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## TRUSTS AND ESTATES-ACCUMULATIONS-SETTING ASIDE RESERVE FOR DEPRECIATION ON TRUST BUILDINGS

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TRUSTS AND ESTATES—ACCUMULATIONS—SETTING ASIDE RESERVE FOR DEPRECIATION ON TRUST BUILDINGS—Testator created a testamentary trust of several parcels of real property improved with apartment houses, authorizing the trustees to pay the net annual income therefrom to his sons in equal shares. The trust was to terminate when the youngest son attained the age of twenty-one, or, if he died before majority, when the second youngest son attained the age of thirty-seven, or sooner died. Remainder was to the testator's sons living at the termination date or their issue, per stirpes. Testator, while living, had maintained accounting records for the properties in such manner as to reflect an annual charge for depreciation on the buildings, thereby creating a reserve for depreciation. The special guardian for infant contingent remaindermen objected to the failure of the trustees to create and maintain a reserve for depreciation after the death of the testator, while the special guardian for the testator's youngest son, who was an income beneficiary of the trust, maintained that any direction, express or implied, authorizing the setting aside of income as a reserve for depreciation would be invalid under the New York statute restricting accumulations of income.<sup>1</sup> *Held*, in the absence of a definite direction to the contrary, the trustees not only had a right, but also were under a duty to establish a depreciation reserve, and such a practice would not amount to accumulation of income. *In re Kaplan's Will*, 195 Misc. 132, 88 N.Y.S. (2d) 851 (1949).

The determination of what constitutes trust income depends largely upon what is to be regarded as trust principal.<sup>2</sup> If a trust of a specific piece of property was intended, it would seem that income might properly be enhanced by an increment representing the reduced value of the property through physical depreciation. But if the property in trust was intended as a fund of a specific amount, the conclusion is inescapable that a reserve for depreciation should be provided by charges on income in order to preserve the principal intact. In the usual case, the testator does not express his intent in clear language, and an inferred intent must be derived from the circumstances. Where the principal is rental property, such as apartment houses, consideration of the manner in which the testator handled depreciation on his own records, while he lived, would appear to be a highly significant factor. In the principal case, the fact that the testator carried in his accounts a reserve for depreciation, which was increased annually by an amount calculated to offset the wear and tear resulting from use, strongly suggests an intent that the property be treated as a fund to be preserved. It would seem, therefore, that the court in the principal case reached a logical and just result. However, it does not follow that a definite direction to the contrary should be necessary to negative such intent. It is arguable that a

<sup>1</sup> 40 N.Y. Consol. Laws (McKinney, 1938) §16; 49 N.Y. Consol. Laws (McKinney, 1938) §61.

<sup>2</sup> Isaacs, "Principal—Quantum or Res," 46 HARV. L. REV. 776 (1933). See also the Uniform Principal and Income Act, promulgated in 1931 by the National Conference of Commissioners on Uniform State Laws and since enacted in several states. The act, however, does not purport to be a codification of the common law, but, rather, purports to indicate desirable solutions in a variety of situations.

contrary intent might as easily be inferred from the circumstances, particularly in a situation where the testator, while living, had withdrawn the income without regard to any provision for depreciation. Historically, the courts have been reluctant to allow a trustee to set aside a reserve for depreciation when the trust corpus consists of buildings,<sup>3</sup> unless they are used in a business.<sup>4</sup> Today, however, the holding and managing of rental properties may form a going concern, without the necessity of buying or manufacturing and selling.<sup>5</sup> In view of generally accepted accounting principles and business usage, depreciation should be a proper deduction in determining net income available for distribution in either case,<sup>6</sup> subject only to the proviso that it is in accord with the testator's intent.

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<sup>3</sup> 2 SCOTT, TRUSTS, §239.4 (1939), and cases therein cited. The court in the principal case discusses *Smith v. Keteltas*, 62 App. Div. 174, 70 N.Y.S. 1065 (1901), a case often cited in support of the proposition that a trustee is under no duty to set aside a reserve, and seeks to distinguish that case as one denying the duty of a trustee to set aside a reserve for the purpose of erecting *wholly new buildings* when the old ones should become incapable of further repair. In drawing such a distinction, the court in the principal case appears to be limiting its decision to finding a duty in the trustee to establish a reserve only for the cost of "anticipated future repairs."

Cases disallowing a reserve may do so on alternative grounds: (1) by analogy to successive legal interests, (2) by the theory that a settlor's primary concern is for the life beneficiary, or (3) by holding that buildings are not classified as wasting assets, where a reserve for depreciation may be required. For further discussion see 2 SCOTT, TRUSTS §239-239.4 (1939); 60 HARV. L. REV. 952 (1947).

<sup>4</sup> *Matter of Jones*, 103 N.Y. 621, 9 N.E. 493 (1886); *In re Rose* [1940] 1 D.L.R. 139 (N.B. S.Ct. 1939). Even in this situation there is little direct authority.

<sup>5</sup> In the principal case, at p. 853, the court says, "That he was engaged in business is uncontrovertible. That the nature of his business activity was not that of the manufacturer or seller of commodities, is beside the point. Testator was for all practical and legal purposes engaged in a business operation, without regard to the fact that his sole income was derived from rents of real property." The term "business" has a variety of meanings depending upon the purposes of definition. 5 WORDS AND PHRASES, Business, p. 970.

<sup>6</sup> Depreciation is a proper accounting charge to operations in determining net income. PATON, ACCOUNTANTS' HANDBOOK, 3d ed., 136 (1943).

There is no apparent reason for excluding buildings from the legal classification of wasting assets. Clearly, the difference is one only of degree. "Even so called permanent improvements, such as buildings, are all subject to the ravages of time. . . . All machinery is on an irresistible march to the junk heap, and its progress, while it may be delayed, cannot be prevented by repairs." HATFIELD, ACCOUNTING 130 (1928).

For a theoretical discussion of the depreciation factor and the various concepts, see 1 BONBRIGHT, VALUATION OF PROPERTY, c. 10 (1937). See note on principal case in 63 HARV. L. REV. 180 (1949).