

# EXISTING RULES OF TRUST ADMINISTRATION: A STRANGLEHOLD ON THE TRUSTEE- CONTROLLED BUSINESS ENTERPRISE

## I. THE UNINCORPORATED BUSINESS \*

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In recent years there has been growing interest among trustmen and estate planners in the problems surrounding the retention of a going concern in trust. The discussion has centered on threshold tax and nontax factors affecting the planning decision to retain rather than sell the business and on the personal liabilities of the fiduciary who continues an unincorporated business.<sup>1</sup> So far as I am aware, there has been little discussion of the effect which existing rules of trust administration have upon the vitality and financial stability of such a business.

In this article I plan to show that the provisions made by existing law for the administration of a going concern in trust are so outmoded and unworkable that neither incorporation nor careful draftsmanship can sufficiently assure its continued vitality and financial stability. The existing rules of trust administration drive the trustee to outside financing of operations which should be self-financed by the enterprise. They force the estate planner to furnish the trustee, if possible, with additional assets which can be invaded to sustain the operation of the business. The encouragement which the rules of trust administration lend to the process of outside financing and invasion of nonbusiness assets of a trust to sustain the operation of the business prevent early discovery of the financial instability of the enterprise and obscure the point at which the business should be sold to protect the interests of remaindermen.

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<sup>1</sup> See TRUST DIV., AMERICAN BANKERS ASS'N, *HANDLING BUSINESSES IN TRUST* (1959); Becker, *Trustee Management of Family Businesses*, 100 TRUSTS & ESTATES 506 (1961); Durand, *Changing Concepts of Trust Investments—Retention of Decedent's Business*, 95 TRUSTS & ESTATES 907 (1956); Polasky, *Planning For the Disposition of a Substantial Interest in a Closely Held Business, Part One—The Proprietorship*, 44 IOWA L. REV. 83 (1958); cf. Cahn, *Estate Corporations*, 86 U. PA. L. REV. 136 (1937); Comment, *The Fiduciary Aspects of Estate Corporations*, 57 MICH. L. REV. 738 (1959); Note, *The Trust Corporation: Dual Fiduciary Duties and the Conflict of Institutions*, 109 U. PA. L. REV. 713 (1961).

The existing rules of trust administration applied to a going enterprise, though poorly conceived in the first instance, have become progressively less workable in an economy suffering from a steady decline in the purchasing power of the dollar, rapid rates of obsolescence, and a tax structure which throws the main burden of these forces upon the smaller business.

Several factors seem to have rendered the application of the rules of trust administration to the trustee operated or controlled business relatively immune from reexamination. It has not been the prevailing practice of estate planners to expose a going concern, whether incorporated or not, to the tender mercies of the trust law. Few smaller concerns possess the business characteristics which are favorable to their retention as an investment component of a trust estate.<sup>2</sup> Moreover, retention in trust, rather than sale or outright disposition, must be demanded by the family situation for which a plan is prepared. Difficulties in estate tax valuation have, in general, led to widespread use of buy-sell agreements designed to control such valuation.<sup>3</sup> It should be noted, however, that certain provisions, new in the 1954 Code, have lent encouragement to retention.<sup>4</sup>

Apart from business, family, and tax considerations, a number of which will be further developed in this article, institutional trustees have been reluctant to undertake the administration of a going concern, whether in corporate or sole proprietorship form.<sup>5</sup> But the drawbacks so far discussed by trustmen pale into comparative insignificance in the light of the provision which rules of trust administration make for the continued vitality of the enterprise.

If one were not aware of the historical development of those rules, one would be inclined to conclude that they were specifically designed to lead to its improvident strangulation.

This point has not been sufficiently considered, possibly because of a belief that an unrealistic underlying law is what the good draftsman is for.<sup>6</sup> But this excuse for leaving well enough alone is not satisfactory for two reasons. The first is that the law does not exist so

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<sup>2</sup> See 1 CASNER, *ESTATE PLANNING* 740-42 (2d ed. 1956); Polasky, *supra* note 1, at 130-37; Tremayne, *Estate Planning for the Man With a Business*, 1955 WASH. U.L.Q. 40.

<sup>3</sup> RICE, *FAMILY TAX PLANNING* §§ 126-36 (1960); see Anderson, *Disposition of Business Interests*, 9 U. FLA. L. REV. 459 (1956).

<sup>4</sup> INT. REV. CODE OF 1954, §§ 303, 6166; see Washington, *Redemption of Stock v. Installment Payment of Estate Taxes*, 38 TAXES 721 (1960).

<sup>5</sup> See Cronin, *Caveat Fiduciary*, 94 TRUSTS & ESTATES 392 (1955); McClatchey, *Liability of Fiduciaries in Operating Business Enterprises*, 90 TRUSTS & ESTATES 528 (1951); cf. Trachtman, *Closely Held Businesses—Responsibilities of the Executor or Administrator*, 90 TRUSTS & ESTATES 668 (1951).

<sup>6</sup> I suspect that one could rearrange the last four words of this sentence and still remain with truth.

that only experts can make it protect the individual. The second is that an unrealistic rule in one area almost invariably results in difficulties in another. At the risk of making an unfortunate suggestion, it might be noted that provisions of a testamentary trust designed to prevent a business from being driven into the ground may result in a forfeiture of the marital deduction.<sup>7</sup>

One of the odd fallacies which seems to have taken hold of those who are willing to see the rules reformed is that it is sufficient to press for the recognition of accepted accounting practices.

### I. ACCEPTED ACCOUNTING PRACTICES AND RULES OF TRUST ADMINISTRATION

Since 1947, when United States Steel sought to introduce a system of accounting for exhaustion, wear, and obsolescence which would recover in current dollars of diminishing buying power the same purchasing power as the original expenditure,<sup>8</sup> the controversy over price-level accounting has simmered, more or less explosively, in accounting circles.<sup>9</sup> Although this article does not pretend to contribute to that controversy, it must, even at the expense of stating some fairly meaningless generalities, attempt to distinguish the particular interest of the accountant from the interests of those who are concerned with the success of the business enterprise.

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<sup>7</sup> See Treas. Reg. § 1.643(b)-1 (1956): "[I]ncome . . . means the amount of income of an estate or trust for the taxable year determined under the terms of its governing instrument and applicable local law. Trust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized for this purpose." Compare INT. REV. CODE OF 1954, § 2056(b)(5); Treas. Reg. §§ 20.2056(b)-5(f)(1), (3), (4) (1961). See pp. 546-47 *infra*.

<sup>8</sup> See McMullen, *Depreciation and High Costs: The Emerging Pattern*, 88 J. ACCOUNTANCY 302 (1949). The American Institute of Accountants early took a firm stand against price-level accounting for depreciation, stating:

An attempt to recognize current prices in providing depreciation, to be consistent, would require the serious step of formally recording appraised current values for all properties, and continuous and consistent depreciation charges based on the new values. Without such formal steps, there would be no objective standard by which to judge the propriety of the amounts of depreciation charges against current income, and the significance of recorded amounts of profit might be seriously impaired.

COMM. ON ACCOUNTING PROCEDURE, AMERICAN INST. OF ACCOUNTANTS, ACCOUNTING RESEARCH BULL. No. 33, DEPRECIATION AND HIGH COSTS (1947). In 1953 the position taken in Bulletin No. 33 was reaffirmed by the Institute's Committee on Accounting Procedure. COMM. ON ACCOUNTING PROCEDURE, AMERICAN INST. OF ACCOUNTANTS, ACCOUNTING RESEARCH BULL. No. 43, RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS 67 (1953). Six members of the Committee dissented, being of the opinion that adjustments in depreciation based on accepted price indices would offer a sufficient guarantee of objectivity. *Id.* at 69-71. Similarly, the Securities and Exchange Commission continues to disapprove price-level accounting for statements to be filed with the Commission. SEC S-X, rule 3.20(c), 20 S.E.C. ANN. REP. 107 (1954); 18 S.E.C. ANN. REP. 182 (1952).

<sup>9</sup> See Paton, *Depreciation—Concept and Measurement*, 108 J. ACCOUNTANCY 38 (1959).

### A. *The Function of Accounting and Impediments to Change*

One of the most important canons of accounting is the "going concern" concept. "Accounts are, it is said, to be prepared on the basis that the business is a going concern, not that it is to be liquidated."<sup>10</sup> This canon might conceivably support a system of accounting which would reflect the fact that in a competitive economy "it takes all the running *you* can do, to keep in one place." But the accountant has never pretended to such a broad concept of his function. Moreover, a business' failure to maintain its relative position vis-à-vis its competitors is early reflected in its income statements. The effects of inflation, however, are not so obvious. Failure to make provision for replacement at higher cost, in fact, results in an overstatement of income and may, if liberal dividend policies are pursued, lead to a gradual contraction of the enterprise. Accountants have recognized that this result is within the sphere of their concern.<sup>11</sup>

George O. May, characterizing the study made by a special group of accountants and economists appointed by the American Institute of Accountants, has aptly stated:

A major question presented by the study is whether the determination of income, as most usefully conceived, is to be regarded as an accounting task, or whether the accountant should accept, as the limit of his function, the classification of facts and transactions in terms of money, and leave the classification to be interpreted by others. In the monograph I have assumed that accountants should be qualified and prepared to perform both functions.<sup>12</sup>

However, when the determination of income "as most usefully conceived" can be accomplished only at the expense of simplicity, the accountant can afford the luxury of choosing simplicity. Provided the conventions upon which his accounts are prepared are well understood, he can leave them to be interpreted by others.

The major obstacle to reform of accounting conventions has been the federal income tax law. Except in the case of L.I.F.O. inventories, recognized in the Revenue Act of 1938,<sup>13</sup> the income tax laws have given no recognition to rising price levels, and any method of accounting

<sup>10</sup> MAY, BUSINESS INCOME AND PRICE LEVELS—AN ACCOUNTING STUDY 21 (1949).

<sup>11</sup> See Grady, *Conservation of Productive Capital Through Recognition of Current Cost of Depreciation*, 30 ACCOUNTING REV. 617 (1955); Peloubet, *Are We Giving Away Our Capital Without Knowing It?*, 18 N.Y. CERT. PUB. ACCOUNTANT 440 (1948); Van Lierde, *Price-Level Changes and Capital Consumption Allowances*, 32 J. BUS. 370 (1959).

<sup>12</sup> MAY, *op. cit. supra* note 10, at vi.

<sup>13</sup> Revenue Act of 1938, ch. 289, § 22(d), 52 Stat. 459 (now INT. REV. CODE OF 1954, § 472).

which arrives at a net income figure different from "taxable income" cannot be defended for its simplicity. In the past few years, therefore, accountants and economists concerned with the effects of rising price levels have concentrated their attack upon the federal income tax laws. The Treasury's Bulletin F has been characterized as "always an antiquated document looking backward instead of forward."<sup>14</sup> Its depreciation rates for machinery have been blamed for our slow rate of growth as compared with Canada and a number of European countries.<sup>15</sup>

To relieve the plight of smaller businesses, section 179 was added to the Internal Revenue Code in 1958.<sup>16</sup> This section permits a twenty per cent (or \$10,000, whichever is smaller) writeoff in the first year on business or income-producing property of the character which is subject to the allowance for depreciation under section 167.<sup>17</sup> Since it does not disturb the principle that depreciation be taken on original cost, section 179 will not lend impetus to a movement in favor of price-level accounting.

Likewise, recent proposals to encourage investment in new plant and equipment, such as those for allowing tax credits for such expenditures<sup>18</sup> and Representative Keogh's "reinvestment depreciation" scheme,<sup>19</sup> although they offer some relief to firms whose plans for

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<sup>14</sup> *Hearings on the Effects of Current Federal Tax Depreciation Policies on Small Business Before Subcommittees of the Senate Select Committee on Small Business*, 86th Cong., 1st Sess. 31 (1959) (statement of Joel Barlow, Covington & Burling, Washington, D.C.).

<sup>15</sup> *Hearings on Tax Depreciation Policies*, *supra* note 14, at 17-21 (app. II to statement of Maurice E. Peloubet, C.P.A., Pogson, Peloubet & Co., New York City).

<sup>16</sup> 72 Stat. 1679 (1958); see H.R. REP. No. 2198, 85th Cong., 2d Sess. 2-4 (1958).

<sup>17</sup> See Treas. Reg. § 1.179 (1960).

<sup>18</sup> An Administration proposal for tax credits based on the relationship of the investment to current depreciation would provide a credit against taxes of 15% of the amount by which the investment in new productive assets exceeds current depreciation and 6% of the amount by which the investment in new productive assets exceeds 50% of current depreciation. These credits would be limited to 30% of the tax liability in any one year, with provision for carryover. See H.R. Doc. No. 140, 87th Cong., 1st Sess. 3-6 (1961). The measure has met with severe criticism. See 2 *Hearings on the Tax Recommendations of the President Before the House Committee on Ways and Means*, 87th Cong., 1st Sess. 951-57 (1961). It is possible, however, that Congress will adopt a straight 7% or 8% credit for investments in new plants and equipment.

<sup>19</sup> H.R. 422, 87th Cong., 1st Sess. (1961). This bill would continue depreciation deductions based on cost. However, in the year of sale or abandonment of a business asset and reinvestment in any new depreciable business asset—that is, in an asset of the kind subject to the allowance for depreciation provided in § 167—it would allow an additional "reinvestment" deduction of the amount by which the reinvestment exceeds the original cost of the retired asset. No deduction would be allowed in any taxable year in excess of the difference between the original cost of the retired asset—more precisely, "the § 167A basis"—and such cost adjusted for increase in prices according to an index prepared by the Secretary of the Treasury. The basis of the new asset would be reduced by the additional deduction taken on the old, and the bill provides for carryover into two succeeding taxable years.

Substantially the same measure was contained in Rep. Keogh's H.R. 131, 86th Cong., 1st Sess. (1959), and received favorable comments from a number of leading

expansion and replacement have been disrupted by inflation, would do nothing to encourage price-level accounting, since they retain the existing method of depreciation based on historical cost.

Until federal tax laws give recognition to price-level accounting, simplicity will continue to demand adherence to traditional accounting. Both the demands of simplicity and a healthy regard for the uncertainties which would result from annual adjustment to predicted inflationary trends support traditional accounting in the context of its *normal* function of presenting data upon which those concerned with the success of a business may act intelligently.

### *B. Influence of Accounting Concepts on Rules of Trust Administration*

It is an obvious fallacy to treat principles developed for the purpose of presenting financial information as rules of conduct. Consider the effect of a corporation law prohibiting accumulation of surplus: such a law would lead either to the liquidation of most corporate enterprises or to a substantial revision of accounting principles. It is worth noting that accountants have denied responsibility for measuring the amount of funds necessary to maintain relative competitive position and have been slow to account for increasing costs of replacements, precisely because the courts have been more than reluctant to interfere with accumulation of surplus—and this proposition seems to hold quite well vice-versa.

If a corporation law prohibiting accumulation of surplus seems fantastic, what is to be said of the leading statutory contribution to trust administration, the Uniform Principal and Income Act?<sup>20</sup> The act carefully fails to provide for depreciation even on the basis of original cost,<sup>21</sup> and its specific provision for business enterprises speaks with the studied ambiguity of the Delphic Oracle. Section 7 of the act reads:

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accountants and lawyers in *Hearings on Tax Depreciation Policies*, *supra* note 14. Most experts, however, favor accelerated depreciation as the most effective method for encouraging investment in productive assets. See 2 *Hearings on Tax Recommendations*, *supra* note 18, at 951-1007. On H.R. 422, see *id.* at 1029-33 (statement of Rev. William T. Hogan, S.J., Director, Industrial Economics Program, Fordham University).

<sup>20</sup> The act has been adopted in fourteen states.

<sup>21</sup> UNIFORM PRINCIPAL AND INCOME ACT § 12. Alabama appears to be the only state in which the legislature added a provision to § 12 allowing for depreciation. ALA. CODE tit. 58, § 86(5) (1958). In adopting the act, the Texas legislature added a phrase to § 3(3): "All income after deduction of expenses properly chargeable to it, including reasonable reserves, shall be paid . . . [to the income beneficiary]." TEX. CIV. STAT. ANN. art. 7425b-27(c) (1960). (Emphasis added.) The Tax Court recently held that the added phrase must be taken to authorize reserves for depreciation. *Mary Jane Little*, 30 T.C. 936 (1958), *rev'd*, 274 F.2d 718 (9th Cir. 1960). For the question of whether a trustee may charge depreciation against income—and the tax consequences thereof—see pp. 541-52 *infra*; *cf.* *Kearney v. United States*, 116 F. Supp. 922 (S.D.N.Y. 1953).

Where such business does not consist of buying and selling property, the net income shall be computed in accordance with the customary practice of such business, but not in such a way as to decrease principal.<sup>22</sup>

The words "in accordance with the customary practice of such business," presumably are intended to adopt accepted accounting practices. Thus, depreciation based on original cost would seem to be authorized. The reference to "such business" may be a reference to the prior accounting practices of the business in question or to the practices of such businesses in general. If the former is intended, the provision is even less defensible than otherwise.

The main defect of this provision stems from the fact that the draftsmen forgot that they were preparing rules of conduct, not principles to govern financial statements. As has been stated, accountants would not long hold to existing practices if they really expected that what they designate as net income would be unreservedly distributed by those in control of the business enterprise. So what we have here is a provision which requires a course of conduct by reference to accepted accounting practices, conduct which would make the accepted practices unacceptable to accountants. A curious provision.

According to section 7, if a trustee has control over a corporation, he may be under a duty to secure the distribution of all its earned surplus, since earned surplus is admittedly net income "computed" in accordance with accepted accounting practices. We should certainly investigate the effect of such rules in the context of the incorporated enterprise held in trust.

In the opinion of one writer, the wording of section 7 is particularly felicitous because trustees are, he believes, authorized to follow the accounting practices of the settlor.<sup>23</sup> But a sole proprietor may distribute to himself all the income of his business, even reserves for depreciation. It would be a tragedy if this provision were to be read to require that the trustee follow the same practice. The sole proprietor, surely, is not concerned whether he makes provision for the continued operation of his enterprise by accumulation of assets in the business or in his personal accounts. Not so with the corporation

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<sup>22</sup> UNIFORM PRINCIPAL AND INCOME ACT §7(2). Discussion of §7 is sparse. The draftsman, Dean Charles E. Clark, said simply that "in general the rules for ascertaining profit and loss, made familiar by income tax legislation, are followed." Clark, *Interpretation of Proposed Uniform Principal and Income Act*, 54 TRUST COMPANIES 723, 725 (1932). Nossaman sets out the section in a footnote without comment. Nossaman, *The Uniform Principal and Income Act*, 28 CALIF. L. REV. 34, 44 n.39 (1939). The section is discussed with approval in Staver, *The Uniform Principal and Income Act*, 21 ORE. L. REV. 217, 244-47 (1942).

<sup>23</sup> Staver, *supra* note 22, at 247.

which distributes all of its earnings to its shareholders or with the trustee who distributes all the income of a business to his beneficiary.

It is not possible to pin one's hopes for section 7 on the enigmatic "but not in such a way as to decrease the principal." As we shall see, there is no authority in the decided cases for arriving at "principal" other than in terms of the original dollar.<sup>24</sup>

In the light of this criticism of section 7 of the Uniform Principal and Income Act as it now stands, it is worth noting what the Commissioners have done in the most recent draft of the revision of that act.<sup>25</sup> The words "customary practice of such business" have been amended to "customary accounting practice for such business" and the draft makes it explicit that "if the trustee continues the accounting practice of the owner used before the commencement of the trust, the accounting practice is a customary accounting practice." This last clause would seem to compound the suggested difficulty with the present section 7, unless the opening words are to be taken to mean "if the trustee *chooses* to continue . . . ."

In any case, reference to "customary" accounting practices is not very helpful. For example, does the revision put the trustee in a position to take advantage of section 179 of the Code, the proposed tax credits, or the proposals of Congressman Keogh? The answer is simple; neither section 179<sup>26</sup> nor the proposal for tax credits extends to trusts. I am certain also that trusts would be similarly excluded from the proposal presented by Congressman Keogh. On the surface, the reason given for excluding trusts is always that an extension of such benefits to trusts would involve difficult administrative problems in allocating the deductions or credits between the trust and its beneficiaries.<sup>27</sup> At the bottom, however, lurks the absurd and outmoded law of trust administration. How would section 179, for example, operate if it were extended to trusts?

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<sup>24</sup> See, e.g., *Mercantile-Safe Deposit & Trust Co. v. Apponyi*, 220 Md. 275, 152 A.2d 184 (1959). The recent decision in *In re Trusteeship Under Agreement With Mayo*, 105 N.W.2d 900 (Minn. 1960), raises doubts as to whether this position will be maintained with regard to the trustee's duty to pursue sound investment practices. Attempts to impose an affirmative duty to combat inflation have so far been rejected by the courts. See *Commercial Trust Co. v. Barnard*, 27 N.J. 332, 142 A.2d 865 (1958); *Estate of Spitzer*, 138 N.Y.L.J. No. 67, p. 14 (N.Y. Surr. Ct. 1957); Scully, *Changing Concepts of Trust Investments—Diversification of Investments*, 97 TRUSTS & ESTATES 912 (1958); Tenney, *The Trustee, the Stock Market and Measure of Damages*, 96 TRUSTS & ESTATES 824 (1957).

<sup>25</sup> UNIFORM REVISED PRINCIPAL AND INCOME ACT § 7 (Tent. Draft No. 2, 1961).

<sup>26</sup> INT. REV. CODE OF 1954, § 179(d) (4).

<sup>27</sup> This is the reason given for excluding trusts from the benefit of the tax credits proposed by the President, note 18 *supra*. See 1 *Hearings on Tax Recommendations*, *supra* note 18, at 260. The reason for excluding trusts from the benefit of the 20% writeoff of § 179 is not officially given, but appears to be the same. Compare H.R. 5735, 85th Cong., 1st Sess. (1957), with H.R. REP. No. 2198, 85th Cong., 2d Sess. 15 (1958).



As will appear in a fuller discussion of these points later, there remains some doubt whether a trustee can set up reserves for depreciation on original trust assets.<sup>28</sup> Section 179, of course, would come into operation only as to new assets.<sup>29</sup> As to those, trust law not only fails to draw any distinction between "replacements" and "improvements," but provides that improvements—and apparently replacements—shall be depreciated on a straight-line basis. This depreciation, in trust law, is known as "amortization." Straight line amortization of "improvements" is clearly required by section 12(4) of the Uniform Principal and Income Act. The *Restatement* envisages amortization "in accordance with such reasonable plan as [the trustee] . . . may adopt."<sup>30</sup> Professor Scott, however, assumes straight-line amortization.<sup>31</sup>

If one were able to state with certainty that the straight-line schedule is the only one allowed for this "amortization," there would still remain the question what "improvements" may be subject to this treatment. The existing authority on the question defies simple description and for this reason must be left to a subsequent part of this article.<sup>32</sup> Since straight-line amortization of improvements appears to be fair to the income beneficiary, is required by section 12(4) of the Uniform Principal and Income Act, and is favored by Scott, and since "depreciation" in general has received only sporadic and reluctant acceptance in the law of trusts, it is not unreasonable to assume that, at best, the trustee may use the straight-line method of accounting for exhaustion and wear. On this assumption, it would be absurd to extend to a trust the twenty per cent writeoff provided for in section 179 of the Internal Revenue Code, because most of it would pass through to the current income beneficiary under section 176(g). Thus

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<sup>28</sup> This is certainly the case with regard to buildings, see *In the Matter of Estate of Davies*, 197 Misc. 827, 96 N.Y.S.2d 191 (Surr. Ct.), *aff'd mem.*, 227 App. Div. 1021, 100 N.Y.S.2d 710 (1950); *Copron, Reserves Against Depreciation of Real Property Held by a Trustee*, 12 Ohio St. L.J. 565 (1951), and may extend to fixtures, see *Evans v. Ockershausen*, 100 F.2d 695 (D.C. Cir. 1938), *cert. denied*, 306 U.S. 633 (1939). The doubt has intruded itself upon trustee-controlled corporations. See *In the Matter of Hubbell*, 302 N.Y. 246, 97 N.E.2d 888 (1951); *In the Matter of Estate of Adler*, 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937). *But see In the Matter of City Bank Farmers Trust Co.*, 306 N.Y. 733, 117 N.E.2d 910 (1954). There is some support for the view that depreciation may be taken by a trustee on other than building and fixtures. The *Restatement of Trusts* does not expressly recognize depreciation on original trust assets, but refers to "machinery and farm implements" in comment (a) to § 239 authorizing "amortization" of wasting assets. The cases lend support to depreciation of business assets. See *Rafferty v. Parker*, 241 F.2d 594 (8th Cir. 1957); *In re Trust Created by Will of Bailey*, 241 Minn. 143, 62 N.W.2d 829 (1954); *In the Matter of Jones*, 103 N.Y. 621, 9 N.E. 493 (1886).

<sup>29</sup> INT. REV. CODE OF 1954, § 179(a).

<sup>30</sup> RESTATEMENT (SECOND), TRUSTS § 233, comment l (1959). See also *id.* § 239, comment b.

<sup>31</sup> 3 SCOTT, TRUSTS § 233.3, at 1759-60 (2d ed. 1956).

<sup>32</sup> See pp. 524-29 *infra*.

the ultimate justification for excluding trusts from the benefit of the twenty per cent writeoff, and from similar benefits, whether by way of additional deductions or credits, is that these measures, which are intended to rescue the smaller business from the stifling effects of the inflationary spiral, would not have their intended effect if applied to trusts because the rules of trust administration place the trustee-held business in a situation beyond rescue.

## II. THE STRANGLEHOLD APPLIED: *Holmes v. Hrobon*—AN ILLUSTRATIVE CASE

*Holmes v. Hrobon*<sup>33</sup> serves as a good illustration of the application of trust administration rules to a going concern. Clay M. Thomas died in 1938. By his will, after directing payment of certain legacies, he left his Atlas Linen, Laundry & Supply business, a sole proprietorship, to his executor as trustee, directing him to continue the business "until such a time as the same can be sold, as a going business, for a price, which, in the opinion of my said executor, and in the opinion of my . . . wife, Mae Thomas, is a reasonable value thereof . . . ." The will directed that the residuary estate, of which the business constituted a principal asset, be held in trust to pay Mae Thomas "all the income after the payment of operating expenses and taxes and other charges from my business . . . ." The trust was to cease upon her death, and the trustee was directed to convey and transfer the balance of the property to the testator's heirs at law, share and share alike.

The opening entry in the records of the executor and information scattered through the report indicate the following to have been the financial position of the trust at its inception. The plant and equipment of the Atlas business were worth \$73,191.27. There was a mortgage on the land and building of the business with unpaid principal of \$17,500. Cash and accounts receivable were approximately equal to accounts payable. Inventories were \$20,847.16. Thus, excluding accounts receivable, the operating assets of the Atlas business were \$94,038.43.

In addition to these assets the trustee received real estate (in the process of development for housing) of a value of \$156,209.69. Mortgages on this property were approximately \$97,081.<sup>34</sup> The legacies left by the testator's will amounted to \$55,000. It can be seen that, after payment of these legacies, the trustee was left with little more

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<sup>33</sup> 93 Ohio App. 1, 103 N.E.2d 845 (1951), *aff'd in part, rev'd in part*, 158 Ohio St. 508, 110 N.E.2d 574 (1953).

<sup>34</sup> The mortgage indebtedness of the estate was \$114,581. In the figure given the \$17,500 mortgage on the Atlas property was subtracted.

than the operating assets of the Atlas business subject to a mortgage debt of \$17,500.

The Atlas business was engaged in the manufacture, rental, supply, and laundering of commercial and industrial linens. The trustee continued to operate the business. Up to August 31, 1946, he paid to the widow, Mae Thomas, as income, a total of \$263,299.72<sup>35</sup>—an average of \$32,912 annually. On September 23, 1946, the widow (who had remarried) demanded that the trustee pay over to her an additional sum of approximately \$300,000 which she claimed should have been distributed to her as income of the trust. This figure included \$140,091.20 current income of the business used by the trustee for “replacements” of machinery and equipment and \$61,792.13 used for “additions” to the physical plant. It also appears that the trustee had used approximately \$100,000 of current income from the Atlas business to purchase five competing businesses in 1945.

Threatened by the widow’s demand for additional distribution, the trustee filed an action for a declaratory judgment. He asked the court to determine a whole series of questions involving every facet of his past and future administration of the business. Many of these specific questions were not directly relevant to the widow’s demand, which, as we have seen, was addressed to the validity of the trustee’s use of current income for the purchase of competing businesses and for “replacements and additions.” The meaning which the court assigned to these terms remains characteristically vague because of the absence, in the opinion, of an adequate listing of the items referred to. This, as will appear, is not so much a failure on the part of the court to divulge relevant facts as it is an example of the appalling confusion in the relevant law.

#### *A. The Trustee’s Method of Accounting*

The trustee charged the expenditures for “replacements” and “additions” to current income in the years in which they were made. He then proposed to restore (and during the years 1938 to 1946 gradually did) to the widow the cost of replacements and additions by crediting her income account with the depreciation calculated on the items so purchased. The trustee’s total expenditures on “improvements” and “additions” (not counting the cost of the competing businesses) during the years 1938 to 1946 were \$201,883.33.<sup>36</sup> By 1946 the depreciation credits amounted to \$39,823.18 for “replacements” and \$18,163.25 for “additions,” or a total of \$57,986.43. The opinion of the Ohio Court of Appeals states:

<sup>35</sup> 158 Ohio St. 508, 517, 110 N.E.2d 574, 580-81 (1953).

<sup>36</sup> Of this \$140,091.20 was for “replacements” and \$61,792.13, for “additions.”

The difference between the latter figure and \$201,883.33, the total cost of such assets purchased up to the year of 1946, will be credited back to net income of the life tenant in succeeding years so that by 1955 the total depreciation credits will equal the amount of the cost of the assets.<sup>37</sup>

When the business was sold, according to the opinion of the court, the trustee intended to distribute to the life beneficiary or her estate, out of the proceeds of sale or out of the assets of the business, an amount equal to the credits then shown on her income account.<sup>38</sup> It is difficult to accept this as a correct report of the trustee's method. It seems clear that he did not set up reserves for depreciation on the original assets of the business. In fact, his system, which was to take expenditures for "replacements" out of current income, is inconsistent with the existence of such reserves. He recognized, it appears, that the widow had a claim to the amounts taken from current income and expended upon "replacements" and "additions." Recognizing this, he might have viewed the expenditures as, in effect, forced loans by the widow to the business or forced investments by her in the productive assets purchased. If they are viewed as forced loans, the widow was entitled to a return of the entire principal amount regardless of the date on which the business happened to be sold or the widow happened to die. The trustee's reported method of accounting, however, would return to the widow or her estate the whole of her "loan" only if the business were sold or the widow died after 1955 (the date when the credits would equal the expenditures).

If the expenditures are viewed as forced investments in productive assets, the amount which should be returned to the widow is the undepreciated cost of the assets, not the depreciated cost. It is at this point that the reported method of the trustee becomes incredible. He surely did not expect to distribute the depreciated cost of assets out of the proceeds from the sale of such assets unless he kept reserves for depreciation on them. If he did keep reserves on the replaced assets, it is hard to see on what theory he sought to justify depriving the widow of the undepreciated cost of the assets. She, surely, would be entitled to a return of her entire "investment" in these assets, on the theory that any loss in the value of these assets is being restored by depreciation charges to current income. At one point, the report of the case suggests that the trustee may have planned to distribute to the widow the undepreciated cost of these assets.<sup>39</sup> This would certainly

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<sup>37</sup> 93 Ohio App. 1, 34-35, 103 N.E.2d 845, 865 (1951).

<sup>38</sup> *Id.* at 35-36, 103 N.E.2d at 865.

<sup>39</sup> *Id.* at 35, 103 N.E.2d at 865.

be acceptable, from a theoretical point of view, but only if he did not keep depreciation reserves on such assets. If he did keep depreciation reserves on such assets, it is difficult to see why the widow would be entitled to a return of all or part of the original investment before its cost had been restored out of current income but not after.

Although, as reported, the trustee's method has little to recommend it, a modified version of it is entitled to consideration:

(1) The trustee would not set up reserves for depreciation on the business assets, whether on the original assets or on replacements and additions; (2) he would charge all necessary expenditures for "replacements" and "additions" to current income; (3) as to expenditures on "replacements" he would make no further adjustments in favor of the income beneficiary; (4) he would credit all expenditures on "additions," as well as expenditures on replacements of "additions," to the income beneficiary's separate account;<sup>40</sup> (5) he would then diminish these credits for "additions" by the amount of depreciation on the assets represented by these credits; (6) when the business is sold or the life beneficiary dies, the trustee would distribute to the life beneficiary or her estate, out of the proceeds of sale or out of the assets of the business, an amount equal to the credits then shown on the income beneficiary's account.

Confined to "replacements," and apart from its incredible complexities, this method is superior to a method which merely sets up reserves for depreciation based on original cost and charges "replacements" to corpus. It enables the trustee to replace at higher cost without being driven to outside financing. Its major defect lies in its haphazard effect on annual income. If expenditures for "replacements" are kept at the same level annually the method can be defended. It should be noted that if the expenditures are kept at the same level annually the method in effect differs not at all from a depreciation reserve based on cost of replacement rather than on original cost of the asset. Such expenditures, however, may be expected to vary considerably from year to year. The fluctuations in annual income which would result would impose substantial hardship on the beneficiary.

Applied to "additions" the method poses a problem of different dimensions. Even when such expenditures are kept on a constant level from year to year, it cannot be said that this method has the same effect on income distributable to the current income beneficiary as would price-level accounting—since accountants do not purport to measure

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<sup>40</sup> The trustee would be faced with the almost impossible task of distinguishing "additions" and "replacements of additions" from replacements of original assets.

funds needed for expansion. Therefore, the question is whether, when expansion is essential to the survival of the business, the trustee should be required to seek outside financing. As we shall see, the glib solution of existing trust law is to require the trustee to charge such expenditures to corpus of the trust and amortize them, on a straight-line basis, out of income. If the corpus is the business and no more, this solution drives the trustee to outside financing. But amortization on a straight-line basis makes this unavailable, since banks do not make it a practice to agree to loans which are to be repaid over a period equal to the useful life of the asset.<sup>41</sup>

Here, then, in a nutshell, we have the problem facing the trustee whose sole asset is the business. If he sets up reserves for depreciation "in accordance with accepted accounting practices" he may find that he has insufficient funds for replacements at constantly increasing costs. This will drive him to outside financing. Outside financing is his only source of funds for necessary expansion. Whenever he is forced to seek outside financing, trust law permits him to accumulate funds for repaying the loan at a rate much slower than most lenders would accept. Even when the trustee, by some form of juggling mixed with magic, is able to keep up with his borrowings, the procedure is unsound financially, since interest which would have been moving in favor of the income beneficiary, had the trustee retained enough funds to meet the expenditures, is now moving to an outside party—a dead loss to the estate as a whole.

### *B. The Decision of the Ohio Court of Appeals—The Traditional Rule of Trust Administration*

Needless to say, the Ohio Court of Appeals did not approve the trustee's method of accounting and administration of the trust. The proper method of accounting for "replacements" and "additions," the court held, is set forth in the *Restatement of Trusts*, which requires that all improvements be charged to corpus and that:

If the improvements are not permanent in character but the probable life of the improvements is limited in duration, although the cost of the improvements is payable out of principal, the trustee is under a duty to the beneficiary entitled in remainder to amortize the cost of such improvements out of income, in accordance with such reasonable plan as he may adopt.<sup>42</sup>

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<sup>41</sup> See *Hearings on Tax Depreciation Policies*, *supra* note 14, at 4 (testimony of Maurice E. Peloubet, C.P.A., Pogson, Peloubet & Co., New York City).

<sup>42</sup> 93 Ohio App. at 36, 103 N.E.2d at 866, citing RESTATEMENT, TRUSTS § 233, comment 1 (1935). See RESTATEMENT (SECOND), TRUSTS § 233, comment 1 (1959), for substantially the same provisions.

The amortization required by the *Restatement*, the court held without discussion, "should be computed by dividing the cost of the article by the number of years of its life expectancy in use."<sup>43</sup> To summarize, the court held:

If some of the assets which are considered to be corpus are replaced, the cost is charged to the corpus and a depreciation charge should be made against the income of the life tenant for each year during the life of such replacement. The same is true with respect to additions which depreciate through use and produce income.<sup>44</sup>

So much, therefore, for the trustee's expenditures of \$201,883.33 on replacements and additions. As to the purchase of competing businesses, the court held that the trustee exceeded his powers under the trust instrument but that, having made the expenditure, he should account for it in the same manner as for the replacements and additions.<sup>45</sup> The court concluded its opinion:

The court has not formulated definite and specific answers to the questions propounded, believing that it would be sufficient to lay down fundamental principles of law which are applicable and controlling and being satisfied that counsel will be able to draw the proper journal entry therefrom.<sup>46</sup>

It is a monument to counsel's skill and endurance that they were able to draw such an entry—to appeal the decision. Let us assume that all the "replacements" and "additions" were made in the second year of operation (1940) and that their useful life was twenty years. In 1952, when the decree was entered, the trustee would be required to distribute to the widow \$80,753 because, had he charged the entire sum to corpus in the first instance, \$121,130 would by now have been amortized against income. This does not take into account the fact that in 1940, according to our best guess, the trust assets did not exceed \$100,000. How the trustee was supposed to charge \$201,883 to this corpus taxes the imagination. Even if the business assets, in 1940, consisted of \$100,000, less a reserve for depreciation of \$50,000, the expenditure for replacements and additions would involve outside financing to the tune of \$151,883. Such financing would carry interest which, according to well-settled rules of trust administration, is chargeable to income.<sup>47</sup>

<sup>43</sup> 93 Ohio App. at 38, 103 N.E.2d at 867.

<sup>44</sup> *Id.* at 36, 103 N.E.2d at 866.

<sup>45</sup> *Id.* at 33-34, 103 N.E.2d at 864-65.

<sup>46</sup> *Id.* at 83, 103 N.E.2d at 886.

<sup>47</sup> UNIFORM PRINCIPAL AND INCOME ACT § 12(1); RESTATEMENT (SECOND), TRUSTS § 233, comment 1 (1959); 3 SCOTT, TRUSTS § 233.2, at 1752-53 (2d ed. 1956).

Even if the amount which now should be distributed to the income beneficiary could be calculated by reference to assumptions as to the type of loans the trustee could have secured, the interest rates, and the number of times he would have been forced to refinance in order to keep up with schedules of repayment (bearing in mind that he is entitled only to charge the income beneficiary amortization on a straight-line basis)—assumptions which defy demonstration—, how is the trustee to provide the funds for such a distribution now?

The Ohio Court of Appeals summarized the position of the trustee under the traditional rule of trust law as follows:

Had the trustee, in the conduct of the trust thus far, confined his purchases of replacements and additions to items required to take care of the normal increase in trade, it is our opinion he would have been able to conduct the trust by securing bank loans and mortgaging trust property.<sup>48</sup>

Bearing in mind that the court had held that expenditures of about \$200,000 on "replacements" and "improvements" were required to take care of the normal increase of trade,<sup>49</sup> that the assets of the business in 1938 were approximately \$94,038.43, and that the business premises were then subject to a mortgage of \$17,500 (which the court held should have been amortized out of trust corpus<sup>50</sup>), there remains some doubt in my mind whether, had the trustee borrowed the funds, as suggested by the court, he would have had a going concern for very long.

It is a deplorable state of affairs when rules of trust administration make it impossible for a business whose net assets are \$100,000, from which the income beneficiary is receiving, as Mae Thomas was in this case, an annual return of \$32,000, to be continued in that manner. To secure a \$32,000 return invested in normal trust investments the business would have to have been sold for more than \$640,000 in 1938. This seems unlikely; the whole estate of the testator, Clay Thomas, was valued at \$89,764.90 for inheritance tax purposes, and this figure, with slight modification, was apparently accepted by the Commissioner of Internal Revenue.<sup>51</sup>

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<sup>48</sup> 93 Ohio App. at 82, 103 N.E.2d at 886.

<sup>49</sup> *Id.* at 39, 103 N.E.2d at 867.

<sup>50</sup> *Id.* at 61, 103 N.E.2d at 876-77. This is the accepted rule for mortgages upon the original trust corpus. *Kramer's Estate*, 59 Pa. D. & C. 329 (C.P. 1947); 3 *Scott, Trusts* § 233.3, at 1756 (2d ed. 1956). For an interesting recent decision, involving the application of this rule to a trustee-owned corporation which was dissolved for tax reasons, see *Freeman v. Farmer's Bank & Trust Co.*, 339 S.W.2d 427 (Ark. 1960).

<sup>51</sup> 93 Ohio App. at 18, 103 N.E.2d at 858.



### *C. Origin and Defects of the Traditional Rules*

#### 1. Apportionment of Costs Between Legal Life Tenant and Remainderman

The existing rules of trust law for the administration of physical assets held in trust were developed as an extension and modification of rules applicable to the legal life tenant and remainderman in an age when the economy was largely agrarian and when the most common physical asset was the mansion house. The rules applicable to the legal life tenant and remainderman were not well conceived themselves, and some of this confusion seems to have been projected into the area of trust administration. Because the legal life tenant was under no duty to make improvements to the property, the rules concerning "improvements" came to deal largely with repayment of mortgage principal and special assessments for municipal improvements.<sup>52</sup> That is, the rules dealt with "forced" improvements only.

When the legal life tenant was forced to repay the principal of a mortgage on the property, or when he was forced to pay a special assessment for municipal improvements, the common law required that the expenditure be apportioned between the life tenant and remainderman.<sup>53</sup> The favored formula for apportionment was to require the life tenant to pay the present worth of the annual interest payments on the principal expenditure over the remaining period of his life.<sup>54</sup> Since the remainderman would pay the balance out of pocket, the rule was fair only if the value of the improvement at the end of the period of the life tenant's tenure was at least equal to the total expenditure on the "improvement." Under the stated rule the remainderman, in effect, was required to pay out of pocket the present worth of the principal expenditure to be received at the end of the life tenant's tenure. If the value received by the remainderman at the end of the period was less than the principal expenditure, the rule would work to the financial detriment of the remainderman. Fortunately, in the cases for which this rule was developed, the value received by the remainderman was most likely to be equal to the original expenditure. This would be so, by definition, in the case of an expenditure for the repayment of mortgage principal because, regardless of the value of the property, the added value free of debt would be exactly equal to the debt removed. The rule as to improvements as between legal life

<sup>52</sup> See, e.g., *In re Estate of Dailey*, 117 Mont. 194, 203-07, 159 P.2d 327, 331-33 (1945); *Appeal of Datesman*, 127 Pa. 348, 359, 17 Atl. 1086, 1087 (1889).

<sup>53</sup> 1 TIFFANY, REAL PROPERTY § 63, at 89; § 64, at 95-96 (3d ed. 1939).

<sup>54</sup> *In re Estate of Dailey*, 117 Mont. 194, 203-04, 159 P.2d 327, 332 (1945); 4 KENT, COMMENTARIES \*74-75; 1 STORY, EQUITY § 487 (13th ed. 1886); TIFFANY, REAL PROPERTY § 63 (3d ed. 1939).

tenant and remainderman also made provision for the case where the improvement was not likely to outlast the life tenant. In such a case the life tenant alone was required to bear the cost.<sup>55</sup>

So far as I have been able to determine, however, no thought seems to have been given to the case of an improvement which, while it will outlast the life tenant, is of a character which depreciates in use. To force the remainderman to contribute out of pocket the present worth of an improvement which at the end of the period taken in the calculation of its present worth will be worth less than the principal sum on which the calculation was based is to deprive the remainderman of the interest on his contribution. Moreover, if the improvement is worth less at the end of that period than his contribution at the beginning, the remainderman has sustained a loss in capital. The Uniform Principal and Income Act, in an effort to improve upon the old formula, requires the remainderman to contribute at the beginning of the period the value of the "improvement" at the end of the period.<sup>56</sup> This, of course, still deprives the remainderman of interest on his contribution.

## 2. Adaptation to Trust Administration

When this confusion was first contemplated by those who sought to state a clear rule for trust administration, it seemed to them that its worst difficulty would automatically be avoided by requiring that all "improvements" be charged to principal. Since the source of payment here is a fund to which the remainderman is entitled only in the future, the objection that he receives no interest is removed. There remained only the question of improvements which suffer loss in value through use. This, it was believed, could be handled by requiring the trustee to "amortize" such improvement out of income over its useful life.<sup>57</sup>

It should be noted that even on its own assumptions, all of which fail miserably when applied to a business, the above rule does not solve the problem of self-generation of physical assets received in trust. The amortization permitted under the rule begins only when the "improvement" is made. Thus, if all the assets of the trust wear out and have to be replaced on the same day, the rule literally requires that the replacement be charged to a nonexistent corpus and amortized out of a

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<sup>55</sup> See, *e.g.*, *Hitner v. Ege*, 23 Pa. 305 (1854).

<sup>56</sup> UNIFORM PRINCIPAL AND INCOME ACT § 13(2).

<sup>57</sup> An early case, *Plympton v. Boston Dispensary*, 106 Mass. 554 (1871), required the income beneficiary to restore the cost of the improvement through an annual interest charge. Since the going rate of interest has little, if anything, to do with rates of wear and tear and obsolescence, there is hardly anything to recommend this rule.

nonexistent income. As will be shown, the trust law was forced reluctantly to recognize that amortization may start with the assets received in trust. Recognition of this problem came so late that it was tacked on, halfheartedly, under the heading "wasting assets," so that the subject of wear and tear and obsolescence, instead of being treated under its own proper heading is dealt with under two, one being the rule as to "improvements" and the other the rule as to "wasting assets."

Since my criticism of the law on this subject is addressed to the result obtained under these rules, whether taken separately or together, I prefer to take them separately—just as they present themselves in the authorities on the subject. The main defense of these rules would appear to lie in an appeal to certainty and in the claim that they represent the accumulated wisdom of the ages. Fortunately, it is comparatively easy to demonstrate that neither are they very certain in their application nor do they go back very much further than the *Restatement of Trusts*.

### 3. The Rule That All "Improvements" Must Be Charged to Corpus

#### *a. Modern Expression*

The rule as to "improvements" is stated by Professors Bogert<sup>58</sup> and Scott,<sup>59</sup> and is expressed in the *Restatement*<sup>60</sup> and in the Uniform Principal and Income Act.<sup>61</sup> However, each of these statements, when fully developed, contains an element which is not present in the others.

Bogert,<sup>62</sup> Scott,<sup>63</sup> and the *Restatement*<sup>64</sup> draw a distinction between "permanent" and "temporary" improvements. The *Restatement* requires that the cost of improvements which are "not permanent in character" be paid initially out of corpus, but that the trustee is under a duty to amortize their cost out of income, "in accordance with such reasonable plan as he may adopt."<sup>65</sup> According to the *Restatement* there should be no amortization of improvements which are "permanent in character."<sup>66</sup> What is to be understood by the words "improvement" or "permanent in character" is not made clear in the *Restate-*

<sup>58</sup> BOGERT, TRUSTS AND TRUSTEES § 601, at 380 n.27, 381 n.28 (2d ed 1960).

<sup>59</sup> 3 SCOTT, TRUSTS § 233.3, at 1759 n.13 (2d ed. 1956).

<sup>60</sup> RESTATEMENT (SECOND), TRUSTS § 233, comments k, l (1959).

<sup>61</sup> UNIFORM PRINCIPAL AND INCOME ACT § 12(2).

<sup>62</sup> 4 BOGERT, TRUSTS AND TRUSTEES § 803, at 128 (1948).

<sup>63</sup> 3 SCOTT, TRUSTS § 233.3, at 1759 n.11 (2d ed. 1956).

<sup>64</sup> RESTATEMENT (SECOND), TRUSTS § 233, comments k, l; § 239 (1959).

<sup>65</sup> *Id.* §§ 233, 239.

<sup>66</sup> *Id.* § 233, comment k.

ment, or indeed anywhere else. But the *Restatement* regards erection of buildings as an improvement "permanent in character."<sup>67</sup>

The Uniform Principal and Income Act, on the other hand, requires amortization of improvements through a retention out of income each year of "a sum equal to the cost of the improvement divided by the number of years of the reasonably expected duration of the improvement."<sup>68</sup> This formulation may or may not include the building which is excluded by the *Restatement*, since even the most durable of buildings possesses a "duration." If this is one point of difference between the Uniform Principal and Income Act and the *Restatement*, it introduces a whole congeries of shadowy distinctions. For example, under the *Restatement*, improvements upon buildings may not be amortizable whereas they may be under the act. The reference to "reasonably expected duration" is unfortunate because it appears to exclude obsolescence.

Professor Scott's discussion generally mirrors that of the *Restatement*. But there is one interesting departure. Where Scott speaks of improvements the cost of which the trustee is required to amortize, he refers to them as "improvements [which] are not of a permanent nature . . . especially where the probability is that they will not last longer than the probable duration of the trust."<sup>69</sup>

Professor Bogert also makes some reference to "determining whether the improvement will outlast the life tenant."<sup>70</sup> It is not clear whether he is speaking of the rule obtaining in connection with legal life tenant and remainderman or whether he is suggesting a test for determining whether an improvement is "permanent" or "temporary" in the trust context.

As to "temporary" improvements Professor Bogert states that "the trustee should pay the cost *out of income*, or if he pays it out of trust capital the corpus of the trust should be reimbursed from the income . . . by annual contributions."<sup>71</sup> As we have seen in connection with *Holmes v. Hrobon*, it makes a good deal of difference whether "temporary" improvements are to be paid out of corpus in the first instance or out of income. The matter cannot be treated lightly.

Enough has been said to make the point that if, for some reason, the case law were to become inaccessible to the student, he would not

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<sup>67</sup> *Ibid.*

<sup>68</sup> UNIFORM PRINCIPAL AND INCOME ACT § 12(4). This provision was not included in the act as adopted by Pennsylvania. See PA. STAT. ANN. tit. 20, § 3470.1-13 (Supp. 1960).

<sup>69</sup> 3 SCOTT, TRUSTS § 233.3, at 1759 n.13 (2d ed. 1956). (Emphasis added.)

<sup>70</sup> 4 BOGERT, TRUSTS AND TRUSTEES § 803, at 128-29 (1948).

<sup>71</sup> BOGERT, TRUSTS AND TRUSTEES § 601, at 380 n.27 (2d ed. 1960). (Emphasis added.)

be able to tell from the leading texts and principal legislation whether all improvements must be charged to corpus in the first instance or whether some—the ones which are to be classified as “temporary”—may be charged to income. He would not be able to tell what is meant by “improvements”—for example, whether this also covers replacements. He would not be sure how he is supposed to tell a “permanent” improvement from a “temporary” one—whether it be a distinction drawn in terms of bulk and solidity, in terms of useful life, in terms of life (whether useful or not), in terms of useful life as compared with the expected duration of the trust, or in terms acceptable to accountants.

The cases do not offer much relief in these respects. As we have seen in *Holmes v. Hrobon*, no distinction is made in the cases between “improvements” and “replacements.”<sup>72</sup> I believe that we can safely reject the suggestion contained in Scott and Bogert that in determining what is a “permanent” improvement we should compare the duration of the improvement to the duration of the trust.<sup>73</sup> The suggestion represents a confusion with rules applicable to legal life tenant and remainderman, themselves ill-conceived on this point.<sup>74</sup>

Putting aside, for the moment, the question of buildings, which the *Restatement* treats unequivocally as “permanent,” we find that refrigerators have been held to be permanent improvements<sup>75</sup> and elevators, curiously enough, to be “temporary.”<sup>76</sup> Boilers and furnaces have uniformly been treated as permanent.<sup>77</sup> But a new roof has been treated as “temporary.”<sup>78</sup> Thus, even if we confine ourselves only to the more recent cases, it can be seen that the rule as to “improvements” cannot be regarded as a model of clarity or certainty.

<sup>72</sup> See *Estate of Roberts*, 27 Cal. 2d 70, 79-81, 162 P.2d 461, 467-68 (1945); *In the Matter of Trust Estate of Sellers*, 31 Del. Ch. 158, 173, 67 A.2d 860, 868 (1949); *In re Trust of Shurtz*, 242 Iowa 448, 454-57, 46 N.W.2d 559, 563-64 (1951); *In the Matter of Estate of Adler*, 164 Misc. 544, 552, 299 N.Y. Supp. 542, 553 (Surr. Ct. 1937); *Third Nat'l Bank & Trust Co. v. Reihold*, 80 N.E.2d 591, 602 (Ohio P. Ct. 1947).

<sup>73</sup> See *In the Matter of Trust Estate of Sellers*, *supra* note 72, at 168, 67 A.2d at 865, where the court referred to the test as the principle of law but apparently failed to apply it.

<sup>74</sup> See text accompanying notes 54-55 *supra*.

<sup>75</sup> *Evans v. Ockershausen*, 100 F.2d 695, 707 (D.C. Cir. 1938), *cert. denied*, 306 U.S. 633 (1939); *Hill v. Fill*, 57 F.2d 438 (D.C. Cir. 1932). *Contra*, *Estate of Roberts*, 27 Cal. 2d 70, 79-81, 162 P.2d 461, 467-68 (1945); *In re Bohmert's Will*, 102 N.Y.S.2d 394, 397 (Surr. Ct. 1950).

<sup>76</sup> *In the Matter of Estate of Adler*, 164 Misc. 544, 557, 299 N.Y. Supp. 542, 558-59 (Surr. Ct. 1937); *Third Nat'l Bank & Trust Co. v. Reihold*, 80 N.E.2d 591, 602 (Ohio P. Ct. 1947).

<sup>77</sup> *In the Matter of Trust Estate of Sellers*, 31 Del. Ch. 158, 173, 67 A.2d 860, 868 (1949); *In re Trust of Shurtz*, 242 Iowa 448, 455-56, 46 N.W.2d 559, 563 (1951).

<sup>78</sup> *Estate of Roberts*, 27 Cal. 2d 70, 79-81, 162 P.2d 461, 467-68 (1945).

*b. The Early Cases*

For the rule that all "improvements" must be charged to corpus the most miscited early case is *Stevens v. Melcher*.<sup>79</sup> There are, of course, many earlier cases, but they do not add any refreshing touch to the problem which concerns us.<sup>80</sup> *Stevens v. Melcher* is of interest to us because, I believe, it correctly represents the early approach to the problem.

Paran Stevens died on April 25, 1872. By the fifth clause of his will he left \$1,000,000 in trust to pay the income to his wife for life, remainder to their children. To the trust the executor allocated an apartment building valued at \$550,000. It was later discovered that there were latent defects in the building which rendered it unsafe. These defects were remedied at a cost of \$33,707.31. In addition, the trustees expended \$130,000 on a new building. The referee found that the latter expenditure added \$90,000 to the permanent value of the property and accordingly directed that the sum should be charged to corpus of the trust, the balance to be paid out of the income. He directed that the expenditure of \$33,707.31 for extraordinary repairs to the apartment house be charged to corpus. The appellate division confirmed his report on both these points. The court of appeals affirmed the decision allocating the expenditure of \$130,000 on the new building, \$90,000 to corpus and \$40,000 to income,<sup>81</sup> but reversed the decision charging \$33,707.31 in respect of extraordinary repairs to corpus. Instead, it held that this expenditure should be borne by the executor (before the \$1,000,000 trust was constituted).<sup>82</sup>

The treatment accorded to the expenditure for the new building hardly supports a hard and fast rule that all "improvements," par-

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<sup>79</sup> 80 Hun 514, 30 N.Y. Supp. 625 (App. Div. 1894), *modified*, 152 N.Y. 551, 46 N.E. 965 (1897).

<sup>80</sup> See, e.g., *Abell v. Abell*, 75 Md. 44, 64, 23 Atl. 71, 74 (1892); *Parsons v. Winslow*, 16 Mass. 361 (1820).

The early English cases are confused because they represent a struggle in the context of the settlement with the rule applicable to legal life tenant and remainderman, which requires all *voluntary* improvements be paid by the life tenant. *In re Speer's Trusts*, 3 Ch. D. 262 (1876); *In re Leslie's Settlement*, 2 Ch. D. 185 (1876); *Drake v. Trefusis*, L.R. 10 Ch. 364 (1875); *In re Leigh's Estate*, L.R. 6 Ch. 886 (1871); *Dent v. Dent*, 30 Beav. 363, 54 Eng. Rep. 929 (Ch. 1862); *Dunne v. Dunne*, 3 Sm. & G. 22, 65 Eng. Rep. 546 (Ch. 1855); *Caldecott v. Brown*, 2 Hare 144, 67 Eng. Rep. 60 (Ch. 1842); *Hibbert v. Cooke*, 1 Sim. & St. 552, 57 Eng. Rep. 218 (Ch. 1824). In fact, the Settled Land Act, 1882, 45 & 46 Vict. 18, c. 38, § 26, first clearly allowed improvements to be charged to corpus. "[T]he leading purpose of the Legislature was to prevent the decay of agricultural and other interests occasioned by the deterioration of lands and buildings in the possession of impecunious life-tenants." *Bruce v. Marquess of Ailsbury*, [1892] A.C. 356, 363. It is interesting to reflect that by virtue of the rule first clearly sanctioned by that act, we are now facing the reverse problem, namely, the deterioration of a business in the possession of an opulent life tenant.

<sup>81</sup> 152 N.Y. at 571-72, 46 N.E. at 969-70.

<sup>82</sup> *Id.* at 575, 46 N.E. at 971.

ticularly buildings, must be charged to corpus. The court of appeals noted that erection of this building would substantially enhance income, and the allocation of the cost was sustained on the equitable basis that the permanent value of the buildings would be no more than \$90,000. The approach which weighs the increase in the income against the ultimate benefit to be derived by the remainderman is found in a number of the early cases.<sup>83</sup>

The most interesting aspect of the case is the citation by the appellate division to *Ferguson v. Ferguson*.<sup>84</sup> In that case, trustees expended £2,914, 9s, 10d for the completion of rental cottages left unfinished by the testator. Because it was not feasible to charge corpus with this expenditure, the court ordered that the expense be paid by the income beneficiaries. The court ordered, further, that the income beneficiaries should have a lien against the corpus of the trust for the repayment of their advance, and, having found the useful life of the cottages to be forty years, the court ordered that this lien be reduced annually by £58, 5s, 9d, or one-fortieth of the principal expenditure.<sup>85</sup> It is fascinating to find at least one case which supports the modified version of the method used by the trustee in *Holmes v. Hrobon*.<sup>86</sup>

In New York, the *Restatement* rule charging all "improvements" to corpus and amortizing "temporary" improvements out of income was not established until 1942, and then only by reference to the *Restatement* itself.<sup>87</sup> Before 1942 the uniform rule was that "those who receive the benefit must pay the cost."<sup>88</sup> I do not wish to be taken as favoring a return to the rule of *Stevens v. Melcher*, or *Ferguson v. Ferguson*, which would cause income to contribute to improvements, in lump sum, an amount which is fair, taking into account the increased income, the availability of other sources, and the benefit conferred on the remainderman. On the contrary, I point to those cases only for two salutary principles: (1) that in arriving at the figure which should be contributed by income we consider the benefits derived by the income beneficiary and compare them with the benefits derived by the remainderman; (2) that in determining how the contribution is to be made (and I am certainly in favor of spread-

<sup>83</sup> See *Jordan v. Jordan*, 192 Mass. 337, 342-43, 78 N.E. 459, 460 (1906); *Little v. Little*, 161 Mass. 188, 202, 36 N.E. 795, 796 (1894); *Hudson County Nat'l Bank v. Woodruff*, 122 N.J. Eq. 444, 451, 194 Atl. 266, 270 (Ct. Err. & App. 1937).

<sup>84</sup> 17 L.R. Ir. 552 (Ch. 1886).

<sup>85</sup> *Id.* at 580-81.

<sup>86</sup> See p. 518 *supra*.

<sup>87</sup> In the Matter of Estate of del Drago, 179 Misc. 383, 389, 36 N.Y.S.2d 811, 819 (Surr. Ct. 1942).

<sup>88</sup> Matter of Parr, 45 Misc. 564, 568, 92 N.Y. Supp. 990, 992 (Surr. Ct. 1904), *aff'd mem.*, 113 App. Div. 921, 100 N.Y. Supp. 1133 (1906), citing *Stevens v. Melcher*, 80 Hun 514, 30 N.Y. Supp. 625 (App. Div. 1894), *modified*, 152 N.Y. 551, 46 N.E. 965 (1897).

ing it to avoid violent fluctuations in the income beneficiary's return), we consider whether the scheme is workable.

#### 4. Operation of a Business Under the "Wasting Assets" Rule

The rule concerning improvements favored by all the authorities is plainly unworkable because it does not come into operation until an "improvement" is made. A trustee who is directed to retain a group of business assets for the production of income can take little comfort from the proposition that when these assets need to be replaced he can thereafter regenerate the process by amortization against income.<sup>89</sup>

The curious approach of trust law to this problem is evidenced by the fact that there is no discussion in the leading texts under the heading "Depreciation." Professor Scott, for example, states under the heading "Repairs and Improvements" that reserves out of income for future improvements are not favored "since this would be unfair to the income beneficiary, who would obtain no advantage from the improvements . . . ." <sup>90</sup> Under the heading "Wasting Property" he states that reserves for depreciation are sanctioned in trust law for "wasting assets" which include machinery and farm implements, but he cites no authorities.<sup>91</sup> In fact, the rule as to wasting assets did not, until the *Restatement* made it do so, sanction "amortization."

Confined to the type of assets with which we are concerned—personal property or fixtures which depreciate in use—the rule, always based on the presumed intention of the testator, had two aspects: (1) If the asset was specifically bequeathed in legal life tenancy and remainder, or if it was bequeathed as a gift of residue but there appeared an intention on the part of the testator that the asset was to be retained and enjoyed *in specie* by the life tenant, the legal life tenant was entitled to its full enjoyment and to all of its income, and he was not accountable to the remainderman for the normal depreciation or consumption of the asset.<sup>92</sup> (2) If the asset was bequeathed as part of a gift of the residue without an intention of the testator that it be enjoyed *in specie*, the doctrine of *Howe v. Earl of Dartmouth*<sup>93</sup> required that the asset be sold and the proceeds reinvested in safe investments for the benefit of life tenant and remainderman. The corollary of the

<sup>89</sup> See pp. 523-24 *supra*.

<sup>90</sup> 3 SCOTT, TRUSTS § 233.3, at 1761 (2d ed. 1956).

<sup>91</sup> *Id.* § 239, at 1857.

<sup>92</sup> As to specific bequests, see *Christley's Ex'r v. Meddis*, 45 Ky. (6 B. Mon.) 35 (1845); *Healey v. Toppan*, 45 N.H. 243 (1864); *Spear v. Tinkham*, 2 Barb. Ch. 211 (N.Y. 1847); *Robertson v. Collier*, 1 Hill Ch. 370 (S.C. Ct. App. 1833). As to residue, see *Holman's Appeal*, 24 Pa. 174 (1854); *Alcock v. Sloper*, 2 My. & K. 699, 39 Eng. Rep. 1111 (Ch. 1833).

<sup>93</sup> 7 Ves. Jr. 137, 32 Eng. Rep. 56 (Ch. 1802).



doctrine was that if the sale of the asset was delayed, the legal life tenant was entitled only to a return equal to that which he would have enjoyed had the asset been so sold and reinvested.<sup>94</sup> These rules were faithfully followed by the courts in the context of equitable life tenancies and remainders under a trust.<sup>95</sup> The only aspect of the rules which supports something resembling "amortization" is the corollary of the doctrine in *Howe v. Earl of Dartmouth*, but this is hardly the same thing as the "amortization" sanctioned in the *Restatement*.

The rate of return measuring the right of the income beneficiary under the English rule was three per cent,<sup>96</sup> while the American cases support variously four to six per cent.<sup>97</sup> The choice of the rate is dependent upon what is regarded as "the usual rate of income upon a safe investment."<sup>98</sup> A "safe investment" in a business enterprise produces the return it produces because someone is making the investment safe by holding back, out of the profits, considerably more than the original cost of the assets committed to the enterprise. Therefore, the corollary of the rule in *Howe v. Earl of Dartmouth* is not the same thing as a depreciation reserve on the assets.

It is well settled that, in the absence of testamentary or statutory authorization to continue a decedent's business,<sup>99</sup> the executor or trustee is under a duty to sell, the business being regarded as a "wasting asset."<sup>100</sup> If the sale is delayed for some unavoidable reason, the early cases all apply the corollary of the doctrine of *Howe v. Earl of*

<sup>94</sup> *Buckingham v. Morrison*, 136 Ill. 437, 453, 27 N.E. 65, 67 (1891); *Mudge v. Parker*, 139 Mass. 153, 154, 29 N.E. 543 (1885); *Westcott v. Nicherson*, 120 Mass. 410 (1876); *Kinmonth v. Bingham*, 87 Mass. (5 Allen) 270, 276 (1862); *Cairns v. Chaubert*, 9 Paige 159, 162-63 (N.Y. Ch. 1841); *Matter of Miller*, 64 Misc. 232, 240, 119 N.Y. Supp. 52, 57 (Surr. Ct. 1909), *aff'd per curiam*, 138 App. Div. 885, 122 N.Y. Supp. 1136, *aff'd mem.*, 199 N.Y. 564, 93 N.E. 1124 (1910).

<sup>95</sup> *Dexter v. Dexter*, 274 Mass. 273, 174 N.E. 493 (1931); *Knox's Estate*, 328 Pa. 177, 183-84, 195 Atl. 28, 31-32 (1937); *Industrial Trust Co. v. Parks*, 57 R.I. 363, 375-76, 190 Atl. 32, 36-37 (1937); *Leach v. McCreary*, 183 Tenn. 128, 135, 191 S.W.2d 176, 179 (1945); *McFadden v. Blair*, 42 Tenn. App. 435, 304 S.W.2d 93 (1956).

<sup>96</sup> See, e.g., *In re Claytor*, [1905] 1 Ch. 233. Four per cent for war and post-World War I years, *In re Parry*, [1947] Ch. 23; *In re Beech*, [1920] 1 Ch. 40.

<sup>97</sup> See *Kinmonth v. Bingham*, 87 Mass. (5 Allen) 270, 280 (6%); *Matter of Miller*, 64 Misc. 232, 240, 119 N.Y. Supp. 52, 57 (Surr. Ct. 1909), *aff'd per curiam*, 138 App. Div. 885, 122 N.Y. Supp. 1136, *aff'd mem.*, 199 N.Y. 564, 93 N.E. 1124 (1910) (4%). The UNIFORM PRINCIPAL AND INCOME ACT §10 sets 5%. This section was deleted in the 1947 revision of the Pennsylvania act. The commissioners' comment states that the section, whose application turned on whether there was a duty to convert, was difficult to apply and that the matter is best left to the existing case law.

<sup>98</sup> *Kinmonth v. Bingham*, *supra* note 97, at 278.

<sup>99</sup> 3 SCOTT, TRUSTS § 230.4 (2d ed. 1956).

<sup>100</sup> *Moran's Estate*, 261 Pa. 269, 104 Atl. 285 (1918); see ATKINSON, WILLS §§ 121-22 (2d ed. 1953); *cf. Nagle's Estate*, 305 Pa. 36, 156 Atl. 309 (1931). The rule extends to controlling interests in a closely held corporation. SIMES & FRATCHER, CASES ON FIDUCIARY ADMINISTRATION 317 (1956).

*Dartmouth* to the receipts from the business.<sup>101</sup> In fact, for assets such as "machinery and farm implements" only one case has been found to support the "amortization" method of the *Restatement*.<sup>102</sup> The Uniform Principal and Income Act, it may be noted, faithfully renders the common-law rule in section 10. Except for the enigmatic provision of section 7, relating to businesses, there is nothing in the act supporting depreciation on original assets, whether "wasting" or otherwise. As to businesses, the old cases are clear that they must be sold, unless a different intention appears; that if sale is delayed, the current beneficiary is entitled to no more than the normal rate of return on "safe investments"; and that if an intention appears that the business be retained, the settlor is presumed to have intended that all of the profits be distributed to the current income beneficiary. There is no room in this structure for depreciation reserves, and there was no case supporting them until quite recently.

This history accounts for the fact that Professor Scott states, on the one hand, that depreciation reserves on original assets are frowned upon and, on the other, that amortization of "wasting assets" is required and that wasting assets include "farm implements and machinery" but not buildings.

It is believed, therefore, that when accounting for depreciation became better understood and the need for it on original assets became evident, the subject was tacked on for lack of a better place under the heading "wasting assets." The process involved, among other things, a misinterpretation of the corollary to the doctrine in *Howe v. Earl of Dartmouth*. That corollary, I believe, contains the seeds of a sound solution to the administration of businesses in trust. But the development of this point must be left until later. Meanwhile, the energies of trustmen have been channelled to developing, under the heading "wasting assets," a rule which would allow for cost or inventory value depreciation. The process has been hampered by the fact that the older cases, whenever an intention to retain such assets appeared, regarded this as an indication that all of the profits thereof should go to the current income beneficiary.

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<sup>101</sup> See cases cited note 94 *supra*. Professor Bogert refers to these cases for the proposition that "a portion of the current income should be amortized to be added to capital unless the instrument otherwise directs *so as to maintain the original dollar value of the capital*." 4 BOGERT, TRUSTS & TRUSTEES § 832, at 323 (1948). (Emphasis added and footnotes omitted.) Maintaining the original dollar value of the capital, which is the effect of depreciation on trust inventory value, is not the same thing as what these cases require. See *McFadden v. Blair*, 42 Tenn. App. 434, 304 S.W.2d 93 (1956), for a collection of cases.

<sup>102</sup> *Matter of Housman*, 4 Dem. 404, 414 (N.Y. Surr. Ct. 1886). Actually, the court applied the older equitable principle discussed in connection with "improvements" that the life tenant must contribute a reserve which is justified by the degree to which these assets increase the income of the estate.

In the case of buildings, moreover, there has always existed a feeling on the part of the judiciary that any loss in value is purely theoretical.<sup>103</sup> In a period of rising land values and inflation such loss may continue to impress the courts as being theoretical until shortly before the building collapses. In any case, depreciation on buildings held in trust has been uniformly disapproved.<sup>104</sup> The rule has intruded itself upon real estate corporations held in trust.<sup>105</sup> As to depreciation of other assets, the indications are inauspicious.<sup>106</sup>

Fortunately, in the area of our main concern, we can point to the present enigmatic provision of section 7 of the Uniform Principal and Income Act,<sup>107</sup> which would appear to permit depreciation in the case of business assets held in trust. Whether the provision would be sufficiently potent to modify the general reluctance to approve depreciation on buildings remains open to question. One of the earliest cases permitting depreciation on business assets confined itself to personal property.<sup>108</sup> Two recent cases, however, taking a bold step forward, approve depreciation on all depreciable business assets.<sup>109</sup> Moreover, the Uniform Revised Principal and Income Act would require trustees to set up reserves on all depreciable assets.<sup>110</sup>

The adoption of such a provision or the universal recognition of the position taken in the two cases just mentioned would certainly render redundant the treatment of wear and tear in the context of a business held in trust under the existing two headings, "improvements" and "wasting assets." But it would not render redundant the

<sup>103</sup> See *Matter of Fifth Madison Corp.*, 297 N.Y. 155, 161-62, 77 N.E.2d 134, 136 (1948). Compare *North Carolina Midland Ry. v. United States*, 163 F. Supp. 610, 612 (Ct. Cl. 1958) (on effects of obsolescence).

<sup>104</sup> For a collection of authorities and criticism, see Copron, *Reserves Against the Depreciation of Real Property Held by a Trustee*, 12 OHIO ST. L.J. 565 (1951); Propp, *Depreciation of Buildings Held in Testamentary Trusts*, 19 N.Y. CERT. PUB. ACCOUNTANT 170 (1949).

<sup>105</sup> In the *Matter of Hubbell*, 302 N.Y. 246, 97 N.E.2d 888 (1951); In the *Matter of Estate of Adler*, 164 Misc. 544, 556, 299 N.Y. Supp. 542, 558 (Surr. Ct. 1937). *But see* In the *Matter of City Bank Farmers Trust Co.*, 306 N.Y. 733, 117 N.E.2d 910 (1954).

<sup>106</sup> See In the *Matter of Estate of Adler*, *supra* note 105 (denying depreciation on an elevator); *Matter of Chapman*, 32 Misc. 187, 66 N.Y. Supp. 235 (Surr. Ct. 1900), *aff'd*, 59 App. Div. 624, 69 N.Y. Supp. 1131, *aff'd*, 167 N.Y. 619, 60 N.E. 1108 (1901) (denying depreciation on a ferryboat).

<sup>107</sup> See pp. 511-13 *supra*.

<sup>108</sup> In the *Matter of Jones*, 103 N.Y. 621, 624, 9 N.E. 493, 495 (1886).

<sup>109</sup> *Raffety v. Parker*, 241 F.2d 594 (8th Cir. 1957); *In re Trust Created by Will of Bailey*, 241 Minn. 143, 62 N.W.2d 829 (1954). These cases rest heavily on settlor's intent and broad discretionary clauses. *Re Robertson*, [1951] Ont. 309, 312, 317-19, [1951] 3 D.L.R. 241, 244, 249-51, contains the best statement of the reasons for depreciation (2½% on building). *But see* *Holmes v. Hrobon*, 93 Ohio App. 1, 82-83, 103 N.E.2d 845, 886 (1951), *aff'd in part, rev'd in part*, 158 Ohio St. 508, 110 N.E.2d 574 (1953).

<sup>110</sup> UNIFORM REVISED PRINCIPAL AND INCOME ACT § 11(1)(b) (Tent. Draft No. 2, 1961).

lessons to be learned from the development which caused the subject to be so mistreated. Nor would it solve the problem discussed in this article.

#### 5. The Inadequacy of a Rule Allowing Reserves for Depreciation Based on Original Cost

Had the benefit of this recent trend been available to the trustee in *Holmes v. Hrobon*, the Atlas business entrusted to his care would have been destroyed less rapidly but as decisively as it would had the decision of the Ohio Court of Appeals been permitted to stand.<sup>111</sup>

The trustee started in 1938 with plant and equipment valued at approximately \$74,000. Part of this figure represents building and land. The trustee did not replace the building. Assuming therefore that the land and building account for \$20,000 of this figure (it should be recalled that there was a \$17,500 mortgage on these), the trustee's reserves for depreciation would have to have started from a base of \$54,000. Even if it had been depreciated and replaced twice over between 1938 and 1946, this would account for only \$108,000 in replacements. The trustees, in fact, expended \$140,000 on "replacements." The discrepancy between this figure and the opening entry for plant and equipment must be based on two factors. The testator, Clay Thomas, made no provision on the books of the business for depreciation. At his death he had assets, in addition to the business, sufficient to pay \$55,000 in pecuniary legacies. Assuming, for the sake of argument, that these assets represented the reserve he failed to set up on the books of his business, it is possible that the replaced assets cost somewhere in the neighborhood of \$110,000. The difference between this figure and the cost of replacement may be due to the fact that between 1938 and 1946 the increase in cost of wholesale commodities was 54%.<sup>112</sup>

In other words, if the testator had made provision for depreciation based on original cost and the trustee had continued this practice, the reserves thus established would not have been sufficient to absorb the replacements because of the intervening drop in the purchasing power of the dollar. Moreover, the trustee also expended \$61,792.13 on "additions" and, so far as we can tell, \$100,000 on competing businesses. These sums could not have been produced by a reserve for depreciation. The Ohio Court of Appeals, it is true, held that the

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<sup>111</sup> The court of appeals categorically denied the trustee's right to set up reserves for depreciation. 93 Ohio App. 1, 82-83, 103 N.E.2d 845, 886 (1951).

<sup>112</sup> The Bureau of Labor Statistics figures show that the wholesale price index rose from 51.1 in 1938 to 78.7 in 1946. See U.S. BUREAU OF THE CENSUS, DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 1961, at 329.

trustee exceeded his authority in purchasing the competing businesses. But it did not address itself to the question whether the Atlas business could have been operated profitably without this move.

I do not think that it requires demonstration that the trustee did an excellent job. Unquestionably he could not have done it under the existing rules of trust administration, even as modified by soothing references to "accepted accounting practices." The most these practices would allow are reserves for depreciation based on original cost. The begrudging recognition given to such practices in the law of trusts suggests that the trustee at best may expect to receive approval for depreciation on long-drawn-out straight-line schedules. On this basis, the twin factors of rising prices and obsolescence will alone create a financial crisis for the trustee. To keep the business afloat in the face of these factors and in the face of competition, the traditional trust law provides two solutions, one of which is more or less unworkable and both of which are unsound.

The trustee may be authorized to borrow. As we have seen, the system devised for him, whether it be called depreciation or amortization of "improvements," will not put him in funds sufficiently quickly to meet the normal schedules of repayment.

The trustee may be furnished—by a far-sighted estate planner—with substantial additional assets which he may invade when necessary to the operation of the business. There are indications that, at common law, an express direction contained in the will to continue the decedent's business did not empower the executor or trustee to venture any other assets of the estate.<sup>113</sup> If this position had been clearly adhered to,<sup>114</sup> more, if estate planners had been expressly prohibited from providing for the invasion of other trust assets to sustain the operations of the business, the results would be unsatisfactory but infinitely better than the results obtained under the existing law. As it is, well-informed trustees will insist on a clause which permits them to use the general assets of the trust for purposes of the business.<sup>115</sup>

It is at this point that the solution of the *Restatement* and other authorities, which require that all "improvements" be charged to corpus and that some—the ones classified as "temporary"—be amortized out of income, takes on a sinister and fallacious hue. The effect

<sup>113</sup> *Willis v. Sharp*, 113 N.Y. 586, 21 N.E. 705 (1889); In the Matter of Kohler's Will, 193 App. Div. 8, 24, 183 N.Y. Supp. 550, 562 (1920), *rev'd on other grounds*, 231 N.Y. 353, 132 N.E. 114 (1921); *Hake v. Dilworth*, 96 S.W.2d 121, 124 (Tex. Civ. App. 1936); *cf.* *Sulzer's Estate*, 323 Pa. 1, 7, 185 Atl. 793, 795 (1936).

<sup>114</sup> Compare *Sulzer's Estate*, *supra* note 113, at 7, 185 Atl. at 795; *Parry's Estate*, 244 Pa. 93, 90 Atl. 443 (1914).

<sup>115</sup> TRUST DIV., AMERICAN BANKERS ASS'N, HANDLING BUSINESSES IN TRUST app. B, at 87 (1959); Golden, *Perpetuating Family Business Through Estate Planning*, 99 TRUSTS & ESTATES 906, 918 (1960) (regards this as "doubtful wisdom").

on a very profitable, well-managed business which has not been provided with additional working capital has its perfect illustration in *Holmes v. Hrobon*. Its effect is to stifle and destroy the business.

But it is its effect on a less profitable and possibly mismanaged business whose trustee has been furnished with substantial "working capital" by a provident estate planner which is particularly deplorable. Let us assume, for example, that the Atlas business came into the hands of the trustee with equipment and machinery valued at \$100,000 in 1938. Let us assume that the trustee was expressly authorized to set up reserves for depreciation and was furnished, in addition, with a well-diversified portfolio of securities valued at \$50,000 in 1938. Let us assume further that the trust instrument directed the trustee to continue the business for the benefit of the widow and then to transfer the business to a son (then in high school) with the expressly stated hope that the son become interested in and continue the family business. Under the existing rules of trust administration the trustee would have paid to the widow approximately \$45,000 annually during the years 1938-1946. This figure may be obtained as follows: The trustee completely depreciated and replaced the machinery received in 1938 and this depreciation reserve, together with the salvage value of the old machinery, contributed \$120,000 to the replacement of the new. The replacements cost \$140,000 because of the rise in price levels experienced between 1938 and 1946. But since the reserve for depreciation will benefit somewhat from the inflation if placed in shares of stock, and since the salvage value of the machines may also increase, we have assumed that only \$20,000 of this replacement cost would be unaccounted for. Moreover, it should be remembered that the replacements were not all made in the last year of a period over which price levels rose 54%. The extra \$20,000 was charged to corpus—to the securities which by that time had increased in value, let us assume, to \$80,000. The trustee also charged approximately \$60,000 for "additions" to these securities. In the actual case, the trustee charged replacements and additions costing approximately \$200,000 to current income. He also charged the cost of purchasing the competing businesses to income, but since the Ohio Court of Appeals held that this was not authorized,<sup>116</sup> let us eliminate this purchase and also the income which was used for this purpose. The Atlas business, we know, paid to the widow approximately \$250,000. If we eliminate its purchase of competing businesses and the income used in that purchase, it is not unlikely that the income of the business would have been \$450,000 during the period 1938-1946. In our hypothetical case,

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<sup>116</sup> See note 45 *supra* and accompanying text.

the trustee may have retained approximately \$90,000 as a reserve for depreciation on the original machinery (assuming a \$10,000 salvage value); the balance would have been paid out as income to the widow. This is \$45,000 annually.

In liquidating \$20,000 of the securities to pay for the inflationary increase in the cost of the machinery, the trustee, in effect, distributed capital to the widow. It might be objected that if the trustee continues to depreciate the new machinery, the dollar amount of this expenditure will be preserved for the remainderman and that the courts have not recognized that the remainderman is entitled to demand that the trustee protect him against inflation.<sup>117</sup> But the fact remains that if the trustee had kept the \$20,000 in a reasonably diversified portfolio the remainderman would have been protected. However, this is not the important objection to the trustee's action in respect of the \$20,000. The important objection is that the next eight-year period, 1946-1954, saw a 29% increase in cost of wholesale commodities.<sup>118</sup> But the trustee had exhausted the fund against which further replacements might have been charged. He had liquidated all the additional securities given to him.

The objection to invading corpus for the purpose of keeping up with rising price levels, in a business which can easily make provision for its own replacements out of its own income, is that ultimately the additional fund must be exhausted and if, at that point, trust law still denies the trustee's right to make provision for replacements out of income, the business will have to look to outside financing—which brings us back to the first unworkable solution.

Moreover, like any other business, the Atlas business needed "additions," and it is surely no surprise that it needed to meet or eliminate competition. It could, as the trustee demonstrated in the actual case, have made provision for these needs and still paid \$32,000 annually to the widow. But under the existing rule the trustee would be required to invade whatever additional corpus he is fortunate to receive in order to keep up with these needs. All the while, he is converting securities which carry a return of 4½ to 5% to the income beneficiary into business assets which carry fantastic returns but which involve greater risk and suffer the ravages of inflation and obsolescence.

But there is a more fundamental objection to the encouragement which the rules of trust administration lend to the process above described. The Atlas business was extremely well managed and extremely profitable. Suppose that the business produced income which,

<sup>117</sup> See pp. 512-15 *supra*.

<sup>118</sup> See U.S. BUREAU OF THE CENSUS, DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 1961, at 329 (1946: 78.7; 1954: 103.3).

if the business were required to bear the cost of its own survival, would result in a net return on the investment of 1%. The existing rule of trust administration would too long delay the discovery of this fact if the trustee is permitted to liquidate securities to pay for the replacements and additions needed in the business and distribute the business income which should have been used for this purpose. A business with an investment of \$100,000, which should retain \$9,000 per annum to pay a return of \$1,000, can be made to look good by charging the \$9,000 to the corpus of the trust, thus converting a return of \$1,400 (\$1,000 on a provident business, and \$400 on \$9,000 in securities) into a return of \$10,000 on the "improvement."

While I do not suggest that any trustee would be guilty of such mismanagement, nevertheless, with less extreme figures the nature of the process may be less obvious. And the process itself is decisively encouraged by the existing rules of trust administration concerning "improvements." The existing rules of trust administration, in refusing to allow—or better, to require—the trustee to make provision for replacements and necessary improvements in the business out of the business income, are unsound because they would destroy a profitable business where no additional assets are furnished the trustee and sustain a poor business where such assets are furnished.

#### *D. The Making of a Sound Rule*

The decision of the Supreme Court of Ohio in *Holmes v. Hrobon*, reversing in part the court of appeals decision, is perhaps one of the most underestimated developments in the area of trust administration since the Statute of Uses. On the essential point of trust administration, the court held as follows:

Giving full consideration to the desire of the testator that the Atlas business be continued, the history of its past operation, the fact that it had always been operated and expanded out of earnings, the complete lack of capital with which the trustee could operate, the amount of profits realized from the business during the latter years of operation by the testator and the impossibility of operation by the trustee without using a portion of the income as capital, we conclude that it was the intention of the testator to and he did authorize the use by the trustee of income in the operation and expansion of Atlas, even though such use reduced the amount of profits currently available for payment to the widow. The right of the trustee to so use income would exist only so long as the business was operated profitably and the widow received a reasonable amount of the income.<sup>119</sup>

<sup>119</sup> 158 Ohio St. 508, 520-21, 110 N.E.2d 574, 582 (1953).



While the court emphasized what it found to be the intention of the testator, it is my contention that the normal rule for administration of businesses in trust should be substantially the one which the testator was said to have intended in this case. In the preceding discussion I have attempted to state a number of reasons which have brought me to the point of urging a clear and unequivocal adoption of such a rule.

Rules of trust administration, it is true, do not belong to a sector of the law in which those to whom it applies may be said to have had no opportunity to fashion the results. Nevertheless, the law's own plan for the administration of estates must be one which does least damage to the normal interests of those who fail to fashion a plan of their own. My conclusion rests partly on the points already labored—that the plan now existing is unsound in a practical sense and disappoints the expectations of decedents who, unfortunately, are not in a position to register this fact. My argument, however, does not rest simply on a concern for the improvident. The provident also are not well served by the plan. In urging a clear-cut recognition of a new rule, I am not insensitive to the concern of those who regard the law of trust administration as a set of rules designed primarily to hold in check the incompetent and fraudulent trustee. I suspect, however, that this concern belongs to an era which has long passed and that its strength, sustained by careful choice of teaching materials, is interfering unreasonably with the proper development of the law. In any case, the rule for which I am arguing will, I believe, meet all the requirements born of caution and suspicion.

While the Supreme Court of Ohio suggested, in broad terms, the rule which should obtain in the administration of businesses held in trust, it subjected this to a qualification in detail which, on reflection, should be rejected. The trustee was ordered to set up on his trust accounts a figure representing the net assets of the trust existing at the inception of the trust—an "intact value." The court stated:

The books of account must be so kept that annual statements will reflect the total net assets of the trust and reflect both the unchanging value of the corpus and the additional capital resulting from expenditure of income. It would seem obvious that at any given time the latter element of capital, to wit, the amount thereof resulting from investment of income, will be the difference between the total net assets and the original and unchanged value of the corpus.<sup>120</sup>

The court declared that when the business is sold or the trust terminates, the widow or her estate will be entitled to this difference.

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<sup>120</sup> *Id.* at 523, 110 N.E.2d at 583.

The scheme approved by the court should be compared with the modified version of the trustee's method of accounting discussed earlier.<sup>121</sup> Under that version, the corpus is allowed to keep investments of income which represent replacements at increasing costs. The income beneficiary is entitled only to the depreciated worth of additions. But that method is not urged as a solution here because it suffers from most of the defects which make the "intact value" method unacceptable. It is an improvement over the "intact value" method only to the extent that it does not distribute to the current income beneficiary all inflationary increases in the cost of replacements, all increases in market value not due to reinvestment of income, and the value of intangibles such as good will. The court made no attempt to meet the question of intangible worth, stating that the allocation of this would have to be determined when the distribution occurs.<sup>122</sup>

In theory, the court's decision differs little from the Pennsylvania apportionment rule applied to corporate distributions. There has been growing dissatisfaction with the rule with the result that jurisdictions originally adhering to it have one by one abandoned it.<sup>123</sup> The rule is based on the idea that the current income beneficiary of a trust holding shares of a corporation has an equitable claim to his proportionate share of the undistributed earnings accumulated since the inception of the trust. This claim, if it is recognized, remains inchoate until the corporation or the trustee makes some move which would deprive the current income beneficiary of the possibility of receiving undistributed earnings by way of cash dividend. One such move, for example, is the declaration by the corporation of a stock dividend.

To protect the income beneficiary against the supposed loss of his interest in the earnings capitalized to support a stock dividend, the rule requires calculations which would baffle an electronic computer. Invariably, their result is to secure to the corpus beneficiaries no more than the original dollar value of the corporate investment. Because book values are used liberally and thoughtlessly, the inevitable consequence of the computations, if expressed in terms of market values, is to confer upon the current income beneficiary a windfall and to inflict upon the corpus a substantial loss.<sup>124</sup>

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<sup>121</sup> P. 518 *supra*.

<sup>122</sup> 158 Ohio St. at 523, 110 N.E.2d at 583.

<sup>123</sup> See Cohan & Dean, *Legal, Tax and Accounting Aspects of Fiduciary Apportionment of Stock Proceeds: The Non-Statutory Pennsylvania Rules*, 106 U. PA. L. REV. 157 (1957); Niles, *Fosdick, Cunningham and Chaos*, 98 TRUSTS & ESTATES 924 (1959).

<sup>124</sup> For example, in *Mercantile Safe-Deposit & Trust Co. v. Apponyi*, 220 Md. 275, 152 A.2d 184 (1959), through the application of the rule, the income beneficiary received shares with a total market value of \$68,250, although only \$8.75 per share, representing \$8,750 for the trust's 1,000 shares, had been transferred from earned

In a recent Maryland case,<sup>125</sup> the trustee argued vainly that the income beneficiary was entitled to no more of the dividend shares than are necessary to reflect, at current market values, the amount of the transfer from earned surplus to capital account in respect of such shares. Alternatively, he argued that in determining whether corpus has suffered by reason of the dividend, the original dollar value of the corporate stock held by the trustee (in this case the 1915 value) must be adjusted by means of an appropriate price index.

It is this last argument, rejected by the court, which touches on the fundamental fallacy of the rule. By it, the trustee sought to secure recognition of the fact that, under accepted accounting practices, it is difficult to say how much of the surplus is tied up in replacements at constantly increasing costs. Furthermore, surplus is the business community's solution to the fact that accountants do not purport to measure funds necessary for preserving the relative competitive position of the enterprise. How much of any given surplus represents income which could be distributed without impairment of the going nature of the enterprise cannot easily be determined.

A greater understanding of these factors has worked a change in the arguments advanced against the Pennsylvania apportionment rule. While early dissatisfaction with the rule centered on its complexities and the resulting cost of administration, the more recent attacks have centered on its basic unfairness. The presumptions that the testator intended the current income beneficiary to receive all of the income of a going enterprise has become untenable in the modern economy.<sup>126</sup> It is no longer possible to visualize a tolerably well-informed testator expecting a company to remain operative in an inflationary and competitive economy without a surplus. It is, therefore, impossible to attribute to him, without more, an intention to make that surplus available to the current income beneficiary.

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surplus to the capital account. In contrast, the corpus suffered a net loss in market value of \$76,250 through the court's contenting itself with maintaining the intact value of the 1,000 shares—based on their stated value in 1915, when the trust was created.

<sup>125</sup> *Mercantile Safe-Deposit & Trust Co. v. Apponyi*, *supra* note 124.

<sup>126</sup> See *Cunningham Estate*, 395 Pa. 1, 11-13, 149 A.2d 72, 78-79 (1959):

Present day economic conditions, particularly in the corporate field, present a drastic contrast to the economic conditions in existence at the inception of and during the formative years of the Rule . . . . The sole justification for [the rule] . . . must rest upon the theory that that which corporate management labels as reinvested earnings, earnings, earned surplus, etc., is actually corporate income which has been earmarked and set aside *solely* for eventual distribution to the shareholders. Under modern corporate methods, however, such accounts may be and are set up for various and sundry reasons, for example, to cover future expansion, cost of equipment, future contingencies or reserves for losses in business, etc. and that which is labelled "earnings" may and often does represent items other than income, such as capital gains.

I have stressed the progress of this consideration because it seems to me that if it plays a part in the movement away from the Pennsylvania rule, its force is infinitely greater in the context of a rule which affects directly the conduct of a business. In short, if the argument against the Pennsylvania rule is that it imputes to the testator an intention consistent only with the theoretical destruction of a business—theoretical because such apportionments do not interfere with the conduct of a corporation—it is even more persuasive against the rule adopted by the Ohio Supreme Court in *Holmes v. Hrobon*.

### III. ESTATE AND TAX PLANNING CONSIDERATIONS

This solution to the problem of financing the operation and survival of a business—allowing the trustee to use current income, when necessary, but requiring him ultimately to distribute to the current income beneficiary or his estate the difference between the “intact value” of the business when received in trust and the proceeds of sale or the value of the business at the time of such distribution—must be rejected.<sup>127</sup> It creates, in the name of dubious considerations of equity, a situation which is unsound from the tax viewpoint.

#### *A. The Tax Situation*

If the underlying law of trust administration frankly acknowledges that income used for the necessary restoration and improvement of the productive facilities of a business held in trust must ultimately be accounted for to the current income beneficiary, it would seem clear that the trust must be classified as a “complex” trust for federal income tax purposes. “Complex” trusts, as they are fondly called by students of the subject, are all those trusts which do not qualify for treatment under subpart B of subchapter J, relating to what are over-optimistically called “simple” trusts.

In order to determine whether a trust is “simple” or “complex,” the relevant test for our purposes is whether it provides for the distribution of all its income currently;<sup>128</sup> and “income,” for this purpose, is income as determined under the governing instrument or the applicable local law.<sup>129</sup>

Mindful of the fact that reference to “the governing instrument” might permit settlors to escape the unfavorable rules applicable to “complex” trusts, the regulations provide that “trust provisions which

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<sup>127</sup> Besides *Holmes v. Hrobon*, *Weschler's Estate*, 212 Pa. 508, 61 Atl. 1091 (1905), is the only case found to support the “intact value” approach.

<sup>128</sup> See INT. REV. CODE OF 1954, § 651.

<sup>129</sup> INT. REV. CODE OF 1954, § 643(b).

depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized for this purpose."<sup>130</sup> We shall shortly consider the question how far the "local law" could shift the existing lines drawn between "principal" and "income" without objection that it has overstepped the tolerance of the congressional reference to local law.

The "intact value" solution of the Ohio Supreme Court, however, recognizes that sums reinvested out of current income for necessary replacement, renovation, and improvement of business assets do not lose their essential characteristic as "income" under local law. A trust treated to this rule, therefore, is clearly a "complex" one. This will cause problems when the business is sold and the trustee distributes to the current income beneficiary the difference between the net proceeds of sale and the "intact value" of the business. The distribution, under the pass-through provisions of the 1954 Code, will be taxed to the current income beneficiary to the extent that the trust had "distributable net income" in the year of distribution.<sup>131</sup>

"Distributable net income" is defined in section 643(a) as "the taxable income of the . . . trust," computed with certain modifications. One of the modifications is that capital gains "shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year . . . ." <sup>132</sup> The first serious tax problem posed by the "intact value" solution is whether the capital gains realized on the sale of the business are or are not "paid, credited or required to be distributed" within the meaning of this provision. For example, let us suppose that the "intact value" of the business was \$100,000. The business was sold for \$200,000, which resulted in ordinary income to the trust of \$50,000 and capital gain of \$50,000. The trustee distributes \$100,000 to the current income beneficiary. It is clear that to the extent that the \$50,000 ordinary income of the trust was "taxable income" of the trust, the distribution to the beneficiary will be taxed to him as ordinary income. The question is whether the additional distribution of \$50,000 represents the capital gain or something else. On this question there exists considerable doubt.<sup>133</sup>

The regulations state that capital gains are ordinarily excluded from distributable net income, and are not ordinarily considered as "paid, credited or required to be distributed" to any beneficiary unless they are:

<sup>130</sup> Treas. Reg. § 1.643(b)-1 (1956).

<sup>131</sup> INT. REV. CODE OF 1954, § 652.

<sup>132</sup> See INT. REV. CODE OF 1954, § 643(a) (3).

<sup>133</sup> See Berger, *Taxation of Capital Gains Realized by Trusts*, 12 TAX L. REV. 99 (1956).

(1) Allocated to income under the terms of the governing instrument or local law by the fiduciary on its books or by notice to the beneficiary,

(2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or

(3) Utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.<sup>134</sup>

Clearly, (3) is inapplicable to the "intact value" solution since the amount to be distributed to the beneficiary is not measured by the capital gains realized on sale. In *Dravo Trust*,<sup>135</sup> a Pennsylvania Orphans' Court had to consider who should bear the burden of the federal capital gains taxes when the trustee sells stock and the proceeds are apportioned between the current income beneficiary and the corpus under the Pennsylvania rule.<sup>136</sup> The accounting for the tax, approved by the court, indicates that the court viewed the proceeds apportioned to the current income beneficiary as a distribution of the gains realized on the sale of the stock. This characterization of the distribution to the current income beneficiary accords with the function of the Pennsylvania rule which is to secure to the income beneficiary so much of the proceeds from the sale of the stock, in excess of intact value, as represents "earnings" accumulated in respect of such stock since the inception of the trust. This reasoning is equally applicable to the distribution of the proceeds of sale of a business required by the "intact value" solution. Thus there is support in this case for the view that local law would regard the distribution as capital gains. But the reason given for this view would support the contrary conclusion when the problem is not whether the distribution is a distribution of a taxable capital gain or of nontaxable corpus but whether it is a distribution of taxable capital gain or an "accumulation distribution" governed by the five-year "throwback" of section 666.

If the distribution of \$50,000 in our example is not to be characterized as a distribution of capital gains realized by the trust in the year of sale, it is a distribution which will come under the five-year "throwback" rule of section 666 applicable to "complex" trusts. The \$50,000 will then have to be carried back by the beneficiary into each of the preceding five years and he will be required to report the amount

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<sup>134</sup> Treas. Reg. § 1.643(a)-3(a) (1956).

<sup>135</sup> 99 Pittsb. 397 (Pa. Orphans' Ct. 1951).

<sup>136</sup> *Nirdlinger's Estate*, 290 Pa. 457, 139 Atl. 200 (1927), extended the rule to sale of stock.

on his own returns to the extent that the trust had, in each of these years, "undistributed net income" as defined in section 665. The character of the amounts thus taken into income on his own returns will be the same as the character of the amounts constituting the trust's undistributed net income—most likely ordinary income. Whether it will be to the advantage of the beneficiary to have the distribution classified as a distribution of capital gains in the year of distribution rather than as an "accumulation distribution" depends on the amounts of "undistributed net income" accumulated by the trust in the preceding five years and the tax brackets of the beneficiary.

The proposed amendment to section 643(a)(3)<sup>137</sup> would facilitate for the trustee and beneficiary the choice of the alternative which produces the lowest tax. Absent this amendment, however, under the "intact value" solution, the beneficiary stands to be exposed to a substantial tax liability under the throwback rule. There are other problems with the "intact value" solution. It does not frankly acknowledge the right of the trustee to set up reserves for depreciation. While the "intact value" solution has the same effect as a reserve confined to the original assets of the business, in its treatment of replacements and additions it is strictly a hand-to-mouth operation. This may result in serious problems as to whether it is the beneficiary or the trust which is entitled to depreciation deductions in any particular year.<sup>138</sup>

In addition, the "intact value" solution may result in a substantial estate tax liability, for, if the business is not sold before the life beneficiary dies, the trustee must distribute to the life beneficiary's estate an amount equal to the difference between the intact value and the current value of the business. The five-year throwback rule does not apply to final distributions of a trust made more than nine years after

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<sup>137</sup> H.R. 9662, 86th Cong., 2d Sess. (1960); see H.R. REP. No. 1231, 86th Cong., 2d Sess. 6-7 (1960); *Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code Before the House Committee on Ways and Means*, 86th Cong., 1st Sess. 245-359 (1959). The amendment provides that the capital gain will be considered "paid, credited, or required to be distributed" to the beneficiary to the extent that "(ii) the books or records of the estate or trust or notice to the beneficiary shows an intention to pay or credit such amounts to the beneficiary during the taxable year." H.R. 9662, § 103(b), 86th Cong., 2d Sess. (1960).

<sup>138</sup> Compare INT. REV. CODE OF 1954, §§ 642(e), 167(g); Treas. Reg. § 1.167(g)-1(b) (1956). Under these sections, and the regulations, the deduction would go entirely to the current beneficiary in any year in which the trust did not make any replacements or improvements and, therefore, paid out all of its income to the beneficiary. In *Kearney v. United States*, 116 F. Supp. 922 (S.D.N.Y. 1953), the court, applying the New York authorities denying depreciation on real estate held in trust (see note 103 *supra*), held that the deduction inured entirely to the benefit of the current income beneficiary and that the trust could not claim a net operating loss deduction carryback and carryover of a loss which would have been shown only if the trust had been allowed the deduction for depreciation. Compare *Mary Jane Little*, 30 T.C. 936 (1958), *rev'd*, 274 F.2d 718 (9th Cir. 1960).

the date of the last transfer to such trust.<sup>139</sup> If the current income beneficiary dies less than nine years after the date of the last transfer to such trust, and the trustee is forced to sell the business in order to distribute the required amount to the estate of the life tenant, all the problems discussed with regard to capital gains would be present and compounded by the fact that any distribution to the estate of the deceased beneficiary which is not to be thrown back will be includible in the gross estate of the beneficiary.<sup>140</sup>

The current income beneficiary may, conceivably, be able to renounce or disclaim the right to the additional distribution. The regulations state that a renunciation of ownership in property received by gift, devise, or intestacy "within a reasonable time after learning of the existence of the transfer," if permitted and effective under local law, does not constitute a transfer by such person for gift tax purposes.

In any case where a refusal [renunciation or disclaimer] is purported to relate to only a part of the property, the determination of whether or not there has been a complete and unqualified refusal to accept ownership will depend on all of the facts and circumstances in each particular case, taking into account the recognition and effectiveness of such a purported refusal under local law.<sup>141</sup>

If the right to the additional distribution under the "intact value" solution is considered as part of and indivisible from the right to current income, there is some doubt under local law whether that part of the right can be disclaimed or renounced.<sup>142</sup> If the right is classified as a power of appointment or invasion, a disclaimer or renunciation of such power—in whole or in part—is well recognized under local law.<sup>143</sup> If it is not so classified, some doubt remains. Under the broad wording of section 3 of the Pennsylvania Estate Act of 1947, clearly the current income beneficiary could disclaim the right to the additional distribution.<sup>144</sup> Other statutory provisions are not so clear.<sup>145</sup>

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<sup>139</sup> INT. REV. CODE OF 1954, § 665 (b) (4).

<sup>140</sup> See INT. REV. CODE OF 1954, § 2033. This point seems to have been overlooked in *Second Nat'l Bank v. Dallman*, 209 F.2d 321 (7th Cir. 1954), which arose under § 811 (a) of the 1939 Code, the predecessor of § 2033.

<sup>141</sup> Treas. Reg. § 25.2511-1(c) (1959).

<sup>142</sup> PAGE, WILLS § 1410 (3d ed. 1941).

<sup>143</sup> See, e.g., *District of Columbia v. Lloyd*, 160 F.2d 581 (D.C. Cir. 1947); *Central Hanover Bank & Trust Co. v. Hutchinson*, 22 N.J. Super. 78, 91 A.2d 654 (Ch. Div. 1952); *Lyon v. Alexander*, 304 Pa. 288, 156 Atl. 84 (1931). The matter is now generally covered by statute. See, e.g., N.J. STAT. ANN. § 46:2A-2 (Supp. 1961); statutes cited notes 144, 145 *infra*.

<sup>144</sup> PA. STAT. ANN. tit. 20, § 301.3 (1950).

<sup>145</sup> See, e.g., N.Y. REAL PROP. LAW § 183.



If disclaimer or renunciation is not effective under local law, an assignment of the right to the trust will be a transfer subject to the gift tax and, because of the retention of the right to income from the trust, subject also to the estate tax.<sup>146</sup> These tax problems should not be visited—in the name of dubious considerations of equity—on beneficiaries of a trust which is operating a business.

*B. Adequacy of Express Provisions in the Trust Instrument*

We have seen that even a clear recognition of the power of the trustee to set up reserves for depreciation will not suffice to keep certain businesses afloat. It may be objected that the step is as far as the rules of trust administration should go and that the settlor must provide, if he wishes, for the setting aside of additional reserves to meet the rising costs of replacements and improvements necessary to the survival of his enterprise. My answer to this is that if the settlor left the business in trust, the presumption should be that he wanted it to survive as a going enterprise, and that he should be asked to state explicitly that this was not his intention. There is more to this point. Under the existing rule of trust administration, a settlor whose only substantial asset is a profitable going enterprise, one which could readily be administered by competent trustees in unincorporated form, is forced to give his trustees a mandatory direction or an explicit discretion to set up additional reserves out of income. Because the local law refuses to recognize that the legitimate needs of a going enterprise must be met before one can arrive at what it to be regarded as distributable income, it seems clear that the mandatory direction or discretion given to the trustee is a direction or discretion to accumulate income in the local law sense. This has the following unfavorable consequences to the estate plan as a whole:

(1) The trust is a "complex" accumulating trust subject to the five-year throwback if the trust terminates less than nine years after the last transfer to it.

(2) The trust cannot be easily qualified for the marital deduction in cases where it is considered a wise precaution that the surviving spouse should only be given a general power of appointment by will. The "specific portion" language of section 2056(b)(5), new in the 1954 Code, makes it possible for a settlor to take advantage of the maximum marital deduction although his only substantial asset is the business. However, section 2056(b)(5) requires that the surviving spouse be given, in addition to the general power to appoint by will, "all the income from the entire interest, or all the income from a specific por-

<sup>146</sup> INT. REV. CODE OF 1954, § 2036.

tion thereof." The regulations, on the question what constitutes "all the income" state that this condition, expressed in section 2056(b)(5) is met:

If the effect of the trust is to give her [the surviving spouse] substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Such degree of enjoyment is given only if it was the decedent's intention, as manifested by the terms of the trust instrument and the surrounding circumstances, that the trust should produce for the surviving spouse during her life such an income, or that the spouse should have such use of the trust property as is consistent with the value of the trust corpus and with its preservation.<sup>147</sup>

The last four words of this statement are encouraging, but it is clear from the examples later given that the Internal Revenue Service would, at present, recognize only depreciation and depletion reserves.<sup>148</sup> The warnings against giving the trustee discretion in doubtful cases are legion.<sup>149</sup>

(3) The estate may not be in a position to take advantage of the provisions of section 6166,<sup>150</sup> allowing an election to pay the estate tax on a business interest in ten annual installments. Subsection (h)(2) provides that if the estate has "undistributed net income," as therein defined, for any year after its fourth taxable year, the estate must pay an amount equal to such undistributed net income. Since the provision is confined to "estates," its application to the case where the executor has transferred the business in trust is in doubt. The congressional policy seems to have been to deny the benefit of installment payments where it is not needed—that is, where the estate (or trust?) is accumulating income. There is a possibility, therefore, that if the successor trust is accumulating income, particularly if this is income as defined by trust law, that the benefit of section 6166 may be denied as an extension of the congressional policy expressed in subsection (h)(2).

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<sup>147</sup> Treas. Reg. § 20.2056(b)-5(f)(1) (1959).

<sup>148</sup> Treas. Reg. § 20.2056(b)-5(f)(3) (1959). The regulations require under the "specific portion" provision that the surviving spouse's interest in the corpus and income be expressed in terms of a "fractional or percentile share" of the whole interest. Treas. Reg. § 20.2056(b)-5(c). The trust supposed may still be qualified for the deduction, therefore, if the business requires no more than a 50/50 ratio of capitalization to distribution. See, however, *Gelb v. Commissioner*, C.C.H. FED. EST. & GIFT TAX ¶ 12060 (2d Cir. Jan. 22, 1962), which rejects the regulations of this point on grounds which seem hardly sensitive to the comparison with community property.

<sup>149</sup> *Cantwell, Tax-Wise Drafting of Fiduciary Powers*, 98 TRUSTS & ESTATES 972, 975 (1959).

<sup>150</sup> Added by 72 Stat. 1681 (1958).

(4) The trust may involve a violation of a rule of local law prohibiting accumulations of income except during the life of the settlor and the minority of beneficiaries. This was the rule, until quite recently, in Pennsylvania and New York,<sup>151</sup> although there is authority under the pre-1959 New York law that provision made by the trustee for amortization of an improvement does not constitute an "accumulation" of income for purposes of the rule.<sup>152</sup> In *In the Matter of Estate of Adler*,<sup>153</sup> a lower New York court held that the retirement of a debt and depreciation reserve out of current income by a corporation solely owned by a trustee constituted unlawful accumulation. (This case will be further discussed in Part II of this article dealing with incorporated enterprises in trust.) Under the pre-1959 New York law, a settlor might have escaped the rule against accumulations by vesting the trustee with a discretionary power over distributions of income. However, the cases arrived at this result only by dint of stating that the current income beneficiary has a vested right to the undistributed amounts—with, obviously, unfortunate estate tax consequences.<sup>154</sup>

### C. *The Only Answer—A New Rule*

I cannot accept with equanimity the position that if the underlying law of trusts does not make adequate provision for the survival of the business the settlor can. I believe, rather, that the problems discussed thus far would be avoided or substantially diminished through a clear recognition by the law of trust administration that, in the absence of a contrary intention shown by the settlor, the trustee who is authorized or directed to continue a business enterprise is required (a) to set up reserves for depreciation and (b) to the extent that such reserves will be insufficient to meet the needs of the business as a going concern, to set up additional reserves for this purpose. The authorization to set up additional reserves can be hedged in by the following safeguards: If in any year the authorized retention of what amounts to surplus results in a return to the current income beneficiary which is less than the return which may be obtained by selling the business and investing the proceeds in other investments authorized

<sup>151</sup> N.Y. Sess. Laws 1928, ch. 172 (now N.Y. PERS. PROP. LAW § 16); Pa. Laws 1947, act 39, § 6 (now PA. STAT. ANN. tit. 20, § 301.6 (Supp. 1960)). For laws in other jurisdictions, see SIMES & SMITH, FUTURE INTERESTS § 1466 (2d ed. 1956).

<sup>152</sup> *In the Matter of Nesmith*, 140 N.Y. 609, 35 N.E. 942 (1894). Compare Pa. Laws 1947, act 39, § 6(8) (c).

<sup>153</sup> 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937).

<sup>154</sup> *Curtis v. Curtis*, 185 App. Div. 391, 173 N.Y. Supp. 103 (1918); Application of Bank of New York, 99 N.Y.S.2d 413 (Surr. Ct. 1950). Compare *Emna Earle*, 5 T.C. 991 (1945), *aff'd*, 157 F.2d 501 (6th Cir. 1946).

to the trustee, under the governing instrument or local law, the trustee should be under a duty to apply to the court for instructions whether to sell or retain the business. The court then can make such order regarding the continued administration of the trust as it finds appropriate under the circumstances. The trustee's authority to set up additional reserves to meet the needs of the business should be strictly confined by the trustee's duty of impartiality between successive beneficiaries to reserves necessary to preserve the going concern value of the enterprise but not for indiscriminate expansion. The additional reserves should be regarded as "corpus," not "income," under local law.<sup>155</sup>

I believe that such a rule would accord more nearly with the normal intentions of a testator. It would make available to the estate planner a medium for preserving the testator's businesses in cases in which incorporation will serve little purpose except to increase the tax liability of the estate.

It seems fairly certain that my proposal to shift the local-law line drawn between "principal" and "income" to a more realistic position for going enterprises held in trust avoids the problem with the marital deduction. It certainly avoids the problem of unlawful accumulations under local law.

Under such a shift, there is a good chance that the trust holding an unincorporated business will not be regarded as a "complex" or accumulating trust. This comes from the reference in section 643(b) to the "local law" on what constitutes "income." It is clear from the recent *Kintner* regulations,<sup>156</sup> as well as from antecedent cases, that a normal testamentary trust, even though it operates a business, will not be classified as an "association" taxable as a corporation.<sup>157</sup> It

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<sup>155</sup> If the trustee finds that he has overestimated the level of reserves necessary, he should pay out some of them as current income. I would reject, however, the implication of the cases which hold that upon the liquidation of a corporation held in trust the income beneficiary is entitled to depreciation reserves which proved unnecessary in view of the price obtained for the liquidated assets. *McCahan's Estate*, 18 Pa. D. & C. 171 (Orphans' Ct.), *rev'd on other grounds*, 312 Pa. 515, 168 Atl. 685 (1933); *Estate of Mathews*, 210 Wis. 109, 245 N.W. 122 (1932). I heartily agree with the dissent of Van Dusen, J., in *McCahan's Estate*, *supra* at 181.

<sup>156</sup> Treas. Reg. § 301.7701 (1960); see Wolfman & Price, *Qualifying Under Final Kintner Rules Will Be Difficult in Most States*, 14 J. TAXATION 105 (1961). The reference is to *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

<sup>157</sup> Treas. Reg. § 301.7701-4 (1960); see *Morrissey v. Commissioner*, 299 U.S. 344, 356-57 (dictum). Compare *Scofield v. Commissioner*, 266 F.2d 154, 165-66 (6th Cir. 1959). There is grave danger in this area when the trustee pursues the practice of obtaining the beneficiary's consent to reinvestment of earnings for replacements and improvements—a favorite practice of trustees who are pressed by the rule of trust administration which makes such reinvestment impossible. See *Commissioner v. Guitar Trust Estate*, 72 F.2d 544 (5th Cir. 1934), and particularly its sequel, *Guitar Trust Estate*, 1 CCH Tax Ct. Mem. 312 (1942). The Tax Court's decision rested on *Harry E. Lyman*, 36 B.T.A. 161 (1937). The Commissioner has since withdrawn acquiescence in *Lyman*. Rev. Rul. 57-534, 1957-2 CUM. BULL. 924.

might, therefore, be objected that to give recognition to a "local law" which permits gross income to be reinvested in a business as "principal," without exposing subsequent distributions to the five-year throwback, would be to create another "tax shelter" in this area.

If we compare the position of a sole proprietor with that of a beneficiary of a trust, both of whom have no other source of income, it is true that the trust would always be at an advantage over the sole proprietor except in the case where it plows back all of its profits or distributes all of its profits.<sup>158</sup> This is so because the profits of the enterprise would be split between two taxpayers in the trust situation. In that situation, the trust would obtain the highest advantage over the sole proprietor when it keeps a fifty-fifty ratio of capitalization to distribution. However, the trust, strictly confined to capitalization essential to the preservation and survival of the enterprise and subject to the trustee's duty to make the corpus productive of income, may be expected to continue a high ratio of distribution to capitalization. It should be noted that in that situation, the trust is in a very poor position if it is forced to operate the business in corporate form. This is the situation in which subchapter S (which was enacted in 1958 to permit closely held corporate enterprises to elect to be taxed substantially like partnerships<sup>159</sup>) offers bona fide relief to closely held corporate enterprise, but for reasons which are not recorded,<sup>160</sup> subchapter S denies the election to corporations any of whose shares are held by a trust.

On the other hand, if the business is of the kind which, in order to survive, must preserve a high ratio of capitalization to distribution, the trust holding such business in sole proprietorship is at a substantial

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<sup>158</sup> The following table shows the total tax paid by a corporation and its sole shareholder, by a trust and its sole current income beneficiary, and by a sole proprietor, in respect of \$50,000 taxable income retained and distributed as shown in the left-hand column. Standard deduction and personal exemptions are ignored, and it is assumed that the shareholder and beneficiary have no other source of income.

<i>Retained</i>	<i>Distributed</i>	<i>Corporation &amp; Shareholder</i>	<i>Trust &amp; Beneficiary</i>	<i>Sole Proprietor</i>
0	\$50,000	\$42,820	\$26,820	\$26,820
\$10,000	40,000	36,140	22,380	26,820
20,000	30,000	30,020	20,480	26,820
25,000	25,000	27,150	20,300	26,820
30,000	20,000	24,460	20,480	26,820
40,000	10,000	20,240	22,380	26,820
50,000	0	18,000	26,820	26,820

<sup>159</sup> INT. REV. CODE OF 1954, § 1371(a)(2), added by 72 Stat. 1650 (1958); see S. REP. No. 1983, 85th Cong., 2d Sess. 87, 216 (1958); Anderson, *To Elect or Not to Elect: Advantages of Subchapter S Corporations*, 99 TRUSTS & ESTATES 96 (1960); Harrison, *Pitfalls in Electing*, 99 TRUSTS & ESTATES 98 (1960); Moore & Sorlien, *Adventures in Subchapter S and Section 1244*, 14 TAX L. REV. 453 (1959).

<sup>160</sup> See Comment, *Subchapter S: A New Concept in the Tax Status of Business Associations*, 44 CORNELL L.Q. 560, 562 (1959). The authors surmise that the exclusion "was intended to reduce the complexities of administering the new subsection."

disadvantage over the sole proprietor. This is the situation for which the election of section 1361 is available to the sole proprietor<sup>161</sup> but, again, not to a trust.

Moreover, the question at issue is whether the trust is to be permitted to capitalize such profits of the business as are essential to its survival and preservation free of the five-year throwback. A trust which, by its terms, is to continue for more than nine years or whose life beneficiary survives for more than nine years is, by virtue of the present exception to the throwback, free to capitalize at whatever rate will produce the lowest tax.

If the rule which I advocate is adopted, a recognition that a trust which is operating a business and capitalizing enough of its earnings to guarantee its survival and preservation, but no more, is not a complex trust does not, it seems to me, create a special "tax shelter." If the accumulation exceeds the strict test provided for by local law, the Commissioner can take advantage of this. The test certainly furnishes him with a more sensitive control than do sections 532-37 for corporate accumulations.<sup>162</sup>

I believe that the unrealistic position at which the line is drawn between "principal" and "income" in the case of a business held in trust is driving most estate planners to incorporation. As I plan to show in Part II of this article, the pressures generated by the present position of that line can interfere substantially with the successful operation of a business by a trustee—even though incorporated. I recognize that the present trend in favor of incorporation when the business is to be retained in trust is suggested by a number of additional considerations,<sup>163</sup> but the one factor which should play no part in this

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<sup>161</sup> INT. REV. CODE OF 1954, § 1361 provides that a partnership or sole proprietor may elect to be taxed as a corporation. See McNaughton, *To Be Taxed as a Corporation*, 33 TAXES 253 (1955); Moore, *Should Your Business Be Taxed as a Corporation?*, 33 TAXES 258 (1955).

<sup>162</sup> The Service has abandoned its 70% test for post-1954 years. T.D. 6378, 1959-1 CUM. BULL. 680 (the rules adopted in T.D. 4914, 1939-2 CUM. BULL. 108, not applicable under the 1954 Code). Bona fide plans for expansion, if carried out, are sanctioned. Cases holding that the corporation was "availed of the purposes of preventing the imposition of" the surtax are fairly extreme cases. *I. A. Dress Co. v. Commissioner*, 273 F.2d 543 (2d Cir.), *cert. denied*, 362 U.S. 976 (1960) (accumulations for purchase of leasehold reversion unsupported by evidence that landlord would sell or that any negotiations were in progress); *American Metal Prods. Corp.*, 34 T.C. 89 (1960) (proposed purchase of steel never made); *R. Gsell & Co.*, 34 T.C. 41 (1960) (ratio of current assets to current liabilities 12 to 1 in 1948, 20 to 1 in 1949-50, 17 to 1 in 1952).

<sup>163</sup> The trustee who holds an unincorporated business is exposed to personal liability on all obligations of the business to which he is necessarily a party, unless he specifically contracts this liability away. 3 SCOTT, TRUSTS § 262 (2d ed. 1956). (In the case of negotiable instruments, however, § 20 of the UNIFORM NEGOTIABLE INSTRUMENTS LAW and § 3-403 of the UNIFORM COMMERCIAL CODE substitute for the common-law requirement of express contract against personal liability the requirement that the fiduciary must merely show that he is signing in a representative capacity. Pennsylvania has extended this treatment to all written contracts of the fiduciary. PA. STAT. ANN. tit. 20, §§ 320.522, .939 (1950).) He continues to be

choice is an unrealistic, outmoded underlying rule of trust administration.

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liable also for torts connected with the business, even though he is not personally at fault. 3 SCOTT, TRUSTS §§ 264, 265.4 (2d ed. 1956). This result obtains notwithstanding court approval for continued administration of the business. *E.g.*, Johnston v. Long, 30 Cal. 2d 54, 181 P.2d 645 (1947). Statutes conferring a power on the courts to grant limited liability to the trustee vary greatly in scope. Compare PA. STAT. ANN. tit. 20, § 320.934 (1950), with MICH. STAT. ANN. § 27.3178(646) (1943). But the trustee's liability is cushioned by his right of indemnification against the trust estate. 3 SCOTT, TRUSTS §§ 244-45.1, 246-47 (2d ed. 1956). Unforeseen liabilities in tort in excess of the trust assets may be guarded against through insurance at the expense of the trust estate. See *id.* § 264. Moreover, the trustee is not in business to make a killing. There is nothing in trust law to encourage him to take the kind of risks which drive businesses into bankruptcy. In fact, the suggested rule for businesses will discourage outside financing of expansion and require the trustee to sell the business if it cannot provide its own risk capital and produce a reasonable return thereon. I am not satisfied, therefore, that the law ought to discourage operations in unincorporated form. It is clear that incorporation may involve serious tax disadvantages, particularly because the subchapter S election is not available to the trustee. If the business is operated by an institutional trustee, the problem that "fringe benefits" are not available to owners without incorporation is absent. And it is worth noting, in relation to the last suggestion, that corporate fiduciaries have perhaps begun to reconsider their traditional distaste for unincorporated businesses. See Chapman, *Business Interests and Widening Horizons for Property Management*, 94 TRUSTS & ESTATES 1020 (1955); Durand, *Changing Concepts of Trust Investments—Retention of Decedent's Business*, 95 TRUSTS & ESTATES 907 (1956).