 111 S. Fifth St., Minneapolis, Minn.

¹⁶ For example: N.Y. Pers. Prop. Law (McKinney, 1938) § 17-B (income earned during period of administration); N.Y. Pers. Prop. Law (McKinney, Supp. 1941) § 17-C (salvaging of mortgages); N.Y. Decedent Estate Law (McKinney, 1939) § 150 (increase in value of savings bonds; depreciation funds for obsolescence or amortization); Va. L. 1940, c. 233 (United States savings bonds).

¹⁷ Ill. Rev. Stat. (1941) c. 30, §§ 159-176.

is not affected by the 1941 act unless the deed went into effect on or after July 17, 1941; and if the estate or trust is created by will, the Illinois act does not apply unless the testator died on or after July 17, 1941. Life estates, remainders, and trusts created before July 17, 1941, are governed by the pre-existing case and statute law, but such estates and trusts created on or after July 17, 1941, must be created and administered with this new statute in mind.

The object of this article is to assist lawyers, judges, and corporate or individual trustees who may be considering this statute in connection with the creation, administration, or construction of legal or equitable interests in realty or personalty. The method pursued will be to quote the 1941 Illinois act, section by section, and add to each section relevant comment and illustration. The difficulty of the subject seems to warrant numerous examples of the operation of the act, although to some experts a portion of the illustrations may appear elementary. In the short space which can be allotted to this paper it is impossible to give an exhaustive treatment¹⁸ of the points raised by the act. One can do no more than state its general effect and give guides to its interpretation.

Section 1. Definition of Terms.

"Principal" as used in this Act means any realty or personalty which has been set aside or limited, by the owner thereof or by a person thereto legally empowered, so that it and any substitutions for it are eventually to be conveyed, delivered or paid to a person, while the return therefrom or use thereof or any part of such return or use is in the meantime to be taken or received by or held for accumulation for the same or another person;

"Income" as used in this Act means the return derived from principal;

"Tenant" as used in this Act means the person to whom income is presently or currently payable, or for whom it is accumulated or who is entitled to the beneficial use of the principal presently and for a time prior to its distribution;

"Remainderman" as used in this Act means the person ultimately entitled to the principal whether named or designated by the terms of the transaction by which the principal was established or determined by operation of law;

"Trustee" as used in this Act includes the original trustee of any trust to which the principal may be subject and also any succeeding or added trustee.

Words importing the singular number include the plural and words importing the plural number include the singular.

This section follows the Uniform Act, except for the addition of the last sentence. "Tenant" is broad enough to include the owner of a legal estate

¹⁸ For a more complete discussion of the subjects covered by the Illinois Principal and Income Act of 1941, consult Bogert, *Trusts and Trustees*, §§ 802-805, 811, 816-32, 843-57 (1935); Scott, *Trusts* §§ 232-41 (1939); Nylund, *The Uniform Acts Relating to Trusts*, 16 *Chicago-Kent L. Rev.* 81, 108-17 (1938).

for years or for life and a trust beneficiary with an interest of similar size, and "remainderman" covers the holders of both the legal and equitable ultimate estates, when the definitions are read in connection with Section 2.

Section 2. Application of the Act—Powers of Settler.

This Act shall govern the ascertainment of income and principal, and the apportionment of receipts and expenses between tenant and remainderman, in all cases where a principal has been established with or, unless otherwise stated hereinafter, without the interposition of a trust; except that in the establishment of the principal provision may be made touching any or all matters covered by this Act, and the person establishing the principal may himself direct the manner of ascertainment of income and principal and the apportionment of receipts and expenses or grant discretion to the trustee or other person to do so, and such provision and direction, where not otherwise contrary to law, shall control notwithstanding this Act.

Section 2 of the Uniform Act is copied. It is important to notice that the act applies where a deed or will creates temporary legal interests followed by remainders, as well as where trusts are established.

Illustration 1.—On August 1, 1941, the owner in fee of a farm dies, devising it to his widow for life, remainder to his son. The act applies to receipts and expenses of the farm during the life of the widow, except where otherwise expressly stated in the act, and unless the testator otherwise provided.

Illustration 2.—On September 1, 1941, the owner of corporate stock transfers it to a trust company to hold in trust for A for ten years, and then to sell and divide the proceeds between B and C, and directs that all stock dividends received on the stock during the ten year period shall be treated as income for A. The act applies to the trust during the ten year period, except that the disposition of stock dividends is controlled by the terms of the trust instrument, instead of by Section 6 of the act.

The Oklahoma Trust Act of 1941 (sec. 26) applies to legal estates, as does the California draft (sec. 2); but the Louisiana Trust Estates Act of 1938 (sec. 68) and the Minnesota proposed Trust Administration Act (sec. 20) do not apply to legal interests.

Section 3. Income and Principal—Disposition.

(1) All receipts of money or other property paid or delivered as rent of realty or hire of personalty, or dividends on corporate or trust shares payable other than in shares of the corporation itself, or dividends representing income from a trust or interest on money loaned, or interest on or the rental or use value of property wrongfully withheld or tortiously damaged, or otherwise in return for the use of principal, shall be deemed income unless otherwise expressly provided in this Act.

(2) All receipts of money or other property paid or delivered as the consideration for the sale or other transfer, not a leasing or letting, of property forming a part of the

principal, or as a repayment of loans, or in liquidation of the assets of a corporation, or a trust, or as the proceeds of property taken on eminent domain proceedings where separate awards to tenant and remainderman are not made, or as proceeds of insurance upon property forming a part of the principal except where such insurance has been issued for the benefit of either tenant or remainderman alone, or otherwise as a refund or replacement or change in form of principal, shall be deemed principal unless otherwise expressly provided in this Act. Any profit or loss resulting upon any change in form of principal shall enure to or fall upon principal.

(3) All income after payment of expenses properly chargeable to it shall be paid and delivered to the tenant or retained by him if already in his possession or held for accumulation where legally so directed by the terms of the transaction by which the principal was established; while the principal shall be held for ultimate distribution as determined by the terms of the transaction by which it was established or by law.

This is Section 3 of the Uniform Act. It states the pre-existing Illinois law regarding stock dividends in stock of subsidiaries or affiliates of the declaring corporation, and it settles a disputed point regarding profits on the sale of stock where the profit was due to accumulated, undistributed earnings.

Illustration 1.—S creates a trust on September 1, 1941, with A as life beneficiary and B as remainderman beneficiary. A part of the trust property is stock in the X Corporation which has as a subsidiary the Y Corporation, the larger part of whose stock is held by the X Corporation. The Y Corporation declares a stock dividend and the X Corporation distributes the stock of the Y Corporation, which the X Corporation receives on this stock dividend, to the stockholders of the X Corporation as a dividend. The trustee of S's trust receives stock of the Y Corporation in this way. He should treat it as income of the trust, distributable to A, unless the corporation in issuing the dividend designates it as a distribution of capital assets.

Illustration 2.—In the trust described in Illustration 1 above, the trustee owns stock of the Z Corporation which fails to declare dividends for several years, and instead adds earnings to surplus. The trustee sells this stock at a considerable advance over the value it had when the trust began to hold it, due at least in part to the dividend policy of the Z Corporation and increased book value. The entire proceeds of this sale should be added by the trustee to the principal of the trust. It would be improper to pay that part attributable to undistributed earnings to A, the life beneficiary.

This section is copied without substantial change in Louisiana (sec. 69), Oklahoma (sec. 27), and the California draft (sec. 3), but in the Minnesota draft (sec. 21) Subsection 3 is omitted.

It is in harmony with the Restatement of Trusts, Section 233, Comments a and b.

There is ample common law authority supporting the provisions of the section dealing with eminent domain allowances,¹⁹ insurance money,²⁰ sums received in settlement of claims,²¹ and profits on the sale of trust property aside from corporate stock.²² With regard to profits on the sale of corporate stock, there are several cases allotting to the life tenant such part of the profit as can be shown to be due to accumulated undistributed earnings of the corporation,²³ but the better rule is believed to be that such profits are to be treated as capital.²⁴

Section 4. Apportionment of Income.

(1) Whenever a tenant shall have the right to income from periodic payments of interest and such right shall cease and determine by death or in any other manner at a time other than the date when such periodic payments of interest should be paid, he or his personal representative shall be entitled to that portion of the income from such periodic payments of interest next payable when the same shall have been collected which amounts to the same percentage thereof as the time elapsed from the last due date of such periodic payments of interest to but not including the day of the determination of his right is of the total period during which such interest would normally accrue. Except as herein above provided there shall be no apportionment of income as between said tenant or his estate and the succeeding tenant or remainderman, and the remaining portion of the income from periodic payments of interest, and all other income whether periodic or otherwise, which becomes payable subsequent to the expiration of the preceding estate including, but not limited to, rents and annuities shall be paid to the person next entitled to income by the terms of the transaction by which the principal was established. The provisions of this sub-section shall apply whether an ultimate remainderman is specifically named or not.

(2) Income which, at the time the principal is established, other than when established by the Will of a deceased person, has been earned or accrued to the date of such establishment but which is not payable or which is due but has not yet been paid, shall when received, be treated as income and disposed of as is provided with respect to income in sub-section (3) of Section 3.

¹⁹ *Askew v. Woodhead*, 14 Ch. D. 27 (1880); *Gibson v. Cooke*, 1 Metc. (Mass.) 75 (1840).

²⁰ *Horton v. Upham*, 72 Conn. 29, 43 Atl. 492 (1899); *Will of Barron*, 163 Wis. 275, 155 N.W. 1087 (1916).

²¹ Where the claim was for the benefit of both income and capital the sum received in its settlement should be apportioned. *In re Dashiell's Estate*, 181 Atl. 681 (Del. Ch. 1935); *Matter of the Estate of Kight*, 167 Misc. 296, 4 N.Y.S. (2d) 63 (1938).

²² *Van Blarcom v. Dager*, 31 N.J. Eq. 783 (1879); *Devenney v. Devenney*, 74 Ohio St. 96, 77 N.E. 688 (1906). In *Billings v. Warren*, 216 Ill. 281, 74 N.E. 1050 (1905), a gain on the sale of property was given in part to the successor of the life tenant, on the ground that the settlor had expressed an intent to that effect.

²³ *Nirdlinger's Estate*, 290 Pa. 457, 139 Atl. 200 (1927); *Matter of Schaefer*, 178 App. Div. 117, 165 N.Y. Supp. 19 (1917), *aff'd* 222 N.Y. 533, 118 N.E. 1076 (1917).

²⁴ *Long v. Rike*, 50 F. (2d) 124 (C.C.A. 7th 1931) (applying Illinois law); *Matter of the Will of Schley*, 202 App. Div. 169, 195 N.Y. Supp. 871 (1922), *aff'd* without opinion, 234 N.Y. 616, 138 N.E. 469 (1922); *Will of Roebken*, 230 Wis. 215, 283 N.W. 815 (1939).

(3) In respect to the Will of a person dying after this Act takes effect, all income from real and personal property which has been earned or accrued to the date of death of such testator but which is not yet payable or which is due but has not yet been paid and which is not payable to others or otherwise disposed of by the Will, shall when received be added to the principal of the estate.

This section covers the same topic as Section 4 of the Uniform Act, but differs materially from it. The Uniform Act provides for apportionment of all income, except dividends, when a tenant dies, and for the apportionment of all income when a tenant's right accrues in the middle of a periodic payment period. The Illinois act requires the apportionment of interest only where a tenant's right ceases between payment dates, and as to the case of income accrued or payable at the time the first tenant's rights are established it differentiates the case of deeds from that of wills. In the case of a deed or living trust income accrued at the time the trust is established, whether payable or not, is, when later collected, deemed income; while like income in the case of a will is, when collected after the will goes into effect, to be treated as principal.

Illustration 1.—S on October 1, 1941, establishes a trust of bonds and real estate for A for life, remainder to B. A dies on January 1, 1942. Interest on the bonds is payable December 1 and June 1. The realty is rented and the rents are payable on the fifteenth of each month for the past month, but no rent was collected by the trustee after October 15 until January 15, 1942, when he collected the rents due in November, December, and January. Under the act A's estate is entitled to one-sixth of the bond premium collected June 1, 1942, since he was life tenant of the bond for one-sixth of the interest period, and to the rent due in October, November, and December, since he was life tenant on those due dates, but to no part of the January rent, since under the act rent is not apportionable and the tenant at the time the rent becomes due gets it all.

Illustration 2.—A by deed on November 1, 1941, transfers bonds, stocks, and real estate to his wife for life, remainder to his son. Under Section 4(2) of the Illinois act all bond interest, dividends, and rents collected during the life of the wife are her property, whether they accrued or were payable before November 1, 1941, or later.

Illustration 3.—On October 15, 1941, A dies leaving a will by which he gives bonds, stock, and real estate to a trustee for B for life, then for C. Interest accrued on bonds and rent payable before October 15 should, when collected, be added to trust capital. Dividends do not accrue from day to day and if paid after October 15, they should be treated as income for B, even if declared for a period a part of which extended back beyond October 15, 1941.

In Louisiana (sec. 70) and Oklahoma (sec. 28) the Uniform Act is followed and interest, rents, and annuities are apportioned, but not dividends, but the California draft (sec. 4) denies all apportionment and the Minnesota draft (sec. 22) follows the Uniform Act as to the death of the tenant in the middle of an income period but does not cover the case of the trust starting in the middle of such period.

The Restatement of Trusts, Sections 235, 238, declares that the common law is that all receipts except rents, annuities, and dividends are apportionable, if the trust begins or ends, or the life tenant dies, in the middle of a period.

In England,²⁵ Kentucky,²⁶ Massachusetts,²⁷ New York,²⁸ North Carolina,²⁹ Pennsylvania,³⁰ Rhode Island,³¹ Virginia,³² and West Virginia,³³ there are statutes providing for apportionment of some or all kinds of receipts. Illinois has seen fit to follow the common law rule³⁴ that only interest is apportionable, and has refused to adopt the statutory trend toward greater liberality.

Section 5. Income During Period of Administration.

(1) In respect to the Will of a person dying after this Act takes effect, all income to which the personal representative is entitled from property, except property sold or used for the purposes of paying legacies and discharging debts, taxes, and expenses of administration, earned or accrued during the period of administration of the estate of such testator and not payable to others or otherwise disposed of by the Will shall be distributed pro rata as income among the beneficiaries of any trusts created out of the residuary estate of such testator and the other persons entitled to such residuary estate. The balance of income earned or accrued during the period of administration shall be considered as principal. Nothing contained in this Section shall affect the right of

²⁵ 33 & 34 Vict., c. 35 (1870).

²⁶ Ky. Stat. Ann. (Carroll, 1936) § 2070 (apportions annuities).

²⁷ Mass. Gen. Laws (1932) c. 197, §§ 26, 27 (apportions all but dividends).

²⁸ N.Y. Real Prop. Law (McKinney, 1937) § 275-a (apportions all payments due at fixed periods).

²⁹ N.C. Code Ann. (Michie, 1931) § 2346 (similar to New York).

³⁰ Pa. Stat. Ann. (Purdon, Supp. 1940) tit. 20, § 634 (applies only to wills; apportions all payments).

³¹ R.I. Gen. Laws (1923) §§ 4328-29 (similar to Massachusetts).

³² Va. Code Ann. (Michie, 1936) §§ 5544-47 (apportions rents and other moneys coming due at fixed periods).

³³ W. Va. Code Ann. (Michie & Sublett, 1937) c. 37, art. 9, §§ 3688-91 (similar to Virginia).

³⁴ *Greene v. Huntington*, 73 Conn. 106, 46 Atl. 883 (1900); *Heizer v. Heizer*, 71 Ind. 526 (1880); *Nehls v. Sauer*, 119 Iowa 440, 93 N.W. 346 (1903); *Quinn v. Madigan*, 65 N.H. 8, 17 Atl. 976 (1889); *Will of Barron*, 163 Wis. 275, 155 N.W. 1087 (1916).

any person to income on any portion of the estate not part of the residuary estate of such testator.

(2) Unless otherwise provided by the Will, the income beneficiary of any trust shall be entitled to receive income from the date of the testator's death provided that in determining the income to be paid to an income beneficiary of a pecuniary legacy in trust, the trustee shall be entitled to receive from the executor not only the designated sum but income thereon at the rate of return received by the executor upon the whole estate from the date of the death of the testator.

This section is not found in the Uniform Act. It settles some perplexing problems on which there has been a division of authority.

Illustration 1.—A dies November 1, 1941, leaving a will by which he made the following gifts: legacy of \$1,000 to B; gift of \$10,000 to a trustee for C for life, remainder to C's children who survive C; gift of 100 shares of the common stock of United States Steel Corporation to a trustee for D for life, remainder to the children of D who survive D; gift of the residue of the estate to a trustee for E for his life, remainder to the children of E who survive E. The debts, legacy to B, taxes, and expenses of administration of A's estate paid by his executor amounted to \$40,000, to pay which the executor sold bonds of the X corporation at various dates during the executorial administration. Between the date of the testator's death and the dates of their sales these bonds earned \$1,200 interest which the executor collected. The executor accounts and turns over to the trustees for C, D, and E the remaining estate property. Under the Illinois Act the trustee for C should collect from the executor \$10,000, plus income at the average rate earned by the estate during administration from the death of the testator until delivery of the \$10,000 and this income should be paid by the trustee to C; the trustee for D should collect from the executor the 100 shares of stock bequeathed plus their income actually earned during the executorial period and this income should be paid to D; and the trustee for E should collect the residue of the estate from the executor, and should treat the income of \$1,200 on the bonds of the X corporation as principal of the trust. The income on all property received by the trustee which was collected during the executorial year should be treated by the trustee as income of the residuary trust and be paid to E, and all other property received by him from the executor should be treated as trust principal.

Neither the Louisiana nor Oklahoma acts, nor the California and Minnesota drafts, contain any section corresponding to Section 5 of the Illinois act. The section does not affect the right of the legatee, B, receiving a cash legacy not under a trust, to receive interest on the amount given, beginning one year after the death of the testator.

The Restatement of Trusts, Section 234, is believed to harmonize with Section 5 of the Illinois act, and numerous authorities also support it.³⁵

Section 6. Corporate Dividends and Share Rights.

(1) All dividends on shares of a corporation forming a part of the principal, which are payable in the shares of the corporation, shall be deemed principal. Excepting as in this Section otherwise provided, all dividends payable otherwise than in the shares of the corporation itself, including ordinary and extraordinary dividends and dividends payable in shares or other securities or obligations of corporations other than the declaring corporation, shall be deemed income except that any such dividends or part thereof as shall be designated by the corporation as a distribution of capital assets shall be deemed principal.

Where the trustee or tenant in possession shall have the option of receiving a dividend either in cash or in the shares of the declaring corporation, it shall be considered as a cash dividend and deemed income, irrespective of the choice made by the trustee or tenant in possession.

(2) Where the assets of a corporation consist in whole or in part of property in lands from which may be taken timber, minerals, oils, gas or other natural resources, or of other wasting assets or property subject to depletion, amounts paid upon the corporate shares as cash dividends shall be deemed income or principal or partly income and partly principal as designated by the corporation and in the absence of such designation shall be considered as income.

(3) All rights to subscribe to the shares or other securities or obligations of a corporation accruing on account of the ownership of shares or other securities in such corporation, and the proceeds of any sale of such rights, shall be deemed principal. All rights to subscribe to the shares or other securities or obligations of a corporation accruing on account of the ownership of shares or other securities in another corporation, and the proceeds of any sale of such rights, shall be deemed income.

(4) Where a corporation is being liquidated, amounts paid upon corporate shares as dividends on arrears of preferred or guaranteed dividends shall be deemed income; all other amounts paid upon corporate shares on disbursement of the corporate assets to the stockholders shall be deemed principal.

(5) Where a corporation succeeds another by merger, consolidation or reorganization or otherwise acquires its assets, and the corporate shares of the succeeding corporation are issued to the shareholders of the original corporation in like proportion to, or in substitution for, their shares of the original corporation, the two corporations shall be considered a single corporation in applying the provisions of this section. But

³⁵ *Date when income begins:* Harrison v. Com'r, 119 F. (2d) 963 (C.C.A. 7th 1941); McDonough v. Montague, 259 Mass. 612, 157 N.E. 159 (1927); Matter of Bird's Will, 241 N.Y. 184, 149 N.E. 827 (1925). *Where res is specific property:* Dennison v. Lilley, 83 N.H. 422, 144 Atl. 523 (1928). *Where res is a sum of money:* State Bank of Chicago v. Gross, 344 Ill. 512, 176 N.E. 739 (1931). *Income of residuary estate:* Bridgeport-City Trust Co. v. Beach, 119 Conn. 131, 174 Atl. 308 (1934); Waterman v. Alden, 42 Ill. App. 294 (1890); Folsom v. Strain, 138 Neb. 497, 293 N.W. 357 (1940). *Income of property used to pay debts:* Proctor v. American Security & Trust Co., 98 F. (2d) 599 (App. D.C. 1938); York v. Maryland Trust Co., 150 Md. 354, 133 Atl. 128 (1926). But see Old Colony Trust Co. v. Smith, 266 Mass. 500, 165 N.E. 657 (1929); Wachovia Bank & Trust Co. v. Jones, 210 N.C. 339, 186 S.E. 335 (1936).

two corporations shall not be considered a single corporation under this section merely because one owns corporate shares of or otherwise controls or directs the other.

(6) The person who is entitled to a dividend shall be the tenant at the date specified by the corporation as the one on which the stockholders entitled thereto are determined, or if no such date is specified, then the tenant at the date of the declaration of the dividend shall be entitled thereto.

(7) The trustee or tenant may rely upon the statement of the paying corporation as to any fact relevant under any provision of this Act concerning the source or character of dividends or disbursement of corporate assets.

This section is substantially the same as Section 5 of the Uniform Act, except that Subsections (2) and (7) are new and peculiar to the Illinois act.

Illustration 1.—On October 15, 1941, A dies leaving a will by which he leaves his residuary estate to T in trust for B for life, remainder to C. When T receives the residuary estate he finds that it includes 1) stock of the D Grocery Co.; 2) stock of the E Mining Co.; 3) stock of the F Oil Co.; and 4) stock of the G Realty Co., which T is entitled to hold under the trust. Thereafter, and during the life of B, the D Grocery Co. declares a 100 per cent stock dividend of its own stock, the E Mining Co. declares a 5 per cent cash dividend without a statement as to its source or object, the F Oil Co. gives its stockholders the right to subscribe to new stock at par, and the G Realty Co. goes out of business, sells its assets, and distributes the proceeds to its stockholders. T should treat the stock dividend of the D Grocery Co. as trust principal, the cash dividend of the E Mining Co. as trust income, the right to subscribe in the stock of the F Oil Co. or its proceeds as trust principal, and the G Realty Co. liquidating dividend as trust principal.

Illustration 2.—The facts are the same as in Illustration 1 above, except that the testator leaves the stock to B for life, remainder to C, and does not create a trust. B's duties with regard to the various benefits distributed are the same as those of T in Illustration 1.

The Uniform Act is followed in Louisiana (sec. 71) and Oklahoma (sec. 29) and is modified only slightly in the California (sec. 5) and Minnesota (sec. 23) drafts.

The Uniform Act and Illinois act adopt, in a general way, the Massachusetts rule. They are, therefore, very different from the Restatement of Trusts, Section 236, which adopts the Pennsylvania rule as the better common law rule, gives ordinary dividends to income, extraordinary dividends no matter what their form to income only to the extent that they reflect corporate earnings during the trust's holding of the stock, gives stock subscription rights to principal, and apportions liquidation

dividends to bring to trust income the corporate income accumulated during the trust's holding of the stock.

Illinois had, previous to 1941, clearly adopted the Massachusetts rule regarding the distribution of benefits flowing from the holding of corporate stock, as between life tenant and remainderman. The rules announced in Section 6 of the Illinois act are supported by cases in the states following the Massachusetts rule, both as to ordinary³⁶ and extraordinary³⁷ cash dividends,³⁸ dividends in the stock of the declaring corporation,³⁹ dividends in the stock of another than the declaring corporation,⁴⁰ optional dividends,⁴¹ dividends of a corporation with wasting assets,⁴² rights to subscribe,⁴³ liquidating dividends,⁴⁴ and dividends in the stock of a successor corporation.⁴⁵ The recent trend has been toward the Massachusetts rule, both by decision⁴⁶ and statute,⁴⁷ on the ground of its simplicity and

³⁶ *Buchanan v. Nat'l Savings & Trust Co.*, 23 F. (2d) 994 (App. D.C. 1928); *Balch v. Hallet*, 10 Gray (Mass.) 402 (1858).

³⁷ *Boardman v. Boardman*, 78 Conn. 451, 62 Atl. 339 (1905); *De Koven v. Alsop*, 205 Ill. 309, 68 N.E. 930 (1903); *Talbot v. Milliken*, 221 Mass. 367, 108 N.E. 1060 (1915).

³⁸ *United States v. Blow*, 77 F. (2d) 141 (C.C.A. 7th 1935); *Laffin v. Com'r*, 69 F. (2d) 460 (C.C.A. 7th 1934).

³⁹ *Blinn v. Gillet*, 208 Ill. 473, 70 N.E. 704 (1904); *Billings v. Warren*, 216 Ill. 281, 74 N.E. 1050 (1905); *Eastman v. State Bank of Chicago*, 259 Ill. App. 607 (1931); *Burns v. Hines*, 298 Ill. App. 563, 19 N.E. (2d) 382 (1939); *Waterman v. Alden*, 42 Ill. App. 294 (1890).

⁴⁰ *Lloyd v. Lloyd*, 341 Ill. 461, 173 N.E. 491 (1930); *Whiting v. Hagey*, 366 Ill. 86, 7 N.E. (2d) 885 (1937).

⁴¹ *Davis v. Jackson*, 152 Mass. 58, 25 N.E. 21 (1890); *Newport Trust Co. v. Van Rensselaer* 32 R.I. 231, 78 Atl. 1009 (1911).

⁴² *Washington County Hospital Ass'n v. Hagerstown Trust Co.*, 124 Md. 1, 91 Atl. 787 (1914); *Waterman's Estate*, 279 Pa. 491, 124 Atl. 166 (1924). But see *Union County Trust Co. v. Gray*, 110 N.J. Eq. 270, 159 Atl. 625 (1932); *Estate of Wells*, 156 Wis. 294, 144 N.W. 174 (1913).

⁴³ *De Koven v. Alsop*, 205 Ill. 309, 68 N.E. 930 (1903); *Powell v. Madison Safe Deposit & Trust Co.*, 208 Ind. 432, 196 N.E. 324 (1935).

⁴⁴ *Rock Island Bank & Trust Co. v. Rhoads*, 353 Ill. 131, 187 N.E. 139 (1933); *Anderson v. Bean*, 272 Mass. 432, 172 N.E. 647 (1930); *Wilberding v. Miller*, 90 Ohio St. 28, 106 N.E. 665 (1914); *Girard Trust Co. v. Mueller*, 125 N.J. Eq. 597, 7 A. (2d) 413 (1939) (statement of directors as to purpose of dividend respected).

⁴⁵ *Title Guarantee Loan & Trust Co. v. Woodward*, 238 Ala. 304, 191 So. 363 (1939); *Brownell v. Anthony*, 189 Mass. 442, 75 N.E. 746 (1905); *Buist's Estate*, 297 Pa. 537, 147 Atl. 606 (1929).

⁴⁶ The supreme courts of three states have recently adopted the Massachusetts rule, when the problem was presented to them for the first time. *Powell v. Madison Safe Deposit & Trust Co.*, 208 Ind. 432, 196 N.E. 324 (1935); *In re Joy's Estate*, 247 Mich. 418, 225 N.W. 878 (1929); *Hayes v. St. Louis Union Trust Co.*, 317 Mo. 1028, 298 S.W. 91 (1927).

⁴⁷ In 1926 a New York statute provided that in trusts going into effect thereafter stock dividends should be treated as trust capital. N.Y. Pers. Prop. Law (McKinney, 1938) § 17-a.

approximate justice, in preference to the complex, expensive, and almost unworkable Pennsylvania rule.

Section 7. Premium and Discount Bonds.

(1) Where any part of the principal consists of bonds or other obligations for the payment of money which were purchased at a premium after the time the principal was established, the amount of such premium shall be amortized to the maturity of said obligation out of income subsequently collected thereon by deducting from such income each year during the remaining life of said obligation such sum as, together with equal sums similarly deducted and to be deducted in other years, will amount to the premium paid.

(2) In case of the sale, payment, exchange or distribution of any such bonds or other obligations prior to maturity, any loss or gain realized thereon shall fall upon or enure to principal, and no further adjustments shall be made between principal and income in regard to any unamortized balance of the premium.

(3) There shall be no such amortization as to bonds or other obligations purchased prior to the time the principal was established.

(4) There shall be no accumulation or amortization as to bonds or other obligations which are purchased at a discount and upon collection or sale the entire proceeds shall be credited to principal.

(5) Bonds or other obligations received by the trustee at their market value in lieu of cash in satisfaction of a cash bequest in trust, for the purposes of this Section only, shall be considered as purchased by the trustee after the time the principal was established, but if bonds or other obligations are received by the trustee as a specific bequest they shall be considered as purchased prior to the time the principal was established.

(6) Where any part of the principal consists of a bond or other obligation for the payment of money, bearing no stated interest but redeemable at maturity or a future time at an amount in excess of the amount in consideration of which it was issued, such accretion shall enure to income and shall be subject to apportionment under subsection (1) of Section 4 in the same manner as interest.

This section is like Section 6 of the Uniform Act in that it provides for no accumulation or amortization in the case of bonds bought by the trustee at a discount and also in that Subsection (2) is the same; but it differs from the Uniform Act as to premiums and Subsections (4), (5), and (6) of the Illinois act cover matters not specifically treated in the Uniform Act.

Illustration 1.—A dies on October 1, 1941, leaving a will by which he gives to T as trustee for A for life, remainder to B, \$100,000 in cash and specified bonds of the value of \$100,000, some of which had been bought by the testator at a premium and some at a discount. The executor of A turns over to T in payment of the \$100,000 cash gift \$50,000 in cash and bonds of the X Co. which have a face value of \$45,000 but which are quoted then in the market at \$50,000. With the cash received T purchases 1) bonds of the Y Co. at 105, 2) bonds of the Z Co. at 95, and 3) a

United States savings bond for \$875 which in ten years will have a maturity value of \$1,000. Under the Illinois Act T has no duty to amortize or accumulate with regard to the bonds bought by the testator and received by the trustee as a specific bequest, but has a duty to amortize the \$5,000 premium on the bonds received in lieu of cash; and T must amortize as to the bonds he bought at a premium, but need not accumulate as to those he purchased at a discount. The accretions on the United States savings bond when realized should be treated as income of the trust. In amortizing the premium T should use the "straight line" method, and deduct from each interest payment received by him on the bond such sum as, together with a similar deduction from all subsequent coupons until maturity, will equal the premium, without consideration of interest on such deductions. The deductions are added to trust capital at once and remain there no matter what happens to the bond, whether it is sold or called or held to maturity.

In Louisiana (sec. 72) the Uniform Act is followed, and the same is true in Oklahoma (sec. 30) except that the savings bond case is covered by a clause harmonious with the Illinois act;⁴⁸ and the California (sec. 6) and Minnesota (sec. 24) drafts are similar to the Oklahoma section.

The subject matter of Section 7 of the Illinois act is covered by the Restatement of Trusts, Section 233, Comment d, Section 239, Comment f, and Section 240, Comment h. The trustee is said to be permitted to amortize premiums if necessary in order to be impartial between life tenant and remainderman, and not to be under a duty to accumulate for discounts prior to the maturity and collection of the bond or after such collection unless the discount was due to the low interest which the bond carried. The accumulation of value on United States savings bonds is said to be income when collected.

The common law authorities, although not numerous, support Section 7 of the Illinois act, and require amortization of premiums,⁴⁹ but do not re-

⁴⁸ For similar statutes, see Del. L. 1939, c. 150; Va. Code Ann. (Michie, Supp. 1940) § 5133h.

⁴⁹ In the Matter of the Estate of Gartenlaub, 185 Cal. 648, 198 Pac. 209 (1921); New England Trust Co. v. Eaton, 140 Mass. 532, 4 N.E. 69 (1886); Matter of Stevens, 187 N.Y. 471, 80 N.E. 358 (1907); consult Edgerton, Premiums and Discounts in Trust Accounts, 31 Harv. L. Rev. 447 (1918); Vierling, Interest on Investments, and Amortization of Premiums Paid and Accumulation of Discounts Allowed Thereon, 5 St. Louis L. Rev. 59, 134 (1920); Vierling, Amortization of Premiums and Accumulation of Discounts on Trust Investments, 8 St. Louis L. Rev. 1 (1923); Vierling, Accumulation of Discounts, 11 St. Louis L. Rev. 266 (1926); Vierling, Amortization of Premiums and Accumulation of Discounts on Trust Investments, 36 Trust Companies 177 (1923); Adjustment of Discounts on Trust Investments, 39 Trust Companies 711 (1924); Forer, Discounts in Trust Investments, 24 Minn. L. Rev. 291 (1940).

quire or permit accumulation or other procedure to give the life tenant the benefit of discounts when realized.⁵⁰

Section 8. Principal Used in Business.

(1) Whenever a trustee or a tenant is authorized by the terms of the transaction by which the principal was established, or by law, to use any part of the principal in the continuance of a business which the original owner of the property comprising the principal had been carrying on, the net profits of such business attributable to such principal shall be deemed income.

(2) Where such business consists of buying and selling property the net profits for any period shall be ascertained by deducting from the gross returns during and the inventory value of the property at the end of such period, the expenses during and the inventory value of the property at the beginning of such period. Such inventory value shall in each case be the market value if there be one or the cost price of the articles comprising the inventory whichever is less.

(3) Where such business does not consist of buying and selling property, the net income shall be computed in accordance with the customary accounting practice, but not in such way as to decrease the principal.

(4) Any increase in the value of the principal used in such business shall be deemed principal, and all losses in any one calendar year, after the income from such business for that year has been exhausted, shall fall upon principal.

This is Section 7 of the Uniform Act, without important change.

Illustration 1.—A dies November 1, 1941, leaving his clothing store which he had operated alone, and without corporate or partnership form, to T as trustee for B for life, remainder to C. The trustee receives the stock of clothing and fixtures and operates the store as directed by the will. In ascertaining the income distributable to B at the end of a quarter, or year, or other accounting period selected by T, he should first add the inventory value at the end of the period and the gross receipts during the period, and then subtract from such total the expenses of the business during the period and the inventory value at the beginning of the period. The sum reached by this process is trust income. The same procedure should be followed by B if he were a legal tenant of the store for life.

Section 7 of the Uniform Act is copied in Louisiana (sec. 73), Oklahoma (sec. 31), and the California draft (sec. 7), but in the Minnesota draft (sec. 25) Subsection (4) is omitted.

The Restatement of Trusts, Section 233, Comment c, is in accord with Section 8 of the Illinois Act. It is believed that the common law decisions also support it.⁵¹

⁵⁰ In the Matter of the Estate of Gartenlaub, 198 Cal. 204, 244 Pac. 348 (1926); In the Matter of the Will of Houston, 19 Del. Ch. 207, 165 Atl. 132 (1933).

⁵¹ Buckingham v. Morrison, 136 Ill. 437, 27 N.E. 65 (1891); Heighe v. Littig, 63 Md. 301 (1885); Rossi v. Davis, 345 Mo. 362, 133 S.W. (2d) 363 (1939).

Section 9. Principal Comprising Animals.

Where any part of the principal consists of animals employed in business, the provisions of Section 8 shall apply; and in other cases where the animals are held as a part of the principal partly or wholly because of the offspring or increase which they are expected to produce, all offspring or increase shall be deemed principal to the extent necessary to maintain the original number of such animals and the remainder shall be deemed income; and in all other cases such offspring or increase shall be deemed income.

Section 8 of the Uniform Act is copied.

Illustration 1.—A dies November 1, 1941, and leaves a will by which he gives all his property to a trustee to hold for the widow of A during her life, remainder to B. A part of the trust property consists of a farm on which hogs are raised. When the trustee takes possession of the farm there are 100 hogs on it. At the end of the first year of operation the hogs have increased to 200. In computing what part of the hogs constitute income for the widow, it will be the duty of the trustee to reserve 100 hogs as nearly like the original 100 as possible and treat those animals as trust principal, and to consider the remainder of the 200 hogs as income of the trust.

Louisiana (sec. 74), Oklahoma (sec. 32), and the California (sec. 8) and Minnesota (sec. 26) drafts follow Section 8 of the Uniform Act without change.

There appears to be no portion of the Restatement of Trusts which deals specifically with this topic.

The common law cases are believed to support the section.⁵²

Section 10. Disposition of Natural Resources.

Where any part of the principal consists of property in lands from which may be taken timber, minerals, oils, gas or other natural resources and no provision is made in the transaction by which the principal was established for the disposition of the net proceeds thereof after the payment of expenses and carrying charges on such property, such proceeds, if received as rent on a lease, shall be deemed income, but if received as consideration, whether as royalties or otherwise, for the permanent severance of such natural resources from the lands, or as a bonus for a lease, shall be deemed principal to be invested to produce income. Nothing in this section shall be construed to abrogate or extend any right which may otherwise have accrued by law to a tenant to develop or work such natural resources for his own benefit.⁵³

This is Section 9 of the Uniform Act, except that the italicized words are new and that the Illinois act omits the following words which appear in the Uniform Act after the words "natural resources": "and the trustee or tenant is authorized by law or by the terms of the transaction by which the principal was established to sell, lease or otherwise develop such nat-

⁵² Leonard v. Owen, 93 Ga. 678, 20 S.E. 65 (1894); Horry v. Glover, 2 Hill Eq. (S.C.) 515 (1836); Dunbar's Exec'rs v. Woodcock's Exec'r, 10 Leigh (Va.) 628 (1840).

⁵³ (Italics added.)

ural resources." This omission is not believed important. No question under the section is assumed to arise, unless there is proper use of the natural resources. The last sentence of the section is to that effect.

Illustration 1.—In October 1941, a trust is established for A for ten years, with remainder to B. A part of the trust property consists of land on which oil is discovered. The trust instrument permits development of the oil resources. The trustee grants to X permission to drill for oil in return for a royalty of one-eighth of the proceeds of the oil obtained. The trustee should treat the royalties as trust principal.

Louisiana (sec. 75) follows Section 9 of the Uniform Act. The Oklahoma act (sec. 33), after the introductory matter, substitutes the following language for the wording of the Uniform Act:

... such proceeds, if received as extension payments on a lease or bonus for the execution of the same, shall be deemed income, but if received as consideration whether as royalties or otherwise, for the permanent severance of such natural resources from the lands, shall be apportioned to principal and income as follows:

Such percentage thereof as is permitted to be deducted for depletion under the then existing laws of the United States for federal income tax purposes shall be treated as principal and invested or held for the use and benefit of the remainderman, and the balance shall be treated as income subject to be disbursed to the tenant or person entitled thereto, or if no provision for such deduction for depletion is made by the then existing federal laws, then twenty per cent (20%) of the net proceeds thereof each year shall be treated as principal and invested or held for the benefit of the remainderman and the balance shall be treated as income and subject to be disbursed to the tenant or person entitled to such income. Such disposition of proceeds shall apply whether the property is producing or non-producing at the time the trust becomes effective.

Minnesota does not cover this question by her proposed Trust Administration Act. In California the relevant section of the Uniform Act is abandoned and it is provided (sec. 9) that where the trustee or tenant is not under a duty to change the form of the investment, or (the duty to change the form of the investment being absent) is authorized to develop the natural resources, the proceeds of development, whether in the form of rent, bonuses, or royalties, shall be considered income, and if such conditions do not exist and hence not all proceeds are income, then the life tenant shall get 5 per cent of the value of the property annually from such proceeds.

The Restatement of Trusts, Section 239, Comment g, states that the common law requires apportionment of the proceeds of wasting natural resources in whatever way will "preserve the value of the principal at the time of the creation of the trust."

The common law cases are in confusion⁵⁴ and no clear-cut rule can be drawn from them. The Illinois act recognizes the difference between rent paid for the privilege of exploring land which may contain oil or gas, and royalties paid for the extraction of the oil or gas. In the first case the lessee is not exhausting the property. The rent is not received from a wasting asset. But in the second case, that of royalties, the payments made are on account of the exhaustion or consumption of the property. In the first case the entire payment may be considered as income, without damage to the remainderman; but in the latter case the receipts are added to trust principal so that both life tenant and remainderman benefit.

Section 11. Principal Subject to Depletion.

Where any part of the principal consists of property subject to depletion, such as leaseholds, patents, copyrights and royalty rights, but not including types of property described in Section 10, the rents, royalties or return from such property not in excess of five (5) per centum per annum of its value shall be deemed income and the remainder principal.

In the case of a trust the value of the property referred to in this section shall be its fair value, at the time the principal is established, as determined in good faith by the Trustee or its cost where purchased later. Such value, except where based on cost, may be changed by the Trustee in any subsequent year or years provided the Trustee is of the opinion that the original valuation should be revised and such revised valuation, subject to any subsequent change in valuation as herein provided, shall be used in all future apportionments between income and principal but there shall be no re-apportionment for prior years by reason of any such change in valuation.

Any such valuation or valuations shall be conclusive and shall be binding upon all tenants and remaindermen.

This section covers the same question as Section 10 of the Uniform Act, but varies from it considerably. The Uniform Act requires apportionment of the receipts from property subject to depletion only if the trustee or tenant is under a duty to sell the property and delays selling, and then provides for a return of 5 per cent on the value or cost of the property, but gives no method for valuation. The Illinois act gives the tenant 5 per cent on the value of the property, whether there is a duty to sell or not, and stipulates that the trustee may change the valuation of the property, if the facts warrant it.

⁵⁴ For examples of recent cases: *Sewell v. Sewell*, 363 Ill. 166, 1 N.E. (2d) 492 (1936) (proceeds of lease should be invested for benefit of both legal life tenant and legal remainderman); *Pedroja v. Pedroja*, 152 Kan. 82, 102 P. (2d) 1012 (1940) (royalties from leases made by settlor should be paid to life tenant, but royalties from leases made by trustee should be invested as trust capital); *In re Estate of Wernet*, 61 Ohio App. 304, 22 N.E. (2d) 490 (1938) (royalties on gas wells opened after settlor's death should go to life tenant); *Texas Co. v. Marlin*, 109 F. (2d) 305 (C.C.A. 5th 1940) (oil lease made by legal life tenant and adopted by legal remainderman; life tenant entitled to interest on the royalty payments during his life).

Illustration 1.—In November 1941, A by will leaves to a trustee property to be held for B for life, remainder to C. A portion of the trust property is a leasehold in which A was the assignee of the lessor and X the lessee, under which X agreed to pay \$100 a month rent on realty for a period of ten years. Under the Illinois act it is the duty of the trustee to value the leasehold which he holds and pay to the life beneficiary 5 per cent of the value out of the annual rent payments, and to place the remainder of the rent in trust principal. If X, the tenant, gets into financial difficulties so that his rent is necessarily reduced, the trustee may revalue the leasehold on the basis of the prospective rent during the remainder of the lease.

The Louisiana (sec. 76) and Oklahoma (sec. 34) acts follow Section 10 of the Uniform Act, as does the California draft (sec. 10), but the Minnesota code does not cover this matter.

The Restatement of Trusts, Sections 239 and 241, covers the subject matter of this section. It requires a trustee to amortize or sell all wasting property and, if there is a delay in selling, to apportion the proceeds so as to give the life tenant the income he would have had if the sale had occurred at the proper time and the proceeds had then been reinvested.

There are common law cases supporting the duty to apportion the proceeds of wasting assets of the type described in Section 11.⁵⁵ The trustee is not entitled to set aside a depreciation reserve out of the income of real estate.

Section 12. Unproductive Estate.

(1) Where any part of a principal in the possession of a trustee consists of realty which the trustee is expressly directed by the trust instrument to sell, and such sale is delayed but is made before the principal is finally distributed, then if the total of the ordinary expenses payable out of income as provided in subsection (1) of Section 14 shall exceed the total income received from such realty for the entire period that such realty was held by the trustee, the tenant, or in case of his death, his personal representative, shall be entitled to share in the net proceeds received from the property as delayed income to the extent hereinafter stated.

(2) Such income shall be the difference between the net proceeds received from the sale of the property and the amount which, had it been placed at simple interest at the rate of five per centum per annum from the time the trustee acquired title to the property to the time of sale would have produced the net proceeds at the time of sale. The net proceeds shall consist of the gross proceeds of sale received from the property

⁵⁵ *Leaseholds*: *Minot v. Thompson*, 106 Mass. 583 (1871); *Estate of Wells*, 156 Wis. 294, 144 N.W. 174 (1914). *Royalties on a book*: *In the Matter of Elsner*, 210 App. Div. 575, 206 N.Y. Supp. 765 (1924). *Right to renewal premiums on insurance policies*: *In the Matter of Pennock*, 285 N.Y. 475, 35 N.E. (2d) 177 (1941); *Industrial Trust Co. v. Parks*, 57 R.I. 363, 190 Atl. 32 (1937); consult Barry, *Wasting Assets and Amortization*, 21 Va. L. Rev. 611 (1935).

less any expenses incurred in disposing of it and less all carrying charges which may have been paid out of principal during the period while it was held by the trustee. There shall be deducted from such delayed income any income received from such realty during such period which was paid to the tenant but if the amount of such income so received by the tenant from such realty shall exceed the amount to which he would be entitled under this Section, the tenant shall not by reason thereof be required to repay any part of such excess.

(3) Except as stated in the preceding subsections of this Section no portion of the proceeds of sale of property shall be deemed income by reason of the fact that such property, for any period of time, produced no income or produced an unusually low income.

This is Section 11 of the Uniform Act, considerably modified. The Uniform Act requires apportionment of the proceeds of realty or personalty not producing an average net income of 1 per cent per annum, where there is a duty to sell for any reason, and a sale is delayed, and the sale brings more than the inventory value of the property. The Illinois act requires such apportionment only where there is a duty to sell realty expressly imposed by the trust instrument, a delay in selling, and during the whole period of delay the property has more expenses than income. It is immaterial whether the proceeds are greater than the inventory value of the property originally.

Illustration 1.—In November 1941, A dies, leaving a will which creates a trust for B for life, remainder to C, a part of the trust property being two vacant tracts of land, Y and Z. The will expressly directs the trustee to sell tract Y as soon as possible, contains no statement specifically regarding the sale of Z, but gives the trustee a power to sell all trust property. Tract Y is inventoried at \$10,000 and tract Z at \$5,000 when the trust begins. The trustee holds both tracts for two years, during which time they produce no income and taxes amounting to \$400 are paid on tract Y and taxes of \$200 are paid on tract Z, both payments being made from income of other trust property. At the end of two years tract Y is sold for \$8,000 and tract Z for \$3,000, with a \$200 broker's fee for selling Y and a \$100 fee for selling Z. The net proceeds of tract Z, \$2,900, should be added to trust principal after reimbursing trust income for the \$200 tax advance, since the will did not expressly direct a sale of this tract. The net proceeds of the sale of tract Y should be apportioned by finding what sum, if invested two years before the sale at 5 per cent simple interest would have produced \$7,800, the net proceeds of the sale. A formula for

finding this sum is $X = \frac{P}{1 + TR}$. X is the sum sought to be found; P is the net proceeds of the sale; T is the time in years during which a sale

was delayed; and R is the rate of return expressed in decimal form. Thus, in this case the computation would be as follows:

$$X = \frac{\$7,800}{1 + (2 \times .05)} = \frac{\$7,800}{1.10} = \$7,090.90$$

$$\$7,800 - \$7,090.90 = \$709.10.$$

Therefore, the sum to be allotted to trust principal is \$7090.90 and the sum to be awarded to trust income is \$709.10.

The Louisiana (sec. 77) and Oklahoma (sec. 35) acts follow Section 11 of the Uniform Act, as does the California draft (sec. 11), but the Minnesota draft is silent on this subject.

The Restatement of Trusts, Sections 240 and 241, states a duty on the part of a trustee to sell unproductive or underproductive property, and if the sale is delayed to apportion the proceeds in such a way as to give the life tenant the income he would have received if the sale had been made immediately and the proceeds had been invested.

Under the common law cases if there is a duty to sell unproductive property, either because of a direction of the settlor or because the property is not a legal trust investment, and there is a delay in selling, the net proceeds of a sale are to be apportioned in accordance with the same procedure laid down in Section 12.⁵⁶

Section 13. Mortgage Foreclosure Accounting.

In any case in which a trustee shall hold a mortgage upon real property and such trustee shall acquire title to such real property by foreclosure or conveyance in lieu of foreclosure, such acquired real property shall be principal in lieu of such mortgage. The tenant shall be entitled to the net income from such acquired real property from the date of its acquisition and no allocation or apportionment as between tenant and remainderman of the proceeds of the sale of the real property previously subject to a mortgage shall be made.

The expenses of foreclosure or of conveyance in lieu of foreclosure and the arrears of taxes and other liens which accrued prior to such foreclosure or conveyance shall be

⁵⁶ *Edwards v. Edwards*, 183 Mass. 581, 67 N.E. 658 (1903); *Matter of the Will of Jackson*, 258 N.Y. 281, 179 N.E. 496 (1932); *Furniss v. Cruikshank*, 230 N.Y. 495, 130 N.E. 625 (1921). In *Love v. Engelke*, 368 Ill. 342, 14 N.E. (2d) 228 (1938), the court refused to order an apportionment of the proceeds of the sale of unproductive realty, where there had been a power of sale but no duty to sell, and the sale had been delayed. For valuable discussions, consult *Carey and Moodie, Unproductive Property in Trust Accounting*, 33 Ill. L. Rev. 398 (1938); *H. Brandis, Jr., Trust Administration: Apportionment of Proceeds of Sale of Unproductive Land and of Expenses*, 9 N.C.L. Rev. 127 (1931); *Skilton, The Rights of Successive Beneficiaries in Unproductive Trust Assets Not Bearing Interest*, 15 Temple U.L.Q. 241 (1941); *Skilton, The Rights of Successive Beneficiaries in Unproductive Trust Assets Bearing Interest*, 15 Temple U.L.Q. 378 (1941); 49 Harv. L. Rev. 805 (1936).

charges payable out of principal. Where any monies have been advanced out of income to pay such expenses, taxes, or other liens they shall be reimbursed to income out of principal.

The Uniform Act has no special section on salvaging mortgages, but rather leaves the matter to be covered by the general section on unproductive estates, namely, Section 11. Due to the very complex and troublesome problems which have arisen with regard to defaulted mortgages in the last ten years it was thought best in Illinois to deal with the question in a separate section and to simplify procedure and accomplish substantial justice, rather than to require involved bookkeeping and accounting work in an effort to bring about exact justice between life tenant and remaindermen.

Illustration 1.—In October 1941, A dies, leaving a will in which the residue of his estate is left to a trustee to hold for B for life, remainder to C. A portion of the trust property was a mortgage for \$10,000 on a business building. The mortgagor defaulted in payment of interest on the mortgage, the trustee foreclosed the mortgage, bid the property in for the amount of the debt and foreclosure costs, held it for two years during which time it was rented and produced a net income of \$300 a year, and finally sold the building for \$6,000 net. The trustee should pay the expenses of foreclosure out of trust capital, should pay to the life tenant the net income of the realty during the two year period during which it was held, and should treat the \$6,000 proceeds as trust principal. Although the interest on the mortgage was due to the life tenant, and the proceeds of the sale represent mortgage principal and mortgage interest, there should be no apportionment of the proceeds.

The Louisiana and Oklahoma codes have no separate section regarding salvaging of mortgages, thus leaving the matter to be controlled by the section having to do with unproductive estates. In the California draft (sec. 11a) and the Minnesota draft (sec. 27) provision is made for the apportionment of the proceeds of the salvaging of bonds and mortgages, on the basis of the share of the income and principal accounts, respectively, in the investment. This was the New York rule prior to the adoption of a statute in that state.⁵⁷

The Restatement of Trusts, Sections 240 and 241, covers this section under the head of unproductive property, no special treatment of the salvaging of defaulted mortgages being given.

Under the common law the courts have developed two types of calculation for the disposition of mortgage foreclosure operations. In Pennsyl-

⁵⁷ N.Y. Pers. Prop. Law (McKinney, Supp. 1941) § 17-c.

vania⁵⁸ the transaction is treated as merely the sale of one type of unproductive property, with the result that the same formula employed under Section 12 is used; but according to the former rule in New York,⁵⁹ the net proceeds of the salvage were divided between life tenant and trust capital in proportion to the amount of income and capital which was invested in the mortgage, that is, the amount of defaulted mortgage interest and principal. The New York statute of 1940 allocates to principal the entire sum received on foreclosure and sale,⁶⁰ and this law was the basis for the Illinois Section 13.

Section 14. Expenses—Trust Estates.

(1) All ordinary expenses incurred, in connection with the trust estate or with its administration and management including regularly recurring taxes assessed against any portion of the principal, water rates, premiums on insurance taken upon the estates of both tenant and remaindermen, interest on mortgages on the principal or other indebtedness, ordinary repairs, trustee's regular compensation (*not including special compensation for work done in connection with the principal of the estate*) shall be paid out of income.

(2) All other expenses *including special compensation to which the trustee is entitled for work done in connection with the principal of the estate and any acceptance, distribution or termination fee which may be charged*, also attorneys' fees and other costs incurred in maintaining or defending any action to protect the trust or the property or assure the title thereof, and cost of, assessments for, improvements to property forming part of the principal, shall be paid out of principal. *Provided, however, that where attorneys fees and other costs are incurred in maintaining or defending any action to protect the trust or the property or assure the title thereof and the trustee is of the opinion that such costs were incurred on behalf of both the tenant and remainderman, or were due to the fault or cause of the tenant, the trustee may charge or apportion such costs in such manner as it may deem most equitable and the decision of the trustee shall be conclusive.* Any tax levied by any authority, federal, state or foreign, upon profit or gain defined as principal under the terms of Subsection (2) of Section 3 shall be paid out of principal, notwithstanding said tax may be denominated a tax upon income by the taxing authority.

(3) Expenses paid out of income according to subsection (1) of this section which represent regularly recurring charges shall be considered to have accrued from day to day, and shall be apportioned on that basis whenever the right of the tenant begins or ends at some date other than the payment date of the expenses. Where the expenses to be paid out of income are of unusual amount, the trustee may distribute them throughout an entire year or part thereof, or throughout a series of years. After such

⁵⁸ Nirdlinger's Estate, 327 Pa. 171, 193 Atl. 30 (1937). Consult Vaughan, The Salvage of Mortgages by Trustees, 37 Col. L. Rev. 61 (1937); Bailey and Rice, The Duties of a Trustee with Respect to Defaulted Mortgage Investments, 84 U. of Pa. L. Rev. 157 (1935); 53 Harv. L. Rev. 502 (1940).

⁵⁹ In the Matter of the Will of Chapal, 269 N.Y. 464, 199 N.E. 762 (1936); In the Matter of the Will of Otis, 276 N.Y. 101, 11 N.E. (2d) 556 (1937); Hudson County Nat'l Bank v. Woodruff, 123 N.J. Eq. 585, 199 Atl. 399 (1938).

⁶⁰ Note 57 supra.

distribution, where the right of the tenant ends during the period, the expenses shall be apportioned between tenant and remainderman on the basis of such distribution.

(4) *Where a trustee holds any parcel of real estate in trust, all ordinary expenses, as provided in sub-section (1) of this Section, of such real estate, other than the trustee's regular compensation, in excess of the income therefrom, shall be charged annually against the principal of the trust and the principal of the trust shall not be entitled to reimbursement from any net income derived from such property in any subsequent year.*⁶¹

Section 12 of the Uniform Act has been modified by the insertion of the italicized new matter and by the omission of Subsection (4) of the Uniform Act which provided for the apportionment of special taxes or assessments for improvements. The Illinois act throws somewhat more of the compensation burden on trust principal, and puts the cost of special assessments for improvements and of the carrying charges of unproductive realty wholly on trust principal.

Illustration 1.—In a trust established for a life tenant and remainderman in November 1941, the trustee holds a real estate mortgage which has been defaulted and foreclosed, and the trustee buys the land in and holds it for five years before he can sell it. Special compensation allowed the trustee for handling this mortgage and realty might well be charged to trust principal, since the entire proceeds of the transaction would go, under the act, to principal.

Illustration 2.—In a trust established for a life tenant and remainderman in October 1941, the trustee holds 1) a city lot against which a special assessment for paving is levied, 2) a vacant lot in the suburbs which produces no income and is subject to \$50 ordinary property taxes each year, and 3) a house and lot which produce an annual net income of \$500 and against which taxes for the past year are levied on January 1 of each year. The trustee should pay the special assessment and the taxes on the unproductive property out of trust principal. If the life tenant dies on February 1, 1942, his estate should pay one-twelfth of the taxes due on the following January 1 with respect to the house and lot.

Louisiana (sec. 78) adopted Section 12 of the Uniform Act entire, but Oklahoma (sec. 36) omitted Subsection (4). The proposed Minnesota Code (secs. 27 and 28) follows Subsections (1) and (2) of Section 12 of the Uniform Act, with a proviso that the court may allow part of the expenses enumerated in Subsection (1) to be charged to principal, omits Subsections (3) and (4) of the Uniform Act, and provides that the expenses of unproductive realty are to be paid out of trust principal, with a right to reimbursement in a later year if there is any net income from that property.

⁶¹ (Italics added.)

The California draft (sec. 12) copies with some variation Subsections (1) and (2) of Section 12 of the Uniform Act, negatives the rule of Subsection (3), and omits Subsection (4).

The Restatement of Trusts, Section 233, Comments e, f, g, h, i, j, and l, is in general harmonious with Illinois Section 14.

The common law cases usually support Section 14,⁶² although it is somewhat of an advance in its position regarding the duty of the remainderman to share expenses with the life tenant.⁶³ Subsection (4) with regard to the expenses of unproductive realty represents a recent trend⁶⁴ rather than the more conservative attitude of the older decisions.⁶⁵

Section 15. Expenses—Non-Trust Estates.

(1) The provisions of Section 14, so far as applicable and excepting those dealing with costs of, or special taxes or assessments for, improvements to property, shall govern the apportionment of expenses between tenants and remaindermen where no trust has been created, subject, however, to any legal agreement of the parties or any specific direction of the taxing or other statutes; but where either tenant or remainderman has incurred an expense for the benefit of his own estate and without the consent or agreement of the other, he shall pay such expense in full.

⁶² *Administrative expense*: Guthrie v. Wheeler, 51 Conn. 207 (1883); Rothschild v. Weintheil, 191 Ind. 85, 131 N.E. 917, 132 N.E. 687 (1921). *Ordinary taxes*: Bridge v. Bridge, 146 Mass. 373, 15 N.E. 899 (1888); Goodwin v. McGaughey, 108 Minn. 248, 122 N.W. 6 (1909). *Insurance*: Hast v. Wilder's Trustee, 140 Ky. 767, 131 S.W. 793 (1910); Melvin v. Hoffman, 290 Mo. 464, 235 S.W. 107 (1921). *Interest on a mortgage*: In the Matter of the Estate of Morton, 74 N.J. Eq. 797, 70 Atl. 680 (1908); Cogswell v. Cogswell, 2 Edw. Ch. (N.Y.) 231 (1834). *Repairs*: Alberts v. Steiner, 237 Mich. 143, 211 N.W. 46 (1926); Mulford v. Mulford, 42 N.J. Eq. 68, 6 Atl. 609 (1886). *Trustee's ordinary compensation*: Danly v. The Exec'r of Cummins, 31 N.J. Eq. 208 (1879); Spangler's Estate, 21 Pa. 335 (1853). *Extraordinary compensation payable from capital*: Woodruff v. New York, Lake Erie & Western R. Co., 129 N.Y. 27, 29 N.E. 251 (1891); McAfee v. Thomas, 121 Ore. 351, 255 Pac. 333 (1927). *Attorney's fees to protect capital*: Abend v. Endowment Fund Com'rs of McKendree College, 174 Ill. 96, 50 N.E. 1052 (1898); Gray v. Union Trust Co., 213 Ind. 675, 12 N.E. (2d) 931 (1938); Estate of Cole, 102 Wis. 1, 78 N.W. 402 (1899); see Damiani v. De Trana, 206 Ill. App. 64 (1917). *Capital gains income taxes*: Holcombe v. Ginn, 296 Mass. 415, 6 N.E. (2d) 351 (1937); Industrial Trust Co. v. Winslow, 60 R.I. 61, 197 Atl. 185 (1938). *Improvements voluntarily made by the trustee or paid for by special assessment*: Evans v. Ockershausen, 100 F. (2d) 695 (App. D.C. 1938); Ash v. Ash, 126 N.J. Eq. 531, 10 A. (2d) 150 (1940); Peltz v. Learned, 70 App. Div. 312, 75 N.Y. Supp. 104 (1902); Welch v. Welch, 235 Wis. 282, 293 N.W. 150 (1940). *Apportionment of taxes*: Taylor v. Bentinck-Smith, 304 Mass. 430, 24 N.E. (2d) 146 (1939).

⁶³ Bridgeport-City Trust Co. v. First Nat'l Bank & Trust Co., 124 Conn. 472, 200 Atl. 809 (1938), reluctantly follows the old rule, with a recognition of the pressure for change.

⁶⁴ Harvard Trust Co. v. Duke, 304 Mass. 414, 24 N.E. (2d) 144 (1939); Nirdlinger's Estate, 331 Pa. 135, 200 Atl. 656 (1938); Haas v. McGinn, 11 A. (2d) 284 (R.I. 1940).

⁶⁵ Bartlett v. Pickering, 113 Me. 96, 92 Atl. 1008 (1915); Creed v. Connelly, 272 Mass. 241, 172 N.E. 106 (1930); Patterson v. Old Dominion Trust Co., 156 Va. 763, 159 S.E. 168 (1931); cf. Patterson v. Johnson, 113 Ill. 559 (1885).

(2) Subject to the exceptions stated in Subsection (1) the cost of, or special taxes or assessments for, an improvement representing an addition of value to property forming part of the principal shall be paid by the tenant, where such improvement cannot reasonably be expected to outlast the estate of the tenant. In all other cases a portion thereof only shall be paid by the tenant, while the remainder shall be paid by the remainderman. Such portion shall be ascertained by taking that percentage of the total which is found by dividing the present value of the tenant's estate by the present value of an estate of the same form as that of the tenant except that it is limited for a period corresponding to the reasonably expected duration of the improvement. The computation of present values of the estates shall be made on the expectancy basis set forth in the American Experience Tables of Mortality and no other evidence of duration or expectancy shall be considered.

This is Section 12 of the Uniform Act.

Illustration 1.—In September 1941, A dies leaving a will by which he devises his city home to his widow for life, remainder to his son. In October 1941, a special assessment is levied against the property for the construction of a sewer which it is estimated will last fifty years. The expectancy of the widow is, according to the American Experience Tables, five years. If the present value of the widow's life estate is found to be \$5,000, the present value of an estate in this property to last for fifty years, the life of the improvement, will probably be about \$50,000, and hence the widow should pay one-tenth of the assessment and the remainderman nine-tenths.

Section 12 of the Uniform Act is omitted from the Louisiana and Oklahoma codes and the California and Minnesota drafts.

The Restatement of Trusts has no section regarding the material of this section.

The section is believed to be supported by the common law cases.⁶⁶

⁶⁶ The legal life tenant is under a duty to pay interest on incumbrances, *Whitney, Adm'r v. Salter*, 36 Minn. 103, 30 N.W. 755 (1886); *Chamberlin v. Gleason*, 163 N.Y. 214, 57 N.E. 487 (1900); ordinary taxes, *Hagan v. Varney*, 147 Ill. 281, 35 N.E. 219 (1893); *Clark v. Middlesworth*, 82 Ind. 240 (1882); and ordinary repairs, *Lehmann v. Rothbarth*, 111 Ill. 185 (1884); *Kline v. Dowling*, 176 Ind. 521, 96 N.E. 579 (1911); *Kearney v. Kearney*, 17 N.J. Eq. 59 (1864), *aff'd* 17 N.J. Eq. 504 (1864).

The costs of paying off incumbrances on the property and of paying for improvements or assessments thereon are to be apportioned between legal life tenant and remainderman on the basis of the expectancy of the life tenant and the probable life of the improvement. *Ure v. Ure*, 223 Ill. 454, 79 N.E. 153 (1906); *Warren v. Lower Salt Creek Drainage District*, 316 Ill. 345, 147 N.E. 248 (1925); *Thomas v. Evans*, 105 N.Y. 601, 12 N.E. 571 (1887); *Jones v. Gilbert*, 135 Ill. 27, 25 N.E. 566 (1890); *Fuller v. Devolld*, 144 Mo. App. 93, 128 S.W. 1011 (1910). But if the improvement will probably not out-last the life estate, the life tenant must bear its cost. *Huston v. Tribbetts*, 171 Ill. 547, 49 N.E. 711 (1898); *Reyburn v. Wallace*, 93 Mo. 326, 3 S.W. 482 (1887); *Warren v. Warren*, 148 Ill. 641, 36 N.E. 611 (1893). Consult *Tiffany, Real Property* §§ 63-65 (3d. ed. 1939); *Rest., Property* §§ 129-37 (1936).

Section 16. Time of Taking Effect.

This act shall apply only to estates of tenants or remaindermen of non-trust estates which become legally effective on or after the effective date of this Act, and only to trusts created by deed or agreement inter-vivos delivered on or after such date and only to trusts created by will where the testator died on or after such date.

The adoption of this act shall not be considered as declaratory of the law as it existed prior to its enactment and it shall not be so construed. Neither shall its adoption be considered as a criticism of, nor as in any way affecting methods of ascertainment of principal and income and the apportionment of receipts and expenses among tenants and remaindermen, which may have been adopted by trustees in the administration of trusts prior to the enactment of this act, nor to prevent the continued application of those methods as respects trusts to which this act is not applicable.

The first sentence of this section is the equivalent of Section 17 of the Uniform Act, but the last paragraph is new.

Illustration 1.—A died in June 1941, leaving a will by which he gave his farm to his widow for life, remainder to his daughter. The will was not probated until September 1941. The rights and duties of the widow and daughter are controlled by Illinois law as it existed before July 17, 1941, and not by the Principal and Income Act.

Illustration 2.—A trust company is trustee of a trust established in 1935 and has been accustomed not to amortize for premiums on trust investments. Notwithstanding Section 7 of the Principal and Income Act of 1941 the trust company may continue its practice, if it believes the common law of Illinois supports it in so doing.

The Louisiana act (sec. 1) limits its effect to new transactions. The Oklahoma act (sec. 54) states that it applies to new trusts "and all other wills and trust agreements and trust relations in so far as such terms do not impair the obligations of contract or deprive persons of property without due process of law under the Constitution of the state of Oklahoma or the United States of America," thus leaving for the Supreme Court of Oklahoma a nice question as to whether the act can be made retroactive. The Minnesota draft (sec. 48) applies to all trusts, except as it expressly provides otherwise. The California draft (sec. 15) applies to new trusts and "to all revocable trusts existing on and prior to that date and to all other trusts to the extent to which they may be at that or any later time amendable by the settlor in respect to matters covered by this act."

Section 17. Severability.

If any provision of this Act or the application thereof to any person or circumstance is held invalid, such invalidity shall not affect other provisions or applications of the Act which can be given effect without the invalid provision or application, and to this end the provisions of this Act are declared to be severable.

Section 18. Short Title.

This Act shall be cited as the Principal and Income Act.

Effect of the Act in General.—With the slight qualifications noted above, the Illinois Principal and Income Act of 1941 accomplishes the following results as to temporary and permanent estates, both legal and equitable, created on or after July 17, 1941:

- 1) It in many cases reaffirms the common law established by Illinois judicial decision;
- 2) where there have been no Illinois decisions the act follows the majority rules elsewhere established;
- 3) it makes the procedure for determining principal and income questions as simple and inexpensive as possible;
- 4) it makes trust and legal estate administration in Illinois easier because it establishes a symmetrical code covering all points, whereas previously there has been lack of authority and variety of practice; and
- 5) it maintains a reasonable degree of impartiality and fairness as between life tenant and remainderman.