

Reserves Against the Depreciation of Real Property Held by a Trustee

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We live in an age of changing law. We have seen familiar and, what we had come to regard as firmly established, legal concepts give way to new approaches deemed more in keeping with the needs of a society. Therefore, it should cause no particular surprise or concern that this subject has been forced upon our attention.

For many years, neither trustees holding real property nor their counsel gave any thought to this subject, believing that it was a settled doctrine that, in the absence of some clear direction to do so, they were not required, nor were they permitted to set up out of income a reserve against the depreciation of real property, conveyed or devised in trust.

A re-examination of the subject has, however, been forced upon us by judicial utterances. Doubtless these have been induced by the uniform practice of deducting depreciation allowances in the compilation of income taxes, and the more accurate approach of accountancy to the determination of true income.

The United States Supreme Court has furnished a convenient definition of depreciation, which we may adopt for the purposes of this discussion.

Broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy and obsolescence.¹

The conception of depreciation is more readily apprehended if we consider a manufacturing machine. It is now well recognized that sooner or later such a machine will be retired. Such retirement may result from any number of reasons entirely disconnected with the question as to whether it has been duly maintained and all needed repairs have been made. A graphic example of this will be found in the manufacture of textiles. Many textile manufacturers have retired looms because new looms of a later type substantially cut labor costs. Doubtless, the old looms, with proper maintenance, could have continued to operate for many years and would have been capable of producing excellent goods; but they were rendered obsolete by advances in the art. "Depreciation accounting seeks two ends: (1) to provide the retirement cost of assets whose useful life has expired, and (2) to correctly allocate this cost to the various accounting periods."²

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¹Lindheimer v. Illinois Telephone Company 292 U.S. 151, 167 (1933).

²Freeman, *Public Utilities Depreciation*, 32 CORN L. Q. 4 and 412 (1946).

Depreciation of a building upon real property may, therefore, be defined as the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the building, including wear and tear, decay, inadequacy and obsolescence.

In the law of trusts, buildings have never been classified as wasting assets. However, in a recent law review note, the author stated: "Although the deterioration of buildings is less apparent than that of wasting assets, the distinction appears to be one of degree rather than of kind so that the same principles should apply."³ Doubtless, it is accurate to state that deterioration in buildings does occur; but it does not follow that the rules relating to wasting assets should be applied to buildings, for differences in degree may be so great as to require separate treatment and consideration.

The courts have heretofore recognized such a distinction. Said Professor Austin W. Scott, "Wasting property includes such property as leasehold interest; royalties; patent rights; interests in things the substance of which is consumed such as mines, oil and gas wells, quarries and timber lands; interests in things which are consumed in the using or are worn out by use, such as machinery and farm implements. The common element in the case of all such property is that its value will necessarily depreciate or be destroyed . . . the courts have not fully recognized the principle as applied to some types of property such as buildings not used for business purposes."⁴

If it be true that the courts have placed real property and wasting assets in different categories, and promulgated different rules with respect to each, we should not be overly concerned with the law relating to property recognized as "wasting". However, the development of the law relating to wasting property illuminates and helps to clarify the reasons why, over a period of many years, the court refused to require and would not even permit a trustee to set up a reserve out of income against the depreciation of real property.

The important factor here to consider is the wide difference between the theory as to wasting property, and the practical application of that theory.

That theory is clearly set forth in the Restatement of Trusts.

Unless it is otherwise provided by the terms of the trust, if property held in trust to pay the income to a beneficiary for a designated period and thereafter to pay the principal to another beneficiary is wasting property, the trustee is under a duty to the beneficiary who is entitled to the principal, either

- (a) to make provision for amortization, or
- (b) to sell such property.⁵

³ 60 HARV L. REV. 952 (1947).

⁴ SCOTT, TRUSTS § 239 (1939).

⁵ RESTATEMENT, TRUSTS § 239 (1935).

This rule is derived from the 1802 decision of the House of Lords in *Howe v. Earl of Dartmouth*,⁶ which held that where personal property is given generally, or under a residuary bequest, to a tenant for life with remainder over, the court, in the absence of language to the contrary, will presume that the testator intended that the life tenant and the remainderman should enjoy his bounty equally and not that the property should be swallowed up by the life tenant's use, leaving little or nothing to the remainderman, and hence it would not permit the life tenant to enjoy the property in specie, but would order the sale of so much of the property as was of a wasting nature, the proceeds to be invested in permanent securities, and the life tenant to be given only the interest therein.

Where this doctrine is applied and the wasting property is sold immediately, the trustee must invest the proceeds in such securities as are proper for trust investments, and these securities are thereafter treated as the principal. Where there is delay in the sale, the income during the delay is added to the proceeds of sale and an apportionment to determine the amount of the permanent principal is made by ascertaining the amount which, with interest thereon at the current rate of return on trust investments for the period of the delay, would equal the amount actually received. Where, however, the property produces an income, a sale is not necessary, as the trustee may set aside as a fund for amortization so much of the income as is necessary to prevent the value of the principal from depreciating.⁷

While accepting the theoretical correctness of this rule with respect to wasting property, the courts have recognized that it is subject to and must give way to the testator's or settlor's intention, if that can be ascertained, and that theoretical niceties must never be permitted to defeat such intention.

An examination of the authorities in which this question has been considered indicates that the courts entertain grave doubts as to how far testators or settlors may be deemed to have understood this theoretical rule and to have established trusts with the understanding that it would be applied in their administration.

Since the rule was promulgated, the English as well as some American courts have been sympathetic to the claims of life beneficiaries that the application of the rule would contradict the true intention of the testator, and have accepted as evidence of such intention a mere discretionary authority to retain the wasting property as an asset of the trust, if the beneficiary were dependent upon the testator or was one of the chief objects of his bounty.⁸

⁶ 7 Ves. Jr. 137, 32 Eng. Reprint 56, 25 Eng. Rul. Cas. 29.

⁷ See SCOTT, TRUSTS § 241.4, p. 1378 (1939).

⁸ Matter of James, 146 N.Y. 78 (1895).

The attitude of some courts has been to allow even slight indications of a contrary intent to prevent the application of the general rule.⁹ In a 1912 New York decision,¹⁰ the court, in view of a clause in the will which, while not applicable to the property in question, provided that no part of the income of the securities should be reserved for the benefit of the remainderman to make good the wearing away of premiums paid for them, attributed to the testator an intention that the life tenant should enjoy the whole of the income from leaseholds, without retention of any part for the benefit of the remainderman.

An intention of the settlor to permit the trustee to retain wasting investments and to pay the whole of the receipts to the life beneficiary has often been found from the terms of the instrument as interpreted in the light of all the circumstances. Among such circumstances¹¹ are: (a) the specific mention in the instrument of the property, particularly where it is known to the settlor to be wasting property¹² and especially where it comprises the whole of the trust property; (b) a direction or permission in the instrument to retain the property¹³ although no specific provision is made with respect to the receipts from the property;¹⁴ (c) the relatively small value of the wasting property in comparison with the whole property; (d) the relatively small amount of income from the wasting property in comparison with the income from the whole trust property; (e) the purposes of the trust including the relationship between the settlor and the various beneficiaries;¹⁵ (f) the fact that the settlor in dealing with the property prior to the creation of the trust has dealt with the receipts as income.¹⁶

⁹ 77 A.L.R. 753, 774 (1932).

¹⁰ *Frankel v. Farmers' Loan and Trust Co.*, 152 App. Div. 58, 136 N.Y. Supp. 703, *aff'd*, 209 N.Y. 553, 103 N.E. 1124 (1913), later appeal in 168 App. Div. 634, 154 N.Y. Supp. 363 (1915).

¹¹ RESTATEMENT, TRUSTS § 239 Comment e. (1935).

¹² *Knox's Estate*, 328 Pa. 177, 195 Atl. 28 (1937) (stock in a mining corporation).

¹³ *In re Koffend*, 218 Minn. 206, 15 N.W. 2d 590 (1944) (direction to retain the investment in a corporation which had set up a depletion reserve to replace capital invested in oil wells); *cf. Industrial Trust Co. v. Parks*, 57 R.I. 363, 190 Atl. 32 (1937) (right to hold the investment interpreted as an intention merely to relieve the trustee from any liability).

¹⁴ In some cases a direction to give the life tenant the "rents" or "dividends" has been held to indicate an intention that the life tenant should receive the full income, but in others no significance favorable to the life tenant has been attached thereto. 77 A.L.R. 753, 775 (1932).

¹⁵ *Re Hopkins' Estate*, 171 Misc. 910, 14 N.Y.S. 2d 71 (1939), noted in 40 Col. L. Rev. 544, 547 (1940).

¹⁶ *See Re Hopkins' Estate*, 171 Misc. 910, 14 N.Y.S. 2d 71 (1939), where the court said that substantially all of these six factors were present in that royalties case.

That the rule of *Howe v. Dartmouth* is viewed with disfavor by some courts is indicated by the strictness with which they regard the limitations of the holding. Its application is restricted to property given under only a general or residuary bequest.¹⁷ Furthermore, there is a decided tendency on the part of the courts to treat mining property as an exception to the rule.¹⁸ In other cases the view is taken that in the absence of a direction to sell or to make provision for amortization the trustee is not under a duty to do either.¹⁹ Where the trust estate at its creation includes bonds which sell at a premium at the time of the creation of the trust, the trustee has no duty to sell the bonds or set aside an amortization fund.²⁰ Professor Scott advocates that even where bonds are purchased at a premium by the trustee, amortization should not be required.²¹

It may be noted in passing that, when a power of sale is found to be purely discretionary and that the trustee is, therefore, authorized either to sell or to retain the wasting property, and have further determined that until the power is exercised all the income from the wasting property is to be treated as income of the life beneficiary, the courts have thus converted a merely administrative power into a power of appointment to the life beneficiary or remainderman over an amount equal to the depreciation value of the wasting property. Obviously, such a result would hardly have been achieved had the courts believed that the theoretical rule would effect the testator's or settlor's actual intention.

The courts which have refused to apply the theoretical rule, requiring the establishment of a reserve against depreciation out of the income from wasting property, doubtless indicate the real basis for the rule, which until recently was believed firmly established, that a trustee is not required and will not be permitted to establish out of income from real property a reserve against the depreciation

¹⁷ *Britt v. Smith*, 86 N.C. 305 (1882) (universal legacy); *Re Hilliard*, 164 Misc. 677, 299 N.Y. Supp. 788 (1937), *aff'd*, 254 App. Div. 879, 5 N.Y.S. 2d 92 (1938), *rehearing denied*, 255 App. Div. 781, 7 N.Y.S. 2d 111 (1938) (specific bequest).

¹⁸ 170 A.L.R. 133, 142 (1947); *Scott, Trusts* § 239.3 (1939).

¹⁹ *Dexter v. Dexter*, 274 Mass. 273, 174 N.E. 493 (1931). Testatrix devised her residue in trust to pay the income to her husband for life. This residuary trust included the right to receive the income from a trust created by another, which was payable to the estate of the testatrix during her husband's life; *held*: the husband was entitled to the full income without apportionment of a part to the capital of the residuary trust.

²⁰ *Boston Safe Deposit & Trust Co. v. Williams*, 290 Mass. 385, 195 N.E. 393 (1935).

²¹ *Scott, Trusts* § 239.2, p. 1338 (1939); Ohio General Code section 8509-20 provides that a trustee is not required to, but may, amortize such premiums; *see also* N. Y. PERS. PROP. LAW § 17-d (1942), and DEL. REV. CODE 1935, c. 117, § 35 A, as amended by LAWS 1941, p. 991.

of that property. As will be seen from an examination of the authorities upon this subject, the courts have been of the opinion that the establishment of such reserves would defeat the testator's or settlor's intention.

We shall consider later the question as to whether such changes have occurred since the rule was established as to lead to the conclusion that the basis for the rule is no longer sound.

Before turning to a discussion of the authorities upon the subject of reserves against depreciation of real property, we would emphasize that the depreciation of which we speak is entirely separate and apart from that which may be restored through ordinary repairs, or the installation of improvement, such as new roofs or machinery whose usefulness is of limited duration. There is set forth in a note the rules upon these subjects, as well as those relating to reserves out of current income to provide for anticipated expenses, to pay for which the trustee may have no other source.²²

²² In Restatement of Trusts § 233 (1935), Comments *i*, *j*, *k* and *l*, the following propositions are stated:

"The cost of putting into tenantable repair premises which were not in such repair when received by the trustee, whether originally acquired by the trustee as part of the trust property at the time of the creation of the trust or subsequently acquired by him, is payable out of principal; but the cost of thereafter keeping the premises in repair is payable out of income."

"Although the cost of keeping in tenantable repair property held as part of the principal is payable out of income, the cost of improvements when properly incurred by the trustee . . . is payable out of principal. Similarly special assessments levied against trust property for improvements are payable out of principal."

"If the improvements are permanent in character, the principal is benefited, the effect being merely to substitute one form of principal for another. It is therefore fair that the cost for improvements should be paid for out of principal without amortization. While the beneficiary entitled to the income may receive a benefit from the improvements in the form of increased rentals, this is balanced by the fact that he no longer receives income from that part of the principal which is expended in making the improvements."

"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 The result is that if the trust does not terminate before the end of the probable life of the improvements, the whole cost of the improvements will be paid out of income. This is fair because the beneficiary entitled to the income gets the full benefit of the improvements and the remainderman gets no benefit. On the other hand, if the trust terminates prior to the end of the probable life of the improvements, the payments from income will cease on the termination of the trust. This is fair because the beneficiary entitled to the income has not received the full benefit from the improvements but the remainderman receives a part of the benefit."

In dealing with these questions, the courts have been prone to approach them in a practical, if slightly inconsistent manner, rather than on a strictly theoretical basis. Thus it appears that while various parts of a building, such as new elevators, new boilers or the like are regarded as temporary improvements, *Matter of Adler*, 164 Misc. 544, 299 N. Y. Supp. 542 (1937) a whole

The decision which required reconsideration of this subject was that of the late Hon. Francis D. McGarey, the Surrogate of Kings County, New York, in *Matter of Kaplan*,²³ holding that a trustee should establish a depreciation reserve out of the rents of real property held in trust.

The rendering of that decision might lead one of a philosophic frame of mind to speculation on the question as to how far the desire for freedom, particularly that of expression, had so infected the judicial mind as to impinge upon the rule of *stare decisis*. This is certainly one of the straws indicating the impatience on the part of some of our courts with the restraints of that rule and a determination to substitute their ideas of the requirements of justice under modern conditions, and not to await the action of the legislature to correct a rule of law established by earlier decisions. It might be concluded that such a spirit was here particularly discernible for in an earlier case, this same judge, while expressing sympathy with the contention before him that the trustees should establish a reserve "for depreciation and obsolescence" stated "The remedy, however, is within the province of the legislature and not with the courts."²⁴ In *Matter of Kaplan*, however, he asserted that the earlier New York decision had not established the rule that no depreciation allowance should be set aside out of income.

However, we are indebted to the Surrogates for bringing before us for further inquiry not only what the law is upon the subject, but what change, if any, should be made in the rule heretofore established.

In the *Kaplan* case a trust was established for the benefit of the testator's two sons. The will directed that the annual income should be divided between them "after making proper and suitable allowance for expenses and setting up a reserve or sinking fund to meet taxes or other contingencies." The testator owned five parcels of real property improved with apartment houses and also owned all the stock of two corporations, each of which owned an apartment

building is regarded as a permanent improvement. *Smith v. Keteltas*, *infra* note; *Stevens v. Metcher*, *infra* note.

In the prudent management of property, a trustee may, and in some instances probably must, reserve out of current income a sufficient sum to provide for anticipated expenses, to pay for which the trustee has no other funds; but such reservation does not change the character of the income withheld. If it is used to pay items properly chargeable to principal then the life beneficiary is entitled to recoupment when principal becomes available, and if the funds withheld are not expended they still constitute income which belongs to the life beneficiary, *Shirk v. Walker*, 298 Mass. 251, 10 N.E. 2d 192 (1937); *Matter of Parr*, 45 Misc. 564, 92 N.Y. Supp. 990 (Surr. Ct. 1904), *aff'd without opinion* 113 A.D. 921; *Matter of Ridge v. Felt*, 184 Misc. 11 (1945).

²³ 195 Misc. 132, 88 N.Y.S. 2d 851 (May 1949).

²⁴ *Matter of Horowitz*, 192 Misc. 556, 557, 80 N.Y.S. 2d 286 (Surr. Ct. 1944).

house. The trustees continued the decedent's practice of claiming an income tax deduction for depreciation of 2 per cent. If allowance for depreciation were deducted from income it would have amounted to more than \$20,000 annually. The Surrogate held that a reserve for depreciation should be established. The conclusion so reached by the Surrogate with respect to the facts then disclosed would not have been particularly disturbing had he not challenged the view that earlier decisions had established a general rule that a depreciation reserve was neither required nor permitted.

It appears that at the time of the decision in this case, the Surrogate had not finally reached the conclusion that it was appropriate to set up what, in accounting circles, would be regarded as a reserve solely for depreciation. He spoke of the advantages to the beneficiary of the establishment of a reserve fund out of which the cost of large repairs might be met thus making for stability of income to the beneficiary and expressly stated (p. 145 of official report):

The disposition of such reserve fund as between income and principal is expressly reserved for determination until such time as the trust has terminated, or upon an earlier application when the facts shall warrant such determination.

A true reserve for depreciation would, of course, constitute capital. The fact that it might be convenient to use such reserve for large, infrequently recurring repairs or temporary improvements would not change the character of such reserve. If the cost of any such items were properly allocable to income it would be necessary to restore the capital out of income subsequently collected and it would not be material whether the capital had been provided by such reserve.

However, the subject was discussed by the Surrogate in two later decisions,²⁵ in the latter of which he said, "A depreciation reserve represents principal."

There is a strong preponderance of opinion among the New York bar that in New York the courts had established the rule of law, that, in the absence of a contrary direction in the will or other trust instrument, a trustee is not required to establish a reserve against the depreciation of a building constituting part of his trust, and, on the contrary, that it is not appropriate for a trustee to deprive the income beneficiary of the moneys which would be required to establish such a reserve. This view finds support in the earlier decisions.

In *Smith v. Keteltas*²⁶ a parcel of real property forming part of the trust estate had been taken in condemnation proceedings. A

²⁵ *Matter of Dahlmann*, 95 N.Y.S. 2d 74 (1949); *Matter of Kellogg*, N.Y.L.J. 1020 (March 22, 1950).

²⁶ 62 App. Div. 174, 70 N. Y. Supp. 1065 (1901).

large portion of the award was used by the trustee to construct buildings on other lots which had formerly been improved but upon which the buildings were so ancient and dilapidated as to be untenable and had been ordered to be torn down by the municipal authorities. The trust term had then lasted nearly sixty years. After the death of the trustee action was brought against his executrix to recover the plaintiff's share as one of the remaindermen of the condemnation award. The court held that the trustee's action in erecting new buildings was prudent and for the best interests of the property and he was justified in using the award for this purpose. The contention that, during the nearly sixty years in question the trustee should have expended sufficient sums out of income to keep the property in a tenable condition was rejected as impracticable since the condition of the property resulted "not from the necessity of temporary repairs but from age which had rendered them so dilapidated and unsafe that their removal became necessary." Of course, if it had been the duty of the trustee to set up a reserve for depreciation, it would have been apparent that, during the period of nearly sixty years, the trustee should have accumulated at least part of the sum required to erect the new buildings.

The case of *Matter of Chapman*²⁷ while not dealing directly with real property, is commonly cited in considering this subject. There the testator directed that his residuary estate should be held in trust to pay the income to his widow for life and the remainder to his children. The executors were directed to continue the testator's investment in a Great Lakes freight steamer. In a proceeding for the settlement of the executors' account, five years after the death of the testator, it appeared that the net earnings of the steam boat had been computed by deducting from gross receipts every expenditure made in the running of the steamer, both ordinary and extraordinary, and in making such changes in her rig and equipment as became necessary. In addition, the executors had reserved from the estate's share of the profits received from the steamer \$3,075 and invested it and paid the income to the widow. The executors claimed the right to retain this sum, as well as sums out of future earnings, as a sinking fund to provide against the loss to the corpus of the estate by depreciation in the values of the steamer. The court held that the widow was entitled to receive the \$3,075 so reserved from the income. The court said:

There is nothing in the will which indicates to me that the testator intended that she (the widow) should either benefit or lose by fluctuations in the value of the estate or that the remaindermen should be protected at the expense

²⁷ 32 Misc. 187, 66 N. Y. Supp. 235, (Surr. Ct. 1900), *aff'd on opinion of the court below*, 59 App. Div. 624, 69 N. Y. Supp. 1131, *aff'd without opinion* 167 N. Y. 619, 60 N.E. 1108.

of the widow against such depreciation in the value of this boat as arises from age or ordinary use.

In *Stevens v. Melcher*²⁸ the court held that the construction of a new building was a permanent improvement and a proper investment of trust funds, since the trustees were authorized to invest in real property. In that case the widow, who was the life beneficiary but not a trustee, removed some old buildings which were not producing sufficient rental to pay the taxes and upkeep of the premises, and entered into a contract for the construction of a new building. The trustees, after some remonstrance and after having been indemnified against loss, joined in the contract. Although the buildings cost \$120,000 the Referee had found that the construction of these buildings only increased the value of the property by \$90,000 and the trustees were directed to reimburse the widow in such sum of \$90,000. No provision was made for amortization of any part of this amount out of the income of the premises, thus leading to the conclusion that such a building is regarded as a permanent improvement, and that no reserve for depreciation is required or permitted, in the absence of some direction to the contrary.

In *Matter of Danziger*²⁹ the residue of the estate was given in trust for the life of the testator's two children for their support and education, with direction to pay specific sums out of income upon the happening of specified events, and out of principal if necessary. Testator owned one-half of the stock of a corporation which was indebted to him and the other stockholders and which owned an apartment house. The corporation was dissolved and the property was conveyed to the trustee and surviving stockholder in settlement of the corporation's indebtedness to them. Upon an interim accounting the guardian for the minor children claimed that a larger amount of income should have been reported, but the trustee claimed that a reserve for depreciation should be established. It was held that no reserve for depreciation should be deducted from the income.

In a substantial number of other cases arising in various Surrogate's Courts in New York State, the question has been definitely presented and decided that the trustees there involved were neither required nor permitted to establish a depreciation reserve. In those cases where the trustees had set aside such a reserve, upon demand of the life beneficiary, they were required to pay such reserve to the beneficiary.³⁰

²⁸ 152 N.Y. 551, 46 N.E. 965 (1897).

²⁹ 58 N.Y.S. 2d 790 (Surr. Ct. 1945), *modified on other grounds*, 271 App. Div. 888, 67 N.Y.S. 2d 130.

³⁰ *Matter of Edgar*, 157 Misc. 10, 282 N.Y. Supp. 795 (Surr. Ct. 1935); *Matter of Adler*, 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937); *Matter of Horowitz*, *supra* note 24; *Matter of Wadsworth's Will*, 81 N.Y.S. 2d 298 (Surr. Ct. 1948); *Matter of Hubbell's Will*, 90 N.Y.S. 2d 74 (Surr. Ct. 1948); *Matter of Davies*, 96 N.Y.S. (2d) 191 (Surr. Ct. 1950); *Matter of Ottman's Estate*, 95 N.Y.S. (2d) 5 (Surr. Ct. 1949).

The rule thus established in New York is subject to an exception with respect to buildings which are used in connection with a business. *Matter of Nesmith*³¹ involved a trust established by a testator for the lives of his sons who were named trustees of certain property consisting of warehouses, piers and wharves in the City of New York, which had been used by the testator in the operation of a warehouse business. The will gave the trustees broad authority to improve the property as they saw fit and to buy adjoining property and to raise money on mortgages if they saw fit. The trust property was leased for a five year term during which the surviving trustee "deemed it necessary for the purpose of the business" to erect a shed on one of the piers at a cost of \$12,000. In his account he showed an item of \$7,500 paid from income toward that cost. It was held that the cost of the shed was chargeable to the corpus of the trust, but that the trustee should retain the increased income which arose from the additional structure until his advances for its construction were repaid. In *Matter of Jones*³² the court recognized the propriety of charging to profits the losses from uncollectible accounts, the amounts paid for replacement of appliances and horses that had died, and *certain items for repairs*.

It has been argued in some cases that in those states which prohibit accumulations except during minorities or for other limited periods, reserves for depreciation in other trusts may not be directed by a testator or settlor without violating the rule against accumulations. There are authorities, however, in New York State which seem to hold to the contrary.³³

After the decision in the *Kaplan* case, *supra*, some counsel were of the opinion that safety to the trustee dictated a judicial construction of the trust instrument. Such a construction was sought in various cases.³⁴ Surrogate Collins of the New York County Surro-

³¹ 140 N.Y. 609, 35 N.E. 942 (1894).

³² 103 N.Y. 621, 9 N.E. 493 (1886).

³³ *Matter of Jones*, *supra* note 32, *Matter of Schummers*, 210 App. Div. 296, 206 N.Y. Supp. 113 (1924), *aff'd*, 243 N.Y. 548, 154 N.E. 600. *Matter of Nesmith*, 140 N.Y. 609, 35 N.E. 942 (1894). *Equitable Trust v. Prentice*, 250 N.Y. 1 (1928), where the court recognized that even for the purposes of the statute against an unlawful accumulation, the term income must be regarded as flexible and although all or part of a stock dividend might be deemed income as between the life tenant and the remaindermen, in the absence of directions to the contrary, a dividend, if it be added to capital would not result in an unlawful accumulation. Since it is now current accounting practice in computing net income to deduct annually reasonable sums to provide for retirement of an asset, it is not believed that the setting up of such a depreciation reserve would be regarded by the courts as an unlawful accumulation.

³⁴ *Matter of Otzman*, 197 Misc. 645 (Surr. Ct. 1949); *Matter of Davies*, 197 Misc. 827, 96 N.Y.S. 2d 191 (Surr. Ct. 1950), *aff'd*, 277 App. Div. 1021, 100 N.Y.S. 2d 710; *Matter of Ball*, 197 Misc. 1047 (Surr. Ct. 1950); *In re Bohmert's Will*, 102 N.Y.S. 2d 394, 397 (Surr. Ct. 1950), agreeing with decision in *Matter of Davies*, *supra*, this note.

gate's Court and Surrogate Bucaglia of the Erie County Surrogate's Court noted the *Kaplan* case, but arrived at a decision directly to the contrary. Surrogate Collins' decision in the *Davies* case³⁵ was affirmed upon appeal to the Appellate Division of the Supreme Court.

The subject was also considered in *Matter of Hubbell*,³⁶ where real property was held by a corporation. The Appellate Division of the New York Supreme Court, Second Department, indicated agreement with the view that depreciation reserves were appropriate, except where construction of the terms of the trust instrument required that the income undiminished by such a reserve should be paid to the income beneficiary. However, the Court of Appeals,³⁷ in reversing, refused to rule upon this question, finding it unnecessary to do so under the peculiar facts in that case.

The rule so established in New York, with minor exceptions hereafter noted, has also been accepted elsewhere in the country. In the District of Columbia, Illinois, Massachusetts, Minnesota, New Jersey and Washington, it has been held that, in the absence of some direction in the trust instrument to the contrary, it is the general rule that a trustee is not required to and may not properly set aside a reserve for depreciation of buildings.³⁸

³⁵ *Matter of Davies*, *supra* note 34.

³⁶ 276 App. Div. 134, 138 (1949).

³⁷ 302 N.Y. 246, 260 (1951).

³⁸ *District of Columbia*—In *Evans v. Ockerhausen*, 69 App. D. C. 285, 100 F. 2d 695, (1938), *Cert. denied*, 306 U.S. 633, the testator devised his real property to his wife in trust to use the income for her support for life. There also was an ambiguous provision with respect to support of the children. The court there held that the widow was not obligated to establish a depreciation reserve as claimed on behalf of the infant remaindermen. It was further held that the sums expended to purchase and install electric refrigerators in an apartment house were correctly charged to the corpus of the trust since they were fixtures.

Illinois—The United States Circuit Court of Appeals, Seventh Circuit in *Lafin v. Commissioner of Internal Revenue*, 69 F. 2d 460 (1934), determined that the law of Illinois did not authorize or require the setting up of a depreciation reserve on buildings. The buildings there involved were commercial buildings held by a testamentary trustee.

In another case, United States Circuit Court of Appeals, Third Circuit, *Commissioner of Internal Revenue v. Saltonstall*, 124 F. 2d 110 (1931), the court recognized as appropriate the setting up of a depreciation reserve with respect to real property in Chicago where the will authorized the trustees to determine whether expenses should be charged to capital or income, and whether receipts should be treated as capital or income.

Massachusetts—In *Nelligan v. Long*, 320 Mass. 439, 70 N.E. 2d 175, 170 A.L.R. 126 (1946), where the testator directed the trustee to retain shares of a closely held corporation and buildings if they should prove reasonably profitable, it was held that the trustee should not set aside a reserve for depreciation.

Minnesota—In *re Lee's Estate*, 214 Minn. 448, 9 N.W. 2d 245 (1943), it

In *Freuler v. Helvering*,³⁹ a tax case, the United States Supreme Court stated, apparently without dissent, that the Court of Appeals had interpreted the will there in question in accordance with the general law of trusts, which, it was held, forbade the deduction of a depreciation reserve from distributable income, but on the contrary placed upon the remaindermen the burden of any shrinkage of capital of that nature.

In California it appears that the courts have directed in some instances, at least, that reserves should be established.⁴⁰

There is one case in Wisconsin which seems to hold that a depreciation reserve is appropriate, if there be proof that the value of a building has depreciated, but not otherwise.⁴¹

was held that the trustee could not properly set aside a reserve for depreciation of buildings which were a part of the original trust estate.

New Jersey—*Fidelity Union Trust Company v. McGraw*, 138 N.J. Eq. 415, 48 A. 2d 279 (Ch. 1946) involved trusts for three of the testator's children. One of the assets of the trust was a theater building. The will expressly empowered the trustees to "make such provision for deterioration and obsolescence" with respect to real estate included in the corpus "as in their judgment may deem wise." The trustees sought authority to set up a depreciation reserve with respect to the theater. The court held that this was appropriate. But in *Matter of Roth's Estate* 139 N.J. Eq. 588, 52 A. 2d 811 (Prerog. Ct. 1947) where no similar provision was found in the will the court held that while the creation of a reserve for depreciation is in harmony with modern accounting practice, "generally as between life tenant and remaindermen, the latter must bear any loss due to depreciation and obsolescence."

Washington—In *Chapin v. Collard*, 29 Wash. 2d 788, 189 P. 2d 642 (1948), the testator directed that his residuary estate should be held in trust to pay the income to his wife for life, thereafter to his niece for life with remainder to the niece of his wife or her then living children. The assets of the trust included two apartment houses, a theater and store building, a super market store building, wooden garages and a building used as a machine shop. The court held that:

It is a rule of general application that the beneficiary of a trust entitled thereunder to receive the income from such property may not be required to suffer a deduction from such income for the creation of a sinking fund to provide for depreciation and obsolescence, unless, indeed, the trust instrument or the law of the State makes provision therefor.

³⁹ 291 U.S. 35-43 (1933).

⁴⁰ In one unreported case in California, it was held that a depreciation reserve should be established with respect to trust assets which the trustee converted into real estate and other forms of investment subject to depreciation. See *Freuler v. Helvering*, *supra* note 39, where the question arose as to the effectiveness of the decree of the local California court having jurisdiction over the administration of the trust as against the Commissioner of Internal Revenue who had assessed a tax to the income beneficiaries, with respect to income, which under the decree of the local court should have been deducted from income as a reserve for depreciation. In *re Gartenlaub*, 185 Cal. 648, 190 Pac. 209, the California Supreme Court held that it was the duty of the trustee to set aside for depreciation a certain amount of income.

⁴¹ *Matter of Matthews Estate*, 210 Wis. 109, 245 N.W. 122 (1932) leaves doubt as to whether a depreciation reserve is required or permitted. In that

Thus it appears that wherever the courts of this country have considered this question, excepting only the courts of California and possibly Wisconsin, they have followed the general rule against the establishment of reserves for depreciation of real property. However, the question has not been extensively litigated outside of New York and in many states no decisions upon the subject are found.

There is agreement among students of this subject that the general rule is as heretofore stated.⁴² However, there seems to be no decision of the English courts directly dealing with this question before the separation of the colonies and it is doubtful whether this rule may be regarded as part of the common law of those states where no decision upon the subject has been rendered.

Notwithstanding the weight of authority in support of the rule against the establishment of a depreciation reserve, it seems that we would be unwise to stop our consideration there, for criticism of the rule is not confined to the late Surrogate of Kings County, New York.

It is not without significance that the Restatement of Trusts, American Law Institute, contains no statement upon this subject. This, of course, takes on added significance when we remember that the reporter in charge of the preparation of this Restatement was Professor Austin W. Scott, whose current work on trusts in most instances follows the Restatement. It appears that Professor Scott entertains grave doubts concerning the correctness of this rule. He recognizes (1) that it has not been the practice of trustees to set up such reserves, and (2) that, except as to buildings used in connection with a business conducted by the trustee, the decisions neither require nor permit the establishment of such reserves. Since correct accounting theory recognizes that most buildings do

case, the testator bequeathed the use and income of shares in real estate corporations to her brother and two sisters with remainder to four named charities. One corporation retained a depreciation reserve which amounted to a substantial sum in 1922 when the building owned by the corporation was sold and the corporation liquidated its assets. The trustees received by way of a liquidating dividend its share of the depreciation reserve amounting to \$9,111.49. The trust terminated in 1927 and upon the final accounting the trustee was directed to pay this sum to the administrator of one of the life tenants. The court recognized that the setting up of such a depreciation reserve was in accord with sound accounting practice but then went on to state that the sum so set aside in such a reserve had not lost its character of income and stated that there was no showing that the building in fact depreciated in value, and affirmed the direction of the lower court that the moneys received by the trustee representing such reserves should be paid to the life beneficiary.

⁴² 2 SCOTT, TRUSTS § 239.4, p. 1342; New York State Legislative Document (1950) No. 650, p. 20, setting forth the conclusions of Professor Horace E. Whiteside of the Cornell Law School, Research Consultant, who made a study for the Law Revision Commission; 4 BOGERT, TRUSTS AND TRUSTEES, § 803, p. 127.

deteriorate and become obsolete, and it is becoming more usual in business to establish such reserves, he is of the opinion that generally trustees holding rented real property should be permitted, if not required, to set up reserves.⁴³

Professor Scott's views undoubtedly explain the absence of any comment upon this subject in the Restatement. Reference to the views of this eminent scholar is not ill advised for we know that in at least one other instance his views have prevailed in a field where the law had not previously been firmly established.⁴⁴

If not expressly critical, professional accountants have been careful to point out that theoretically the rule against reserves for depreciation in trust estates is unsound if true income is all that should go to a life beneficiary. As stated by Nossaman, "From an accounting standpoint, depreciation is a cost of operation, like material consumed."⁴⁵ Traver has suggested that when depreciation allowance is not deductible from receipts before distribution of trust income, the accountant should, nevertheless, show the depreciation allowance and the payment of an equivalent amount of principal to the beneficiary, so that the payment of principal to the life beneficiary would not be disguised.⁴⁶ Propp has pointed out the fallacies in some of the arguments in support of the rule against such reserves.⁴⁷

A law note suggests that more attention should be given to the testator's own practices in setting aside a fund for depreciation.⁴⁸

In the face of this questioning and criticism, how far may trustees and their counsel rely upon the application of the rule to all trusts, particularly in those states where the courts have not spoken? Should we anticipate the advent of decisions, recognizing the rule, but refusing to apply it because of evidence outside the trust instrument, which might be seized upon as indicating that the testator or settlor did not intend to relieve the trustee of the duty of setting aside such a reserve? Would the fact that testator in his income tax returns claimed a deduction for depreciation, or that the building is being used for business purposes where physical alteration is heavy, or where the art is changing rapidly which would require extensive alteration or abandonment, or other circumstances of like character, be sufficient to induce a court to require the establishment of such a reserve?

⁴³ 2 SCOTT, TRUSTS § 239.4.

⁴⁴ Matter of Stone, 138 Ohio St. 293, 34 N.E. 2d 755 (1941); City Bank Farmers Trust Co. v. Cannon, 291 N.Y. 125 (1943).

⁴⁵ 1 NOSSAMAN, TRUST ADMINISTRATION AND TAXATION § 258.

⁴⁶ Traver, *How Depreciation Affects Distribution of Income from Property Held by Trustees*, 85 JOURNAL OF ACCOUNTING 322 (1948).

⁴⁷ *Depreciation of Buildings Held as Testamentary Trusts*, 19 N. Y. CERT. PUB. ACC'T. 170 (1949).

⁴⁸ 60 HARV. L. REV. 952 (1947).

Before exploring these questions, let us consider the basis for the rule, so that we may consider the extent to which we may rely upon it. The reasons advanced by the courts may be briefly stated.

(a) The life beneficiary of a trust should be entitled to substantially the same benefits as a legal life tenant. The mere fact that one has a legal estate and the other an equitable life interest should not change the benefits to be derived. Since a legal life tenant may use real property and collect all the rents and income arising therefrom, subject only to the obligation to keep it in ordinary repair, it should follow that an equitable life beneficiary should be entitled to the same benefits and should not be required to permit income to be accumulated as a reserve against depreciation.⁴⁹ It would seem that this is reasonably persuasive.

(b) The remainderman should bear the loss caused by depreciation since he will receive the benefit of any appreciation which may occur.⁵⁰ This is an obvious fallacy for the reason that depreciation is not supposed to cover mere market value depreciation based on economic conditions not relating to the character of the property.

(c) The difficulty of predicting the life of a building and its replacement cost would place too heavy a burden upon the trustee, or would make the result too uncertain.⁵¹

This undoubtedly has much practical merit, but an accountant has pointed out that the customary "straightline" method of depreciation has become standardized, so as to "devitalize the objection of uncertainty."⁵² The standardization of depreciation has of course resulted from regulation of the Bureau of Internal Revenue.

(d) The life beneficiary is normally the principal objective of the testator's bounty.⁵³ This undoubtedly is one of the most valid and persuasive arguments.

(e) The income remaining after deducting annual installments of a depreciation reserve would be less than that which was contemplated by the testator.⁵⁴ Here again is a valid and persuasive reason, in cases where the income thrown off from the investment is small, particularly during periods of depression. It is interesting

⁴⁹ Matter of Roth, 139 N.J. Eq. 588, 52 A 2d 811 (1947); Matter of Edgar, 157 Misc. 10, 282 N.Y. Supp. 795 (Surr. Ct. 1935); Matter of Adler, 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937).

⁵⁰ Evans v. Ockerhausen, 69 App. D.C. 285, 100 F 2d 695 (1938), *cert. denied*, 306 U.S. 633. Matter of Edgar, *supra* note 49.

⁵¹ 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.

⁵² Propp, Depreciation of Buildings Held as a Testamentary Trust, *supra* note 47.

⁵³ Matter of Matthews Estate, *supra* note 41; Matter of Danziger, *supra* note 29; Matter of Wadsworth, *supra* note 30; Matter of Chapman, *supra* note 27; Matter of Adler, *supra* note 22.

⁵⁴ Matter of Chapman, *supra* note 27.

to note that, although it appears that Professor Scott does not approve of the present rule, he would permit the trustee to exercise discretion and omit the deduction of a depreciation reserve when the amount of income would otherwise be insufficient.⁵⁵

We would again emphasize that the question as to whether such a depreciation reserve should or should not be provided depends finally on the intention of the settlor or testator. Usually the trust instrument is silent upon the subject and the decision must rest on rules of construction. In many jurisdictions there is such a rule of construction that the trustee is neither required nor authorized to deduct reserves from the income to provide against depreciation. However, if this rule merely raises a presumption concerning the intention of the testator or settlor, how far must a trustee go in examining the surrounding circumstances to learn whether there are any which might lead to the contrary conclusion that the testator or settlor intended to give to the income beneficiary only the true income remaining after deducting a reasonable depreciation reserve?

If there be any such duty on the part of the trustee to make such an inquiry, then it becomes obvious that in most instances he will find some one or more circumstances which might be deemed to indicate such an intent. Reference is made to the almost universal practice of business men to claim deduction for depreciation in rendering their income tax returns. If a testator has been doing that for years and reporting as income only the net amount remaining after such deduction, will the court say his direction to pay the net income to one for life or some other period indicates an intention to give such beneficiary more than the testator has been reporting as net income?

If we add to income tax returns the fact that the testator has held his real properties in one or more corporations and that these corporations have actually retained and have not distributed the reserve, it becomes more difficult to say that the testator did not intend his properties should continue to be managed after his death on the same basis.

This discussion should not be regarded as an expression of opinion that a court would be justified in regarding income tax returns alone as indicating an intent on the part of the testator to vary the rule against setting up such depreciation reserves. We know that it is a regular practice for persons owning real property to claim the permissible deduction in computing the net rents from such property, but that they do not actually set aside such reserve as a capital fund.

What conclusions, if any, may be drawn from the foregoing?

⁵⁵ 2 SCOTT, TRUSTS § 239.4 p. 1346.

First, the general rule is that in the absence of a direction to the contrary, a trustee holding real property is neither required nor permitted to set aside out of income from the real property a reserve against the depreciation of that property.

Second, this is a rule of construction founded upon the sound conclusion that generally, when a testator or settlor directs the payment of income from or the rents and profits of real property to a beneficiary for life or a shorter period, he intends to give the net income undiminished by the setting aside of a depreciation reserve.

Third, this being a rule of construction, it is subject to proof of a contrary intention based upon extrinsic evidence of facts and circumstances surrounding the testator or settlor at the time of the execution of his will or trust instrument.

Fourth, in those states where the general rule has been heretofore recognized, we would expect that the courts will find some means of protecting a trustee who has acted in good faith in not setting up a reserve; but it may be prudent for the trustees, pending a declaration of the courts or legislature along the lines suggested below to make inquiry as to the existence of surrounding facts and circumstances which would indicate a contrary intention on the part of the testator or settlor.

Fifth, and this is undoubtedly the most important, the courts or the legislatures of the states should establish a clear and definite rule, that, in the absence of a clear expression on the face of the will or trust instrument to the contrary, subject to the exceptions noted below, a trustee should not be required or permitted to set aside out of income a reserve against depreciation of real property, unless and until a court of competent jurisdiction shall have found that it was the intention of the testator or settlor that such a reserve should be so established and shall have so directed.

The exceptions are: (1) buildings used by a testator in the operation of a business conducted by himself, (2) buildings held by a testator or settlor through a corporation which has established and actually set aside as capital a depreciation reserve. In these two cases the rule of construction should be to the contrary.⁵⁶

A clear declaration of this effect is of importance. Trust estates should not be subjected to the substantial expense which will otherwise inevitably be cast upon them by the natural desire of trustees to be protected from the hazards of a decision being rendered, years after the inception of the trust, that a depreciation allowance should have been established and holding them liable for

⁵⁶ Matter of Nesmith, 140 N.Y. 609, 35 N.E. 942 (1894); Matter of Jones, 103 N.Y. 621, 9 N.E. 493, (1886). As to (2) see Matter of Dodger, 279 N.Y. 646 (1938), and Matter of Hubbell, *supra* notes 36 and 37.

failure to have done so. Either a judicial construction or frequent proceeding for the settlement of accounts will doubtless be sought unless and until a trustee finds other means of protection from such an eventuality.

No trustee should be called upon at his peril to determine whether there are extrinsic facts and circumstances from which a conclusion, contrary to the general rule of construction, may be drawn. Nor should income beneficiaries be deprived of the full income until it is determined that the testator or settlor wished the income to be diminished by a depreciation reserve.

Doubtless there will be many situations where the establishment of such a reserve would be agreeable to the wishes of the testator or settlor, and it, therefore, seems preferable that the rule should relate to the duty and protection of the trustee rather than being established as a rigid and inflexible rule of construction to be overcome only by an express statement to the contrary in the trust instrument.⁵⁷

It should be noted that in order to place trusts in the same income tax situation as are other owners of real property, it is not essential that reserves against depreciation be deducted from income and added to capital. The federal income tax law has taken cognizance of the general rule of construction and provided that the depreciation allowance may be taken by the income beneficiary.⁵⁸

If legislation be sought in any state to set this subject at rest, at least to the extent of granting protection to the trustee, consideration should be given to the enactment in Delaware, which seems

⁵⁷The New York Court of Appeals adopted such an inflexible rule with respect to the amortization of premiums on bonds. No amortization was authorized or permitted with respect to bonds owned by the testator or settlor but was required where bonds were purchased by a trustee. After the *Kaplan* decision, *supra*, was published, the New York Law Revision Commission, recognizing the great importance of the question to countless trustees in New York, undertook a study of the law upon the subject and proposed legislation to establish rules for the guidance of trustees. (Legislative Document (1950) No. 65 (0). This, however, was not found acceptable to members of the bar or the Surrogates' Association since it failed to establish a definite rule for the protection of trustees, but recognized that extrinsic evidence might be availed of to determine the intention of the testator or settlor. Later a bill was framed by a joint committee of various bar associations and introduced in the legislature. (1950) N.Y. Senate Int. 2394. This embodied the suggestion above recommended, granting protection to the trustee. The bill was not passed however, and later representatives of the Executive Committee of the Surrogates Association expressed the view that the law was sufficiently established in New York as to render legislation unnecessary.

⁵⁸2 STAT. 460 (1938), 26 U.S.C. § 23 (1) and (2), REG. 111, § 29-23 (1)-1.

to be founded on a forward looking and enlightened point of view. It was there enacted:⁵⁹

Unless otherwise provided in the instrument creating a trust, the trustee thereof shall not be required to, but may if the trustee deems it desirable, set aside a sinking fund out of the income of the trust to offset depreciation, obsolescence, amortization or other waste of the principal of the trust.

If it be suggested that it is not appropriate for the legislature to cast upon a trustee the power to determine what should be income and what principal, for this, in its final analysis, is a power of appointment, it should be noted that experience shows that testators and settlors are generally willing and desirous of conferring upon their trustees the discretionary power to determine all such questions, if the subject is submitted to them. Discretionary power of the trustee in this regard has been advocated by Professor Scott.⁶⁰

The advantages of a statute of this character which would give great flexibility are quite obvious. All must recognize that no statute which purports to lay down a fixed and definite rule upon this subject would effectuate the wishes and intent of all testators and settlors. There are doubtless many cases where it would be prudent and desirable and in accordance with the best interests of the settlor's family that such reserve should be established, whereas, in many other instances, it would place undue hardship upon the widow and other objects of the testator or settlor's bounty were the income arising from such a trust to be diminished by the deduction of such depreciation reserve. It should not be too difficult for a trustee to determine when such a reserve would be proper.

However, there seems to be no reason why the trustee's decision should be made final if there be any beneficiary who desires that the question should be determined in some manner contrary to the trustee's ideas. A provision permitting this might be included in a statute which would in general follow the Delaware statute above quoted. For example, the statute might provide somewhat as follows:

Unless otherwise provided in the instrument creating a trust whether heretofore or hereafter executed, and, until and unless a court having jurisdiction of such trust shall otherwise determine, the trustee thereof shall not be required to but may, if the trustee deems it desirable, set aside out of the income of the trust a sinking fund or reserve to off-set the depreciation in any building constituting part of such trust. The court having jurisdiction of such trust may determine whether such a reserve or sinking fund should or should not be established and the amount or proportion of the income which should be set aside for

⁵⁹ DEL. LAWS of 1939, c. 150, § 1, adding § 35-A to the Delaware Revised Code c. 117.

⁶⁰ 2 SCOTT, TRUSTS § 239.4.

such purpose, but the trustee shall be under no obligation to seek the advice or instructions of such court.

It is recommended, however, that either the courts or legislatures should put at rest this question which has assumed new proportions following the discussion induced by the decision of the Surrogate of Kings County, New York, in *Matter of Kaplan, supra*.

