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# Depreciation of Improved Real Property in Trust Estates

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## DEPRECIATION OF IMPROVED REAL PROPERTY IN TRUST ESTATES

Whenever a trust is created, the income beneficiaries are interested in the production of trust income and the remaindermen are interested in the maintenance of the corpus of the trust. The trustee, whose duty it is to act in the best interests of these parties, generally has little trouble in determining what charges are properly allocable to income and to principal.

Income ordinarily includes so much of the return produced by the res that does not impair principal. Interest, cash dividends, rents and produce of land, as well as profits of a business, are, therefore, only treated as income after deducting the charges and expenses that arose in producing these receipts.[1] For the most part, the ordinary expenses of maintaining and operating trust property are payable out of income.[2] Such proper charges in New York and other American jurisdictions are taxes, insurance premiums, ordinary repairs and interest upon indebtedness.[3] However, where the trust corpus consists of improved real property, trustees experience no little difficulty as to the proper beneficial interest which should be charged with depreciation.

Depreciation is usually defined as the loss due to all such factors as wear and tear, decay and obsolescence which is not restored by current repairs and ordinary maintenance of the property. It is a systematic attempt to spread the cost of tangible property over the years of its expected life.[4] Generally, the decisions in the United States indicate that in the absence of an express direction in the trust instrument, the trustee is under no duty to the remainderman to set aside a depreciation reserve for improved real property, and, in fact, he owes a duty to the income beneficiaries not to charge depreciation as an expense.[5]

The test in New York seems to be one of intent. If the trust instrument contains an express provision as to depreciation, there is, of course, no problem.

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1. Restatement, Trusts sec. 233 (1935); 2 Scott, Trusts sec. 233.1, 233.3 (1939); Uniform Principal and Income Act sec. 12 (1931).

2. *Matter of Albertson*, 113 N. Y. 434, 21 N. E. 117 (1889); Restatement, Trusts sec. 233 comment e (1935); Uniform Principal and Income Act sec. 12 (1931).

3. *Matter of Albertson, supra; Spencer* v. *Spencer*, ——Misc.—— 183 N. Y. Supp. 870 (Sup. Ct., 1920); *Matter of Cronise*, 167 Misc. 310, 6 N. Y. S. (2d) 392 (Surr. Ct., 1937); and other cases cited 128 A. L. R. 199 (1940); 175 A. L. R. 1434 (1948).

4. See *Lindheimer* v. *Illinois Bell Telephone Co.*, 292 U. S. 151, 167 (1934); Accounting Research Bulletin No. 22 (1944).

5. 2 Scott, Trusts sec. 239.4 (1939); *Evans* v. *Ockerhausen* 69 App. D. C. 285, 100 F. (2d) 695 (1938), *cert. denied* 306 U. S. 633 (1939); *Freuler* v. *Helvering*, 291 U. S. 35 (1934); *Matter of Roth's Estate* 139 N. J. Eq. 588, 52 A (2d) 811 (1947); *Chapin v. Collard* 29 Wash. (2d) 788, 189 P (2d) 642 (1948).

Where there is no express provision, depreciation may be charged against income only if the creator intended that result, and his intent is to be determined from the instrument construed "under all the circumstances and in the light of his prior practice."[6] Absent the showing of any intent, it may be fairly stated that the rule presumes that the testator or settlor did not wish that depreciation be charged against income.[7] New York has recognized an exception to this rule where the property is used in a "going business."[8]

In two recent cases, this general rule has not been followed. *Matter of Kaplan*[9] decided by Surrogate McGarey of King's County in May, 1949, held that it is the duty of a trustee to deduct depreciation of improved real property from income unless the trust instrument or will has specifically directed otherwise. The same result could probably have been reached by construction of testator's intent under the general rule. He had, during his life, deducted depreciation in the amount of 2% annually for income tax purposes. There was other evidence that he intended the charge be made in that the will authorized the trustee to pay the net annual income "after making proper and suitable allowance for expenses and setting up a reserve or sinking fund to meet taxes or other contingencies." Also, it would have been easy to bring the result under the "going business" exception. The property involved was several parcels of land improved with apartment houses. For many years prior to his death, testator's sole occupation was holding and managing the multiple dwellings for investment purposes. The Court, however, unequivocally stated at page 145 that "the obligation and right to charge depreciation against gross rents is not dependent either upon the wording of the will or trust instrument or the nature of the business in which the decedent was engaged." The opinion concludes, "in the absence of a definite direction to the contrary, it is the fiduciary's duty to establish such a depreciation reserve." In October of the same year, Surrogate McGarey, in the same type of case cited and followed the *Kaplan case*.[10] These two cases cast doubt on the validity of the New York rule, supra.

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6. *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 (3rd Dept. 1901), aff'd 167 N. Y. 619, 60 N. E. 1108 (1901); *Matter of Adler* 164 Misc. 544, 299 N. Y. Supp. 542 (Surr. Ct., 1937); In re *Ottmann's Estate* 197 Misc. 645, 95 N. Y. S. (2d) 151 (Surr. Ct., 1949); In re *Davies Estate* 197 Misc. 827, 96 N. Y. S. (2d) 191 (Surr. Ct., 1950), aff'd 277 App. Div. 1025, 100 N. Y. S. (2d) 710 (1st Dept., 1950); In re *Ball's Will*, 197 Misc. 1047, 96 N. Y. S. (2d) 201 (Surr. Ct., 1950); Report of Law Revision Commission, Legislative Document No. 65-0, 1950.

7. *Matter of Adler, supra.*

8. *Matter of Edgar* 157 Misc. 10, 282 N. Y. Supp. 795 (Surr. Ct., 1935).

9. 195 Misc. 132, 88 N. Y. S. (2d) 851 (Surr. Ct., 1949).

10. In re *Dahlmann's Estate* ——Misc.——, 95 N. Y. S. (2d) 74 (Surr. Ct., 1949).

The next two cases on this point are *Matter of Ottmann,* decided December 30, 1949,[11] and *Matter of Davies,* decided February 3, 1950. [12] In the former, Surrogate Collins sets out the general New York rule and follows the older cases. In the latter at page 834, the Surrogate says: "A rule that has been so long accepted is not to be discarded readily or nullified by tenuous distinctions. Upon the assumption that the court decisions mean what they explicitly say, wills have been made, trusts have been administered, beneficiaries and fiduciaries have been given legal counsel. If, during all these years, trustees have nevertheless been bound to maintain reserves to offset depreciation of real property, no hint of the duty has been made in judicial decisions. If that duty exists and has not been performed, countless trustees would now face large surcharges." Surrogate Buscaglia of Erie County in *Matter of Ball,* decided April 5, 1950,[13] followed the decisions of Surrogate Collins in *Matter of Ottmann* and *Matter of Davies.*

The New York courts have advanced various arguments to justify their position on depreciation. Possibly, the strongest one is that the life beneficiary is normally the principal object of the testator's bounty.[14] However, cases may arise where it would be apparent that the value of the trust estate will become insufficient to produce income before the termination of the trust unless some provision is made to restore the corpus. It is questionable whether the exhaustion of the source of income in this manner was contemplated. Also, the creator must have had some concern for the remainderman, else he would have given the property in fee to the income beneficiary. Again, if the life beneficiary is young when the trust begins he may very well need a depreciation reserve to protect the income in his older age. If the life beneficiary is old at the beginning of the trust it may be doubted that he is the principal object of the creator's bounty.

A second argument usually made is that the remainderman benefits from any appreciation in value of the corpus and therefore should stand the loss caused by depreciation.[15] However, any gain by appreciation depends on the status of the market at the time of sale, something uncertain. This argument is also not tenable when it is considered that the purpose of depreciation is to provide a reserve for exhaustion and wear and tear from age. This process goes on constantly regardless of market value fluctuations produced by economic factors. Theoretically, at least, economic appreciation of the trust res will probably be reflected in an increase of income to the life beneficiary anyway.

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11. In re *Ottmann's Estate, supra.*

12. In re *Davies Estate, supra.*

13. In re *Ball's Will, supra.*

14. *Matter of Chapman, Matter of Adler, supra.*

15. *Matter of Edgar, supra.*

Finally, courts say that the difficulty of predicting the life of a building would place too heavy a burden upon the trustee or would make the result too uncertain.[16] Consistent and accepted business practices, however, recognize depreciation as a valid charge in determining income. The straight line method of depreciation is not only accepted in the business world, but trustees are also allowed to use this or other methods in computing income for tax purposes.[17]

In situations closely akin to the problem under consideration the New York courts have not seen fit to follow the general rule. In *Matter of Jones*,[18] the court allowed a deduction from income for depreciation of personal property used by trustees in carrying on the testator's business. Again, where improvements on real property, whose probable life will not extend beyond the duration of the life interest are paid for out of corpus the courts have held that income may properly be charged with annual depreciation unless the testator directs otherwise.[19] Finally, if the corpus of a trust is made up of "wasting assets," those which are actually consumed in the production of income viz. oil wells, mines, quarries, etc., New York does a turnabout and presumes that the creator of the trust did not intend that the corpus be so destroyed but rather that it be kept intact. Therefore the income therefrom must be charged with a sufficient amount to so retain the corpus.[20] This presumption, of course, is readily overcome by testator's intent to the contrary.[21] Scott points out that the difference between improved real property and "wasting assets" is a difference in degree, not a difference in kind.[22]

From the foregoing it is apparent that trustees in New York may frequently be in a quandary when the question of depreciation of improved real property confronts them. The problem of determining intent from ambiguous words and surrounding circumstances places a heavy burden on trustees, one that could and should be dispelled. The seeming exception where the property is used in a "going business," affords little help, for it presents a serious question of fact requiring determination in a judicial proceeding.

Since a trustee owes a duty to both the income beneficiary and the remainder-

16. See *Matter of Chapmann, Matter of Edgar, supra.*

17. U. S. Treasury Regulation No. 111.

18. *Matter of Jones*, 103 N. Y. 621, 9 N. E. 493, 57 Am. Rep. 775 (1886).

19. Restatement, Trusts sec. 233, comment e; *Matter of Adler supra.*

20. *Matter of Housman*, 4 Dem. Sur. 404 (N. Y. 1886); *Frankel* v. *Farmers Loan & Trust Co.*, 152 App. Div. 58, 136 N. Y. Supp. 703 (1st Dept., 1912), aff'd 209 N. Y. 553, 103 N. E. 1124 (1913); *Matter of Elsner*, 210 App. Div. 575, 206 N. Y. Supp. 765 (4th. Dept., 1924); *Matter of Hall's Estate*, 130 Misc. 313, 224 N. Y. Supp. 376 (Surr. Ct., 1927). See also 2 Scott, Trusts sec. 239; Restatement, Trusts sec. 239, comment a.

21. *Matter of Hall's Estate, supra.*

22. 2 Scott, Trusts sec. 239, 239.4.

man of a trust he may be liable to surcharge even though he acted under a mistake of law as to the extent of his powers and duties notwithstanding that he acted on the advice of counsel.[23] Consequently, as the situation now stands, a trustee is in many cases, forced into court for a judicial construction of the will or instrument in order that he may be adequately protected.

In the *Kaplan* case, *supra,* it seems an attempt was made to change and make certain the rule in New York. In the past it has been the policy of the legislature to resolve questions of testator's intent, to simplify the administration of estates and to save expense to the beneficial interests.[24] Therefore, it is submitted that remedial legislation is called for in order that the necessity of judicial proceedings to apprise the trustee of the course of action he should pursue be substantially reduced, that the difficulties encountered in the application of the general rule of intent be resolved and finally that the question whether the pre-Kaplan rule prevails today or not be answered.

When such legislation is enacted, it should provide that deduction for depreciation of improved real property in trust estates must be made and charged against income according to regular accounting practice, unless the testator expressly provides otherwise. Trusts are predominantly created by that type of person who has considerable means and who has had substantial business dealings. Consequently, more likely than not he would intend that proper deductions for depreciation be made against income. Lastly, since "Trustees are bound in the management of all the matters of the trust to act in good faith and employ such vigilance, sagacity, diligence and prudence as in general prudent men of discretion and intelligence in like matters employ in their own affairs,"[25] trustees should be required to act as prudent business men in all trust matters without exception.

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23. 2 Scott, Trusts sec. 201.

24. New York Pers. Prop. Law sec. 17.

25. *Costello v. Costello,* 152 App. Div. 280, 137 N. Y. Supp. 132 (4th. Dept., 1912), aff'd 209 N. Y. 252, 261, 103 N. E. 148 (1913).