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# Depreciation as a Trust Expense

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# NOTES

## DEPRECIATION AS A TRUST EXPENSE

". . . the prevailing doctrine has been accepted upon a subtle fallacy that never has been analyzed."[1]

Holmes' remark apropos the doctrine of *Swift v. Tyson* may be made as well about the doctrine that depreciation is borne by the remainderman as applied to the treatment of depreciation expense in trust cases. Taking the cases as they are found does not suffice to convey understanding. Those holding proper a deduction from trust income on account of depreciation of corpus have definite shortcomings as precedents. Those in which the courts state that depreciation falls upon the remainderman are traceable to cases involving either a different type of depreciation or a different tenant-remainderman relationship. With the advent of depreciation accounting, *depreciation* and *remainderman* each acquired an ambiguity that has almost completely escaped the notice of the American judiciary. Before stare decisis sets in there is yet time for a reconsideration of the problem of depreciation in trust accounting. A simple hypothetical statement may best illustrate what this problem is.

### I. The Problem

When *T* purchases for $200,000 a building that will last for forty years, he expects not only to make a fair return but also to recover his initial investment. He has no alternative but to consider the productive value of the building in the light of the inevitability of deterioration. Gross rentals minus necessary expenditures should equal a fair return plus value lost through wear, tear and obsolescence. If *T's* income before allowance for depreciation is $15,000, all of this is spendable, but only $10,000 is net income, assuming for illustrative purposes the accuracy of straight-line depreciation. Suppose *T* dies twenty years after acquiring the building. In his accounts it appears thus:

| | | |
|---|---|---|
| Building | $200,000 | |
| *Less* Reserve for Depreciation: | 100,000 | $100,000 |

[1]Holmes, J., dissenting in Black & White Taxicab Co. v. Brown & Yellow

The building is devised to *X* Trust Company, in trust to pay the income to *W* for life and then to transfer the property to *C* in fee simple. Just before his death *T* leased the building to *L* for twenty years for $20,000 per year, *T* to make ordinary repairs, pay taxes, insurance and other expenses, which amount hypothetically to $5,000 per year. The question posed here is whether *W* gets $10,000 per year, the income after allowance for depreciation, or $15,000, the income before allowance for depreciation.

## II. Definition of Terms

*Depreciation* may be used in two basic senses.[2] *Physical* depreciation denotes the loss of utilitarian value of an object, and results from wear, tear and obsolescence. The engineer views physical depreciation with an eye toward actual utility at a given moment of time. The accountant views it with an eye toward allocation of cost among the periods of time during which the asset is of benefit. Both concepts come into play in the process of accounting for depreciation.[3]

Depreciation must be estimated; it cannot be exactly foretold. Since the cost of a building cannot be ascribed wholly either to the period in which the building is acquired or to the period during which it finally ceases to have utility, and since its cost must somehow be charged against the income it has produced, the accountant adopts an estimate of useful life and employs this in determining the amount that will be charged annually against income as *depreciation expense.*

*Economic* depreciation, accurately described, imports a diminution in market value through all causes. As an analytical concept,

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Taxicab Co., 276 U.S. 518, 532 (1928).

[2]See *In re* Kaplan's Will, 195 Misc. 132, 88 N.Y.S.2d 851, 863 (Surr. Ct. 1949); Amory, Materials on Accounting 276-279 (1949); 1 Dewing, Financial Policy of Corporations 559-566 (4th ed. 1941); Graham and Katz, Accounting in Law Practice 215-274 (2d ed. 1938); Mason, Fundamentals of Accounting 317-320 (2d ed. 1947); Accounting Research Bulls. Nos. 16 at 135-143 (1942), 20 at 163-165 (1943), 22 at 179-180 (1944) (Amer. Inst. Accountants).

[3]*E.g.*, when an asset is sold the original estimate of useful life should be re-evaluated in order to determine what portion of the price is attributable to the property itself, in terms of cost-dollars, and what portion is attributable to economic appreciation or depreciation. In trust cases it would be desirable to re-examine the book value of capital assets at the time of commencement and of termination of the trust. See Mason, *op. cit. supra* note 2, at 324-330.

however, economic depreciation must be considered as loss of value through all but the causes embraced in the concept of physical depreciation.

Physical and economic depreciation are distinct in several material ways. Physical depreciation as an accounting concept is purposeful. It facilitates accounting for all costs of operating an enterprise. It is certain of occurrence, though only estimable in rate. Economic depreciation is fortuitous. Physical depreciation has no counteragent; it always detracts from the property. Economic depreciation is but the opposite of economic appreciation.

Whenever the terms appear in this Note, *depreciation* means physical depreciation in the accountant's acceptation, and *economic depreciation* means a reduction in value through all factors other than physical depreciation.

*Tenant* and *remainderman* refer to successive beneficiaries of trust estates, the former identifying one who has the right to receive the income from property, the latter signifying one who will ultimately be entitled to the property itself.[4] These words in any doctrinal context are ambiguous because the rights of a tenant in possession of property and one entitled to income alone differ; therefore, they must be analyzed contextually.

*Expense* and *expenditure* are not synonyms.[5] An expense is the expiration of a value. An expenditure is an outlay of funds or an incurrence of obligation. When a building is purchased, there is an expenditure. As it is used up, there is expense. Depreciation is an expense that entails no expenditure. This fact is probably the efficient cause of the confusion. There is no question about taxes or repairs or the electric bill. They involve payments. But depreciation expense does not; it is accounted for by debiting an expense account, which enters into the income statement, reducing net income by the amount of depreciation charged. A credit is made not to cash or accounts payable, but to a reserve for depreciation.

*Reserves* are not *funds*.[6] A reserve for depreciation, sometimes called a valuation reserve, operates to show in the accounts the

[4]These definitions accord with Section 1 of the Uniform Principal and Income Act, 9 U.L.A. 595; FLA. STAT. §690.02 (1949).

[5]GILMAN, ACCOUNTING CONCEPTS OF PROFIT 289 (1939); KESTER, ACCOUNTING THEORY AND PRACTICE 105-106 (3d ed. 1930).

[6]GRAHAM AND KATZ, ACCOUNTING IN LAW PRACTICE 174-176, 185 (2d ed. 1938); MACFARLANE AND AYARS, ACCOUNTING FUNDAMENTALS 401, 413 (1947); MASON, FUNDAMENTALS OF ACCOUNTING 323 (2d ed. 1947).

original cost of an asset and the accumulated charges to depreciation expense since its acquisition. A reserve is an entry in the books; a fund is an aggregation of assets. Normally, a business does not set up a depreciation reserve fund. Funds are liquidated, though not specifically designated. The purpose of depreciation accounting is to prevent their being designated as income when in fact they are liquidated principal.

## III. The Law and How It Got That Way

To say that depreciation is borne by the remainderman[7] is to utter a compound ambiguity. But the phrase is at home in the context of nontrust estates. In the case of the ordinary legal estate in real property, the tenant is entitled to *occupy* the property. To require the tenant to set aside affirmatively certain amounts in a depreciation reserve fund would unquestionably run counter to the normal testator's intent. Although such a tenant would normally be expected to keep the property in repair, he would not be expected to set aside money on account of usual wear and tear. This is settled law; and it is accurate to say that both physical and economic depreciation are borne by the remainderman who succeeds a tenant having the right to occupy the property.[8]

It is also correct to state that economic depreciation is borne by all remaindermen.[9] It follows, of course, that economic appreciation inures to the benefit of the remainderman. This is a rule that cuts both ways.

Conceding that all depreciation is borne by the remainderman

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[7]This is equivalent to saying that the remainderman takes the property as he finds it, or that normal wear and tear do not constitute waste. Differing expressions of the same idea may be found in all of the cases discussed in Part III.

[8]*In re* Stout's Estate, 151 Ore. 411, 50 P.2d 768 (1935); see 2 Scott, Trusts §239 (1939). It is interesting to note in this connection that in England the occupant of property passing with ecclesiastical office was formerly required to rebuild as well as repair, Wise v. Metcalfe, 10 Barn. & Cr. 299, 109 Eng. Rep. 461 (K.B. 1829). Modern accounting methods would have improved on this procedure. With reference to legal life estates in personalty, there is a rule to the effect that there can be no remainder in a consumable article. The extreme application of the rule is Seabrook v. Grimes, 107 Md. 410, 68 Atl. 883 (1908), where a life estate in printing presses and equipment was converted into a fee.

[9]See Cardozo, J., in Equitable Trust Co. of N.Y. v. Prentice, 250 N.Y. 1, 11, 164 N.E. 723, 725 (1928); Isaacs, *Principal—Quantum or Res?*, 46 Harv. L. Rev. 776, 778, 787 (1933); *cf.* Fla. Stat. §690.04 (2) (1949).

succeeding a tenant *occupying* the property and that *economic* depreciation is borne by any remainderman, regardless of the rights incident to the preceding interest, it does not follow that *all* depreciation is borne by *all* remaindermen. Yet there are many holdings that physical depreciation is borne by the remainderman even though the tenant is entitled to no more than the income from the corpus. The comedy of errors that is their history ensues.

In *Whitcomb v. Blair*[10] the trustee had deducted depreciation expense from income in accordance with the current income tax law, but the tenant received the income before allowance for depreciation. She deducted depreciation expense on trust property from her individual income tax return. This was properly disallowed. Under the law at the time, the deduction inured to the trust and was properly taken by the trustee only, although this procedure resulted practically in the elimination of any benefit from the deduction because no undistributable income remained against which to apply it.[11] *Whitcomb v. Blair* was not a case in which the right to receive income before allowance for depreciation was decided, but is the first of a series of federal cases,[12] of which *Laflin v. Commissioner* is most frequently cited, reiterating that depreciation is borne by the remainderman. The *Whitcomb* case relies on an early South Carolina decision[13] to support its dictum about the nondeductibility of depreciation expense. The words of the South Carolina case support *Whitcomb v. Blair;* the reasoning supports the thesis of this Note that the testator's intent should govern.

Every New York surrogate's court except one[14] follows a strict doctrinal view traceable to the line of federal cases and to an indigenous body of case law headed by In re *Chapman*[15] and *Smith v.*

[10]25 F.2d 528 (D.C. Cir. 1928).

[11]The present law affords the deduction to the trustee if depreciation is deducted to arrive at distributable income, and to the tenant if it is not, INT. REV. CODE §23(1).

[12]United States v. Blow, 77 F.2d 141 (7th Cir. 1935); Laflin v. Commissioner, 69 F.2d 460 (7th Cir. 1934); Dixon v. Commissioner, 69 F.2d 461 (7th Cir. 1934), *cert. denied,* 293 U.S. 560 (1934); Hubbel v. Burnet, 46 F.2d 446 (8th Cir. 1931). *But cf.* Helvering v. Falk, 291 U.S. 183 (1934) (opposite result with respect to depletion).

[13]Calhoun v. Furgeson, 3 Rich. Eq. 160 (S.C. Ct. App. 1850).

[14]The Surrogate's Court for Kings County: *In re* Dahlmann's Estate, 196 Misc. 260, 95 N.Y.S.2d 74 (1949); *In re* Kaplan's Will, 195 Misc. 132, 88 N.Y.S.2d 851 (1949).

[15]32 Misc. 187, 66 N.Y. Supp. 235 (Surr. Ct. 1900), *aff'd mem.,* 59 App.

*Keteltas*,[16] two turn-of-the-century cases. The *Chapman* case involved a three-eighths interest in a freight steamer. The trustee, obligated to distribute the income to the testator's widow, deducted from total receipts an amount claimed to represent depreciation of corpus. This action was disapproved by the surrogate and the Appellate Division and Court of Appeals each affirmed without opinion.[17] There is little doubt that the case was correctly decided on its facts. At the time, depreciation accounting theory had been neither fully developed nor universally accepted.[18] Courts were *expenditure*-minded, not *expense*-minded. In the *Chapman* case the court approved the practice of deducting the cost of changes in rig and equipage of the ship, which seem to be capital expenditures, from income.[19] Further, the testator himself had not charged depreciation to expense, probably had not thought of it and, if he had, might well have approved the scheme of accounting adopted by the surrogate as providing more amply for his needy widow. The only cases cited in the *Chapman* opinion dealt with amortization of bond premium, a significantly different matter.[20]

*Smith v. Keteltas* involved a trust that had continued for almost

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Div. 624, 69 N.Y. Supp. 1131 (3rd Dep't 1901), *aff'd mem.*, 167 N.Y. 619, 60 N.E. 1108 (1901).

[16]62 App. Div. 174, 70 N.Y. Supp. 1065 (1st Dep't 1901), *affirming* 32 Misc. 111, 66 N.Y. Supp. 260 (Sup. Ct. 1900).

[17]59 App. Div. 624, 69 NY. Supp. 1131 (3d Dep't 1901), 167 N.Y. 619, 60 N.E. 1108 (1901).

[18]See 1 DEWING, FINANCIAL POLICY OF CORPORATIONS 554-556 (4th ed. 1941); SALIERS, DEPRECIATION c. 2 (3d ed. 1939); see also note 19 *infra*.

[19]*Cf.* United States v. Kansas Pac. Ry., 99 U.S. 455 (1878). There the Supreme Court held that the cost of rails and ties should be deducted as expense when purchased, but that depreciation on existing assets should not. The opinion typifies judicial thinking about depreciation current until Knoxville v. Knoxville Water Co., 212 U.S. 1 (1909).

[20]*In re* Hoyt, 160 N.Y. 607, 55 N.E. 282 (1899), and McLouth v. Hunt, 154 N.Y. 179, 48 N.E. 548 (1897), were the cases referred to. Amortization of bond premium and depreciation of a building differ in two important particulars. Primarily, the distinction is one of relative significance. Bond premiums are usually small in amount as compared with the principal. Depreciation will eventually account for all of an asset's value except salvage value. The rule to the effect that bond premium should not be amortized is adopted as a matter of convenience in Section 6 of the Uniform Principal and Income Act, FLA. STAT. §690.07 (1949). A second reason is that discounts on some bonds may offset premiums on others. This is never possible with respect to physical depreciation, which has no counteragent.

sixty years. Certain land had been condemned for public purposes, and some buildings on other trust property had been ordered torn down because unsafe. The court approved the trustee's application of principal cash derived from the condemnation award to the erection of new structures on the land from which the unsound ones had been removed. The opinion contains a dictum[21] to the effect that the trustee had been under no obligation to set aside amounts out of income to provide for rebuilding deteriorated structures. This case is also correct on its facts. But the dictum has deterred the acceptance of depreciation accounting in trust practice. It emphasizes the need for clarification of the distinction between recovery of the original cost of a durable asset and a provision for the acquisition of property in the future. The courts that deny depreciation as a trust expense seem to feel that part of the income is being withheld from the tenant in order to permit the remainderman to replace the property. Actually, the charge to depreciation expense signifies that part of the corpus is being altered in form. When the change from building to cash is complete the remainderman is indeed lucky if he can change the cash back into a comparable building again.[22]

If authority were weighed by the reported case, the decided "weight of authority" would be that physical as well as economic depreciation is borne by any remainderman.[23] In the instant context the New York surrogates apply the doctrine rigidly. It is said that the testator's intent is to provide most generously for those

[21] 62 App. Div. at 180-181, 70 N.Y. Supp. at 1069.

[22] See AMORY, MATERIALS ON ACCOUNTING 322-343 (1949); ACCOUNTING RESEARCH BULL. No. 33 (Amer. Inst. Accountants 1947) ("Depreciation and High Costs").

[23] Evans v. Ockershausen, 100 F.2d 695 (D.C. Cir. 1938), *cert. denied sub nom.* Smith v. Ockershausen, 306 U.S. 633 (1939); *In re* Roth's Estate, 139 N.J. Eq. 588, 52 A.2d 811 (Prerog. Ct. 1947); *In re* Davies' Estate, 197 Misc. 827, 96 N.Y.S.2d 191 (Surr. Ct. 1950); *In re* Ball's Will, 197 Misc. 1047, 96 N.Y.S.2d 201 (Surr. Ct. 1950); *In re* Ottmann's Estate, 197 Misc. 645, 95 N.Y.S.2d 5 (Surr. Ct. 1949); *In re* Wadsworth's Will, 81 N.Y.S.2d 298 (Surr. Ct. 1948); *In re* Horowitz' Estate, 192 Misc. 556, 80 N.Y.S.2d 286 (Surr. Ct. 1944); *In re* Danziger's Will, 58 N.Y.S.2d 790 (Surr. Ct. 1945), *modified on other grounds*, 271 App. Div. 888, 67 N.Y.S.2d 130 (2d Dep't 1946); *In re* Adler's Estate, 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937); *In re* Crimmins' Estate, 159 Misc. 499, 288 N.Y. Supp. 552 (Surr. Ct. 1936); *In re* Edgar's Estate, 157 Misc. 10, 282 N.Y. Supp. 795 (Surr. Ct. 1935); Chapin v. Collard, 29 Wash.2d 788, 189 P.2d 642 (1948); *see In re* Lee's Estate, 214 Minn. 448, 9 N.W.2d 245, 247 (1943); Welch v. Welch, 235 Wis. 282, 290 N.W. 758, 780, *modified* 235 Wis. 282, 293 N.W. 150 (1940); *cf.* Nelligan v. Long, 320 Mass. 439, 70 N.E.2d 175 (1946).

closest to him.[24] There is occasional reference to, but no reliance on, evidence of the testator's practice during his lifetime.[25] Other states have applied the doctrine without historical analysis of it.[26]

The doctrine was challenged in New York in 1949. In re *Kaplan's Will*,[27] Surrogate McGarey held that in the absence of express directions the trustee not only may, but must, deduct depreciation expense in determining distributable income. The opinion clearly distinguishes the two types of depreciation. It clearly recognizes that today's testator and the testator of 1900 thought differently. The Surrogate properly distinguished In re *Chapman* and *Smith v. Keteltas*, declined to follow decisions of other surrogates' courts,[28] neglected to mention a previous decision of his own to the contrary[29] and thereby boldly freed the law from entangling verbiage. But the *Kaplan* case has not been followed elsewhere in New York. For hopeful remaindermen in that state the treat still grows in Brooklyn only.

In re *Davies' Estate*[30] is the traditional school's riposte to the *Kaplan* parry. The *Kaplan* case was there criticized as meaning that the deduction on account of depreciation should be made to permit replacement of the building which was the corpus in that case. While the language in the *Kaplan* opinion is susceptible of this interpretation, it is not a fair one. Depreciation is accounted for on the basis of original cost; replacement is not a necessary incident at all. The *Davies* case is a strong one nevertheless, and the opinion contains a good statement of the New York law to date.[31]

[24]*In re* Edgar's Estate, 157 Misc. 10, 282 N.Y. Supp. 795 (Surr. Ct. 1935); *In re* Chapman, 32 Misc. 187, 66 N.Y. Supp. 235 (Surr. Ct. 1900).

[25]*In re* Adler's Estate, 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937).

[26]Evans v. Ockershausen, 100 F.2d 695 (D.C. Cir. 1938), *cert. denied sub nom.* Smith v. Ockershausen, 306 U.S. 633 (1939); *In re* Roth's Estate, 139 N.J. Eq. 588, 52 A.2d 811 (Prerog. Ct. 1947); Chapin v. Collard, 29 Wash.2d 788, 189 P.2d 642 (1948).

[27]195 Misc. 132, 88 N.Y.S.2d 851 (Surr. Ct. 1949); for comments on the case, see Niles, *Trusts*, 24 N.Y.U.L.Q. REV. 1229, at 1239 (1949); Case Comments, 63 HARV. L. REV. 180 (1949); 48 MICH. L. REV. 542 (1950).

[28]*In re* Danziger's Will, 58 N.Y.S.2d 790 (Surr. Ct. 1945); *In re* Adler's Estate, 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937); *In re* Crimmins' Estate, 159 Misc. 499, 288 N.Y. Supp. 552 (Surr. Ct. 1936); *In re* Edgar's Estate, 157 Misc. 10, 282 N.Y. Supp. 795 (Surr. Ct. 1935).

[29]*In re* Horowitz' Estate, 192 Misc. 556, 80 N.Y.S.2d 286 (Surr. Ct. 1944).

[30]197 Misc. 827, 96 N.Y.S.2d 191 (Surr. Ct. 1950).

[31]It is interesting to note that the surrogate approved the policy of spreading the cost of a three-year insurance policy over the entire period covered, but re-

### IV. Cases Supporting the Remainderman

When the problem arose in England it was argued on a different basis. In re *Crabtree*,[32] the tenant argued that a charge to depreciation expense was not justified because the machinery constituting part of the corpus had lost neither utilitarian nor economic value. The Court of Appeal held that depreciation was a proper charge because the eventual total loss of utilitarian value was inevitable and market value was immaterial.

The *Crabtree* case has been followed in New Brunswick.[33] There are indications in New York cases that it would be followed even there if the facts were similar. In re *Jones*[34] the Court of Appeals held that the cost of replacing equipment worn out in a brewing business held in trust was a proper expense.[35]. In re *Crabtree* and the criticized New York cases are opposed in result but not necessarily in theory. The question argued in the *Crabtree* case was depreciation as an actual fact, while in the New York and kindred cases its burden was the salient point. Accordingly these lines of decision can be distinguished on the basis of the questions before the courts. Indeed, many of the American cases expressly recognize the fact of depreciation.[36]

A factual distinction may also be made, but the courts have not made it. In the *Crabtree* case, the principal was used in a going business. The effect of failure to deduct depreciation expense is more quickly manifested there than in a case in which the corpus is a building held for rental purposes. This dichotomy lends weight to the hypothesis that the proper conceptual approach lies in deter-

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fused to concede that depreciation accounting does no more than that for the cost of a building. Of course, the building was not acquired after the trust began. Query whether depreciation is proper in all cases in which the trustee purchases depreciable property; the unreported decision of a California court upon which Freuler v. Helvering, 291 U.S. 35 (1934), is based may have permitted the deduction on this theory.

[32]106 L.T.R. 49 (C.A. 1912).

[33]*In re* Rose, [1940] 1 D.L.R. 139 (N.B. Sup. Ct. 1939).

[34]103 N.Y. 621, 9 N.E. 493 (1886). See also *In re* Housman, 4 Dem. Surr. 404 (N.Y. 1886) (trustee under a duty to sell furniture should provide for depreciation if instead it is used in a rental building owned by the trust).

[35]See note 19 *supra*.

[36]*E.g.*, *In re* Roth's Estate, 139 N.J. Eq. 588, 52 A.2d 811 (Prerog. Ct. 1947); *In re* Horowitz' Estate, 192 Misc. 556, 80 N.Y.S.2d 286 (Surr. Ct. 1944); Chapin v. Collard, 29 Wash.2d 788, 189 P.2d 642 (1948).

mining the business or non-business character of the principal;[37] and this approach is apparently the one adopted in the Uniform Principal and Income Act,[38] but the sense in which the word *business* is used is not discernible from the context. In Florida this matter is of concern because the Uniform Act is in force and almost every rental building is part of a *business*, in the broad sense of that term.[39] It is arguable that the dividing line can be discerned in the New York cases. The argument would run: (1) whenever a business is held in trust, depreciation is an expense—a proposition without substantial support in the cases;[40] (2) depreciation is not an expense of a trust the principal of which consists of a building;[41] (3) therefore a building held for rental purposes is not a business. This makes a neat syllogism, but at the cost of reading into the cases much that is not found elsewhere than between the lines. The cases that go off on a doctrinal tangent to fix the burden of depreciation on the

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[37]One may question whether there is not a negative correlation between intent to deduct depreciation in computing trust income and the business character of the principal. A business is characterized by management. If the testator's income is derived largely from his managerial skills, it is probable that the income to his family will drop sharply when he dies. On the other hand, if the testator merely held the property for the production of income, it may not be characterized as a business, but the income will probably not diminish substantially merely by reason of the testator's death. Yet this conception demands deduction of depreciation expense in the first instance, but not in the second. This leaves as a rational basis for the business conception the fact that depreciation allowances are necessary, in those cases in which the corpora can be characterized as businesses, to permit profitable continuation.

[38]In Section 7, 9 U.L.A. 595 at 599; FLA. STAT. §690.08 (1949). The act is now in force in 14 states: ALA. CODE tit. 58, §§75-87 (1940); CAL. GEN. LAWS act 8696 (1944); CONN. GEN. STAT. §§6899-6908 (1949); FLA. STAT. c.690 (1949); ILL. REV. STAT. c.30, §§159-176 (1949); LA. REV. STAT.. §§2091-2101 (1950); MD. ANN. CODE GEN. LAWS art. 75B (1939); N. C. GEN. STAT. §§37-1 to 37-15 (1943); OKLA. STAT. tit. 60, §§175.1-175.53 (1941);ORE. COMP. LAWS ANN. §§74-101 to 74-114 (1940); PA. STAT. ANN. tit. 20, §§3470.1-3470.13 (1950); TEX. STAT., REV. CIV. arts. 7425b-4, 7425b-26 to 7425b-36 (1948); UTAH CODE ANN. §§ 73A-0-1 to 73A-0-17 (1943); VA. CODE §§ 55.253-55-268 (1950).

[39]Statutes levying taxes on doing business, for example, evoke a broad definition of *business*, see Flint v. Stone Tracy Co., 220 U.S. 107 (1911). While the broad definition is definitely a misfit in the instant context, it is difficult to devise criteria by which the word *business* can be defined in any particular statutory reference.

[40]See note 34 *supra; cf. In re* Hubbell's Will, 276 App. Div. 134, 93 N.Y.S.2d 555 (2d Dep't 1949).

[41]Cases cited note 23 *supra.*

remainderman do not involve the business vel non dichotomy explicitly. The concept is one that is discernible hazily in the cases but that the courts have not brought to the surface. The extent of its significance where the Uniform Act is not in force may be that depreciation is deductible in only those instances in which the continuation of the principal in a productive state demands it. Thus there is a circuitous arrival at a definition of *business* in the present context. But the concept of the principal as a business fails to aid understanding.[42]

The word *business* appears in the Uniform Principal and Income Act and must be dealt with.[43] The best that can be said in this connection is that the Uniform Act starts with a fresh ambiguity in contemplation of better results. Broadly defined as any activity carried on for profit, *business* would include almost all trust corpora. Probably what the framers intended, if anything, was that *business* be contrasted with *investment*.[44]

One other conceptual approach bears mention. It has been suggested that the answer to the problem is referable to the question whether the principal is conceived as a quantum or a res.[45] The res conception works well—witness the widow's estate for life in the old family home. So does the quantum concept when the principal is exactly expressible in pecuniary terms—ten thousand dollars in the X Savings Bank, for example. But conceive a building as a dollar amount, and economic and physical depreciation are completely confused.[46] The quantum-res distinction is helpful to the exent that it focuses attention on the testator's intention, but the quantum concept hinders accurate analysis of the depreciation problem.

[42]*Business* seems here to be just a word awaiting attachment to a preconceived definition.

[43]Section 7 of the Uniform Act was an innovation in the fourth and final draft. It has not yet been interpreted in reported opinions, nor has it been analyzed in detail by the writers. Compare Section 7 with Sections 3 and 10, which are FLA. STAT. §§690.04, 690.11 (1949).

[44]A close analogy may be found in workmen's compensation cases involving the question whether the employer is engaged in business, see Note, 50 A.L.R. 1176 (1927). Consider also the language of INT. REV. CODE §23(1): ". . . property used in the trade or business, or . . . property held for the production of income." The difference is apparent, but where is the dividing line?

[45]Note, 60 HARV. L. REV. 952 at 953 (1947), citing Isaacs, *Principal—Quantum or Res?*, 46 HARV. L. REV. 776 at 780 (1933).

[46]Since confusion of economic with physical depreciation is one of the major factors to be overcome in order to modernize the law respecting the depreciation problem, this quantum-res distinction may do more harm than good. It does serve to focus attention on the desires of the testator, however.

## V. What the Law Should Be

If the testator's intent is the touchstone of testamentary interpretation,[47] the courts should proceed from that basic premise to a conclusion according with the result desired by the decedent himself. Dictionaries and digests are equally insufficient as repositories of the information upon which an intelligent decision must be founded. To decide the case by merely defining the words in the will does not suffice, although this would probably result in the allowance of a deduction on account of depreciation.[48] Ordinarily, however, the testator has used the words *income, net income, profit* and the like without nuances directed toward the depreciation problem. Perhaps he has even said to "pay all expenses." How would one argue the depreciation problem in such a case on a verbal basis? Depreciation is an expense that is not paid.[49] The truth is that probably such words and phrases are standard. They are used to carry the main idea of the testator, and the specific problem of depreciation has usually not been thought of at all.

The doctrinal argument is superficial too.[50] True, "cases in point" can be found; the citations are bulky, and hence impressive. But the spurious ancestry of these cases has already been revealed.

A rule is needed to permit settlement of normal instances without fostering cavil in the courts about ordinary words. The rule should, however, give way to a reasonably definite indication that the testator contemplated the opposite result.[51] What should be the normal rule? This is not a right-or-wrong, but rather a pro-and-con, proposition. There is reason to support either view.

Several arguments support the position that no depreciation ex-

[47]See cases collected in Mosgrove v. Mach, 133 Fla. 459, 182 So. 786 (1938).

[48]See *In re* Crabtree, 106 L.T.R. 49 (C.A. 1912); Amory, Materials on Accounting 302-303 (1949); Propp, *Depreciation of Buildings Held as Testamentary Trusts,* 19 N.Y. Certified Public Accountant 170 (1949); Traver, *How Depreciation Affects Distributions of Income from Property Held by Trustees,* 85 J. Accountancy 322 (1948). See also 2 Scott, Trusts §239 (1939).

[49]See note 5 *supra.*

[50]See Part III *supra*; the doctrine is much criticized, even by the courts that apply it.

[51]Compare Russ v. Russ, 9 Fla. 105 (1860). Perrin v. Morgan, [1943] A.C. 399, is an important decision on the general question of the effect of rules of construction. Viscount Simon, L.C., remarked (at p. 408): ". . . the duty of a judge who is called on to interpret a will containing ordinary English words is not to regard previous decisions as constituting a sort of legal dictionary to be consulted and remorselessly applied whatever the testator may have intended . . ."

pense should be deducted in the normal case.[52] The testator may be presumed to have drawn his will with reference to the cases.[53] Whether right or wrong these cases are numerous, and their doctrine has been repeated by several textwriters as authoritative.[54] The doctrine is not unreasonable. It favors the tenant, who is normally the primary object of the testator's bounty. Too, there is a policy interest in the rule which facilitates the rapid distribution of wealth and the limitation of control over it by the dead.

The argument of the writers who have criticized the New York doctrine is largely verbal. Complete acceptance of their contentions subsumes an identity of the concept of income in the mind of the testator and that in the mind of the writer. The testator envisions results, but the critics of the doctrine would hold him to his words even when carelessly used. It is also arguable that when property is specifically given it should be treated as a wasting asset, such as a mine or a quarry.[55] This approach is equivalent to the conception of the corpus as a res, discussed in Part IV.

On the other side is the fact that depreciation is an expense that must be deducted in order to arrive at net income. This practice is widely understood today, and owners of property worth quibbling over in the courts can be presumed to understand it. Depreciation accounting recognizes gradual liquidation of the principal and the periodic substitution of dollar amounts for the liquidated portion of the property.

The decisions disapproving the deduction are unsound analytically. Too, only one court of last resort has unqualifiedly accepted the

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[52]Bills were introduced in the 1950 session of the New York Legislature to establish the no-depreciation rule as a normal, but not an invariable, one. These failed of passage. See N.Y. Law Revision Commission, *Legislative Document No.* 65(0) (1950).

[53]*See In re* Davies' Estate, 197 Misc. 827, 96 N.Y.S.2d 191, 198 (Surr. Ct. 1950), where it is suggested that the existence of the numerous cases denying depreciation has been taken into account in the drafting of wills. The argument is a good one, but it hardly fit the *Davies* case. The testator died in 1929. Compare chronologically the cases cited in note 23 *supra.*

[54]See AMORY, MATERIALS ON ACCOUNTING 302-303 (1949); JOHNSON, ADVANCED ACCOUNTING 474 (1948); NOBLE, KARRENBROCK AND SIMONS, ADVANCED ACCOUNTING 727 (1941); 2 SCOTT, TRUSTS §239.4 (1939).

[55]Depreciation should be distinguished from depletion. As a matter of business policy, the latter often need not be deducted. See 1 DEWING, FINANCIAL POLICY OF CORPORATIONS 104-105, 561 (4th ed. 1941); GILMAN, ACCOUNTING CONCEPTS OF PROFIT 343 (1939).

doctrine.[56] The depreciation problem is one that may not be thought of at all; the man familiar with income computation for the living can hardly be expected to anticipate that the income from a dead man's property is something radically different.

A normal rule favoring the remainderman would mean that adjustments required by inaccurate estimates of the life of an asset could be made without substantial injury to either party. If the tenant is favored, the remainderman may well get the property after it has been fully depreciated on the accounts but still of value.[57] Should the remainderman then sell the property the entire proceeds from the sale would be taxable as capital gain, since the basis of the property would be zero.[58]

Considerations of policy are not all on the tenant's side. There is a very real social interest in the preservation of capital goods that are producing something needed by the community. Funds retained as part of the corpus may permit at least partial replacement of vital trust assets, whereas these same funds, if distributed to the tenant, may be dissipated.

Consistency is another factor favoring deduction of depreciation in computing trust income. If the corpus consists of shares of corporate stock, the use of depreciation accounting prevents the corporation from paying dividends out of capital.[59] Logically, the same reasoning should apply to the enterprise regardless of whether it is owned in corporate or individual form.

From the standpoint of simplicity of administration, neither rule is superior to the other. A determination is necessary for income tax purposes in any event.[60]

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[56]Chapin v. Collard, 29 Wash.2d 788, 189 P.2d 642 (1948).

[57]Property that is fully depreciated accounting-wise may yet have utility. The equivalence of asset and reserve accounts means merely that all of the cost of the asset has been charged against revenues. For an excellent discussion of the tax consequences of the remainderman's taking the property after it has been fully depreciated on the accounts, see Traver, *How Depreciation Affects Distributions of Income from Property Held by Trustees,* 85 J. ACCOUNTANCY 322 (1948).

[58]INT. REV. CODE § 23 (1); U. S. Treas. Reg. 111. §29.23(1).

[59]See 1 DEWING, FINANCIAL POLICY OF CORPORATIONS 102-107 (4th ed. 1941); FLA. STAT. §612.23 (1949). *But. cf. In re* Adler's Estate, 164 Misc. 544, 299 N. Y. Supp. 542 (Surr. Ct. 1937) (all stock owned by the trust; corporate entity disregarded) See Note, 60 HARV. L. REV. 952 at 956-958 (1947).

[60]Ease of administration should not be an important factor in settling the depreciation question. Depreciation is an important item of expense. Cf. note 20 *supra.*

Any court to which the depreciation problem is presented can, with careful consideration, reach a result reasonably calculated to effectuate the desires of the testator without channeling future litigation into a narrow verbal abyss. Such a decision can be firmly grounded on fact and supported by judicious judicial selection from the legal authorities available. As for the "normal" case, the problem is still factual, rather than legal. Probably it is preferable to allow depreciation expense in the normal case. To establish the New York doctrine as a normal rule of interpretation is to contravene a strong trend in modern thinking.[61] Such a rule will probably prove increasingly unsatisfactory as time goes on. In any event, however, the courts should formulate their decisions in such a way as to preserve the flexibility necessary to decide any particular case either way, as its particular facts require.

## VI. The Role of the Draftsman

The testator can have his way if he expresses himself well, no matter what a court would have done with his will if he had not. He can specify that depreciation be provided for without contravening any rule against accumulations,[62] since the accumulation of assets in a depreciation reserve fund merely signifies a change in form of the principal, not a withholding of income. In Florida the trustee is authorized by the Uniform Trust Administration Act[63] to establish a funded depreciation reserve whenever the instrument is silent on the point. But doubt remains whether to do so would work a desirable result in the particular instance.

It should be borne in mind that depreciation will eventually account for all of the value of a building except its salvage value and, of course, the underlying land. Consideration should be given to the source of the testator's income. If it is derived chiefly from his property, there is reasonable basis for assuming as a working hypothesis that it will be sufficient after his death if depreciation is deducted. If, on the other hand, he relied primarily on his abilities in order to produce his income, his property may well prove insufficient to provide enough income for his family.

[61]See notes 18, 48 *supra*.

[62]*In re* Kaplan's Will, 195 Misc. 132, 88 N.Y.S.2d 851 (Surr. Ct. 1949); 48 Mich. L. Rev. 542 (1950). See also, for a decision upholding depreciation expense charged pursuant to a discretionary power, Fidelity Union Trust Co. v. McGraw, 138 N.J. Eq. 415, 48 A.2d 279 (Ch. 1946).

[63]Fla. Stat. §691.03(14) (1949).

The effect of the business cycle on income must be taken into account. Depression may require spending more than is earned. The gradual liquidation of principal through charges to depreciation expense renders this possible without actual conversion of the assets. In corporate practice this procedure is manifested in depreciation expense greater in amount than expenditures for replacement.[64]

Probably the best alternative is to provide specifically that depreciation be considered a deductible trust expense and also that the trustee may invade principal to make payments to the tenant if necessary. This scheme is adapted to the preservation of the principal without working a hardship on the tenant.

Instructions that are too indefinite are likely to put the trustee on the spot. For example, if the trustee is empowered to sell the property, he cannot fail to deduct depreciation expense without favoring the tenant in fact.[65] Reasonably definite directions will avoid the possibility of converting the depreciation problem into a major factor in the larger problem of managing the estate.

## VII. Conclusion

The existing case law relevant to the problem of depreciation expense in trust estates is such that depreciation can be held either deductible or not. But the cases holding each way do not draw any clean lines. They establish no criteria by which the appropriateness of the deduction can be determined. They overlook the ambiguities of words commonly found in wills. And whatever attention is paid to the results contemplated by the testator seems to be inserted in the opinions merely to rationalize the decisions.[66]

The law is not clear, but it is available in sufficiently diverse verbal forms to permit analysis of the plan envisioned by the testator. Here is the real area for the lawyer's services. The judge is con-

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[64]See 1 Dewing, Financial Policy of Corporations 601-603 (4th ed. 1941).

[65]Economic appreciation can, of course, offset physical depreciation in terms of dollar values, although the two are logically distinct. But see *In re* Matthews' Estate, 210 Wis. 109, 245 N.W. 122 (1932), in which depreciation was held proper as an expense, but the accumulated reserve fund was not paid over to the remainderman because the property had been sold at a considerable profit. This may be a fair result, but it is illogical.

[66]See, *e.g.*, *In re* Adler's Estate, 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937); *In re* Edgar's Estate, 157 Misc. 10, 282 N.Y. Supp. 795 (Surr. Ct. 1935).

fronted with a factual, not a legal, problem; and citable authority is the least of his worries.

The Uniform Principal and Income Act will solve the problem as regards a business held in trust if the principal is clearly "used in business"; but in the case of an apartment building, for example, the difficulty remains. In such an instance the Uniform Act injects artificialities into the argument. The problem of effectuating the testator's intent remains, and the statute has not rendered it possible of solution by reference to mere legalities. The facts remain, but they must now be argued in terms of the business-or-not language of the Uniform Act. It is arguable, of course, that Section 7 does not rule out deduction of depreciation as an expense of non-business trust operations, but the maxim *expressio unius est exclusio alterius* militates against this contention. The remainderman, faced with much of the case law and yet desirous of focusing judicial attention on his contentions, will probably fare better by arguing that the principal is a business than by bucking such a formidable mass of Latin. Rental buildings and citrus groves can be "principal used in business."[67] Courts are still confronted with the problem of devising, if they can, ways to decide any particular case as the testator would have wished it decided without making the framework of the law so rigid that it virtually destroys the unavoidably broad discretion required to reach practical results to work in future cases.

No matter in what jurisdiction the depreciation problem arises, the sound growth of the law demands that lawyers' arguments and judges' opinions be long on facts and short on law. What is really needed more than anything else is increased consciousness of depreciation. Law lags behind accountancy in this matter. Confusion of economic and physical depreciation lies at the root of the legal problem. Perhaps the accounting profession erred in calling this expense *depreciation.* But the word is used everywhere to describe a process and an expense that is no less inexorable than time and tide, no less inevitable than death and taxes. The law in this field is still focused on words. It should be focused on facts.

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[67]On rental buildings, see REP. ATT'Y GEN. FLA. 281 (1945); Crosby and Miller, *Our Legal Chameleon, The Florida Homestead Exemption,* 2 U. OF FLA. L. REV. 346, 374 (1949). On farming as business, see Plant v. Walsh, 280 Fed. 722 (D. Conn. 1922); Waggener v. Haskell, 89 Tex. 435, 35 S.W. 1 (1896); INT. REV. CODE §23(1); U.S. Treas. Reg. 111, §§29.23(a)-11, 29.23(e)-5, 29.23(1)-10.