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Trusts - Improved Real Estate - Validity of Depreciation Reserves

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TRUSTS—IMPROVED REAL ESTATE—VALIDITY OF DEPRECIATION RESERVES—Depreciation of physical assets is an accounting procedure now taken for granted in the business and tax areas of the law. Its emergence in the field of trusts has been relatively slow, however, and even today it has not gained much acceptance by the courts. It is the purpose of this comment to examine some of the reasons why the courts have been reluctant in applying the depreciation concept to trusts, and in particular to those trusts that include improved real estate among the assets of the corpus.

The United States Supreme Court has defined depreciation as follows: "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] Looked at from another viewpoint, depreciation is an allocation of the cost of a building among the periods of time during which the asset is of benefit. It is a charge against the income that the building has produced.[2] For a proper perspective of the development of the depreciation concept as applied to those trusts that include improved realty among the assets, it is advantageous to examine first the law regarding a bequest of property consisting of wasting or consumable assets to a life tenant and remainderman.

1 Lindheimer v. Illinois Bell Telephone Co., 292 U.S. 151 at 167 (1933).
2 4 FLA. L. REV. 41 at 42 (1951).

The Doctrine of Howe v. Dartmouth

The early English case of *Howe v. Dartmouth*[3] established the rule that where property of a wasting or consumable nature[4] is devised generally or under a residuary clause to one for life with a remainder over, the court will presume, in the absence of language in the will to the contrary, that the testator intended both the life tenant and remainderman to enjoy the property. Consequently, the court will not allow the life tenant to deplete the wasting assets to the detriment of the remainderman and will order a sale of the wasting assets and a conversion of the proceeds into securities, with the life tenant receiving only the income therefrom.[5]

The same rule is applicable to trusts which include wasting or consumable property among the trust assets. Under these conditions the courts hold that the trustee is under a duty either (1) to set up an amortization fund out of income received from the wasting property, or (2) to sell the property and reinvest the proceeds in proper trust investments with the life tenant receiving only the income.[6] Of course, if the trust instrument specifies that the wasting property is to be retained, the intention of the settlor will be followed. It is to be noted that some courts are reluctant to apply the general rule and avoid its application by declaring that it would defeat the true intention of the settlor or testator.[7]

The rationale behind the rule of *Howe v. Dartmouth* seems both logical and fair. Payment to the life tenant in specie or income from wasting property could result in virtual depletion of the property by the time that the remainderman's interest vested in possession. The value of such property would decrease annually as depletion occurred, perhaps even in the face of rapidly increasing land values. Thus by a reconversion of the wasting property

[3] 7 Ves. 137, 32 Eng. Rep. 56 (1802).

[4] Wasting or consumable property includes leasehold interests, royalties, patent rights, mines, oil and gas wells, quarries and timberlands. 3 SCOTT, TRUSTS, 2d ed., §239, p. 1857 (1956).

[5] While acknowledging the general rule, some American courts have been sympathetic to the claims of life beneficiaries that the application of the rule would defeat the true intention of the testator. Hence some courts do not apply the general rule if there are even slight indications that the testator intended otherwise, particularly if the life beneficiary was dependent upon the testator or was one of the chief objects of his bounty. TRUSTS RESTATEMENT, §239, comment *e* (1935); Capron, "Reserves Against the Depreciation of Real Property Held by a Trustee," 12 OHIO ST. L.J. 565 at 568 (1951). See generally 77 A.L.R. 753 (1932).

[6] 3 SCOTT, TRUSTS, 2d ed., §239, p. 1857 (1956).

[7] Note 5 supra.

into trust securities or by setting up an amortization fund out of income, the trust res would be more likely to remain relatively intact in value, and the ultimate result would be a more nearly normal distribution between the life beneficiary and the remainderman.

The Rule of Howe v. Dartmouth and Trusts With Improved Realty

Theoretically, at least, one could argue that the rule of *Howe v. Dartmouth* should apply to trusts having improved real estate among the corpus assets. Generally the courts have not treated buildings as a wasting asset.[8] It is apparent, however, that as the years pass, buildings are subject to loss in value due to wear and tear, deterioration, obsolescence and inadequacy. Hence, unless the settlor has indicated that no charges are to be placed against the income allocable to the life beneficiary, it can be argued that the settlor would want the corpus buildings to be kept relatively intact in monetary value as well as physical condition. As one writer has suggested, it is a problem of defining what the settlor meant by the principal. Did he intend the principal to consist of buildings for as long a period as they would last, or did he conceive of the principal as a fund represented by the value of the property?[9] If the latter were the testator's intent, the allocation of a portion of the income for depreciation would appear to be proper. However, most courts that have passed on this question have ignored this distinction and have refused to allow depreciation charges to be deducted from income allocable to the life beneficiary unless the trust instrument so authorizes.[10] Basically, of course, it is a question of a conflict between the interest of the life beneficiary in receiving the full income from the corpus and the interest in the remainderman in preserving the corpus. The New York courts, wherein the great majority of cases passing on this question have been litigated, have resolved this question in favor of the life beneficiary, and have held that the trustee has no duty to the remainderman to set aside out of income a reserve for depreciation, and indeed may not properly do so unless there is an

[8] 60 HARV. L. REV. 952 (1947); 52 COL. L. REV. 808 (1952).

[9] Isaacs, "Principal—Quantum or Res?" 46 HARV. L. REV. 776 (1933).

[10] 3 SCOTT, TRUSTS, 2d ed., §239.4, p. 1871 (1956); 60 HARV. L. REV. 952 (1947); Capron, "Reserves Against the Depreciation of Real Property Held by a Trustee," 12 OHIO ST. L.J. 565 at 572 and 576 (1951); 48 MICH. L. REV. 542 (1950).

authorization for such a reserve in the trust instrument.[11] Most of the courts of other states that have passed on the question follow the New York rule and refuse to permit the trustee to set up a depreciation reserve.[12]

There are probably several basic reasons why the general rule against the allowing of depreciation reserves on buildings held in trusts came into being. One reason could be the relative novelty of the depreciation concept as compared with the much older rules of trust administration. Another might be the analogy to legal interests consisting of a life estate and remainder, in which the life tenant has only the duty of ordinary repairs coupled with a prohibition against the committing of waste. Other courts have stated that taking an allowance for depreciation out of income defeats the primary intention of the testator to benefit the life tenant in that usually the life tenant is the chief object of the testator's bounty. Another argument made is that the remainderman stands to benefit from any increase in the value of the corpus and thus should absorb the loss caused by depreciation. Furthermore, because of the general rise in prices and valuations of property, the possible harm to the remainderman caused by a lack of depreciation reserves has been somewhat alleviated.

Another aspect of the problem that should be borne in mind is the general trust law regarding maintenance of the building held in trust as opposed to the concept of depreciation. Thus expenses for "ordinary repairs" to the trust property are payable

[11] Matter of Edgar, 157 Misc. 10, 282 N.Y.S. 795 (1935); Matter of Adler, 164 Misc. 544, 299 N.Y.S. 542 (1937); Matter of Horowitz, 192 Misc. 556, 80 N.Y.S. (2d) 286 (1944); Matter of Ottman's Estate, 197 Misc. 645, 95 N.Y.S. (2d) 5 (1949); In re Ball's Will, 197 Misc. 1047, 96 N.Y.S. (2d) 201 (1950); In re Abeloff's Estate, 108 N.Y.S. (2d) 39 (1951); In re McCullough's Will, 154 N.Y.S. (2d) 517 (1956). *Contra:* Matter of Kaplan, 195 Misc. 132, 88 N.Y.S. (2d) 851 (1949); In re Dahlmann's Estate, 95 N.Y.S. (2d) 74 (1949). These two cases decided by the late Surrogate McGarey of King's County held that it is the duty of a trustee to deduct a depreciation charge from income of improved real property unless the trust instrument or will has specifically directed otherwise. However, later New York decisions have refused to follow the rationale of the Kaplan case and still apply the general rule. The Kaplan decision evoked wide comment, mostly of an approving nature, among the law reviews, notably 63 HARV. L. REV. 180 (1949); 48 MICH L. REV. 542 (1950); 24 N.Y. UNIV. L. REV. 1229 at 1234 (1949); 1 BUFF. L. REV. 156 (1951); 12 OHIO ST. L.J. 565 (1951).

[12] *District of Columbia,* Evans v. Ockershausen, 69 App. D.C. 285, 100 F. (2d) 695 (1938), cert. den. 306 U.S. 633 (1939); *Massachusetts,* Nelligan v. Long, 320 Mass. 439, 70 N.E. (2d) 175 (1946); *Minnesota,* In re Lee's Estate, 214 Minn. 448, 9 N.W. (2d) 245 (1943); *New Jersey,* Matter of Roth's Estate, 139 N.J. Eq. 588, 52 A. (2d) 811 (1947). There appears to be an exception to the general rule if the trust includes buildings that are being used in a going enterprise. Under such conditions depreciation of the buildings may be allowed. 3 SCOTT, TRUSTS, 2d ed., §239.4, p. 1873 (1956); 60 HARV. L. REV. 952 at 956 (1947); 38 MINN. L. REV. 681 (1954), and cases collected therein.

out of income, whereas "permanent improvements" are payable out of the trust principal.[13] However, "permanent improvements" that will last for only a limited duration of time are payable out of trust principal and their cost is to be amortized out of income for the expected life of the improvement.[14] Theoretically, at least, it is apparent that this procedure would lead to a fair result, because if the beneficiary dies within a short period of time, he has not then paid for an inordinate share of the cost of the improvement, whereas if the beneficiary lives for a relatively long period of time, most of the benefits of the improvement have inured to him and not to the remainderman. It should be emphasized, however, that these rules are applicable to repairs and improvements, and do not apply to depreciation in the sense of general decay and obsolescence.

When May the Trustee Set up a Depreciation Reserve?

As pointed out above, the decisions tend to show that in the absence of a specific authorization or direction in the trust instrument, the trustee is not under any duty to the remainderman to set aside a reserve for depreciation of buildings, and, in fact, owes a duty to the life tenant not to do so. Thus where the trustee has set aside out of income a reserve for depreciation of buildings, without any express authority in the trust instrument, the life beneficiary can compel the trustee to pay over the amount so set aside.[15] If, on the other hand, there is a direction in the trust instrument to the trustee to set aside depreciation reserves out of income, then, of course, the trustee could properly do so and in all probability could be compelled to do so. The problem of the legality of such reserves thus arises when there is no explicit authorization in the trust instrument, but the possibility of such authorization can be inferred from the language used.

A New York surrogate's court[16] has held that instructions in the trust instrument to pay out the "net rents, incomes, and profits" was insufficient evidence of an intent on the part of the settlor to authorize depreciation reserves. The Court of Appeals

[13] TRUSTS RESTATEMENT, §233 and comments thereto. 3 SCOTT, TRUSTS, 2d ed., §233.3, p. 1757 (1956).

[14] Ibid.

[15] Estate of Edgar, 157 Misc. 10, 282 N.Y.S. 795 (1935); Matter of Bohmert, 102 N.Y.S. (2d) 394 (1950); Matter of Roth's Estate, 139 N.J. Eq. 588, 52 A. (2d) 811 (1947).

[16] Estate of Edgar, 157 Misc. 10, 282 N.Y.S. 795 (1935).

for the Eighth Circuit[17] held that a direction to the trustees to charge property income with "all necessary, proper and reasonable expenses of maintenance" was also insufficient evidence of such intent.

In *Laflin v. Commissioner*,[18] the Court of Appeals for the Seventh Circuit declared that language in a trust instrument granting general authority to trustee to pay "all costs of insurance and all necessary and proper costs, charges and expenses of any and every kind and description whatsoever connected with or growing out of the management of the trust estate . . ." did not suggest any duty or right on the part of the trustee to set aside out of income reserves for depreciation.

On the other hand, the Court of Appeals for the First Circuit[19] recognized as appropriate the setting up of a depreciation reserve for a trust consisting of real property where the will authorized the trustee to determine whether receipts should be treated as capital or income and whether expenses should be charged to capital or income. It should be noted, however, that these federal cases are tax cases, and the rights and duties of the trustee are only secondarily involved.[20]

[17] Hubbell v. Burnet, 46 F. (2d) 446 (1931).

[18] 69 F. (2d) 460 (1934).

[19] Commissioner v. Saltonstall, 124 F. (2d) 110 (1941).

[20] The federal income tax laws do make allowance for the depreciation of property held in a trust. "In the case of property held in a trust, the allowable [depreciation] deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each." I.R.C., §167 (g).

Treas. Reg. 1.167 (g) 1 (1956), '57 Fed. Tax Reports, Vol. 2, §1747, explains this provision in the following manner: "If property is held in trust, the allowable [depreciation] deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

"(1) If under the trust instrument or local law the income of a trust computed without regard to depreciation is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

"(2). If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depreciation in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depreciation reserve pursuant to discretionary authority to do so in the governing instrument.

"No effect shall be given to any allocation of the depreciation deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share

Conclusion

If we follow the proposition that the testator's intent should govern in the construction of the instrument, we are not aided to any great extent in the usual situation. In all probability the testator has not thought about the problem of depreciation reserves, and hence the use of the standard phrase "pay over the net income" may be ambiguous in that it does not tell us whether the testator authorized the setting up of reserves for depreciation or not. Perhaps one might infer such authorization from the testator's past conduct. Did he himself make allowances for depreciation in handling this particular property? Generally, the writers who have considered the problem have advocated the allocation of depreciation reserves in the administration of trusts of improved realty.[21] Professor Scott is of the opinion that trustees holding rented real property should be allowed to set up depreciation reserves, unless the buildings produce so little income that were such a reserve withheld there would be either no net income or an income substantially lower than the ordinary return as trust investments.[22] Since the courts have been slow in adopting such suggestions, perhaps the answer would lie in statutory authorization of depreciation reserves. Florida has done so.[23] The only other available procedure thus appears to lie with the attorney in drafting the particular trust instrument. The draftsman should discuss the question with the client, and if the client so desires, a provision authorizing depreciation reserves should be placed in the trust instrument itself.

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of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depreciation."

[21] 63 HARV. L. REV. 180 (1949); 48 MICH. L. REV. 542 (1950); 24 N.Y. UNIV. L. REV. 1229 at 1234 (1949); 1 BUFF. L. REV. 156 (1951); 12 OHIO ST. L.J. 565 (1951).

[22] 3 SCOTT, TRUSTS, 2d ed., §239.4, p. 1874 (1956).

[23] Fla. Stat. (1944) §691.03 (14). "In the absence of contrary or limiting provisions in the trust instrument or a subsequent order or decree of a court of competent jurisdiction, the trustee of an express trust is authorized. . . . (14) to create reserves out of income for depreciation, obsolescence, amortization or to insure prompt payment of taxes or assessments, general or special and other obligations, and to restore to income such reserves as may be unused."