SOME ACCOUNTING PROBLEMS CONCERNING
REALTY HELD IN TRUST

DISSERTATION

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By

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Chapter I
Introduction

**Historical Development of Trusts**

The field of trusts, as it is known today, had its inception in the early Thirteenth Century. When the English Parliament, in 1217, passed the Statute of Mortmain forbidding religious bodies to hold land, many such bodies conveyed their land to close friends who then permitted the religious groups to use the property. About the middle of the Fifteenth Century, the English courts of equity converted what had been merely a moral obligation on the part of the owner to an enforceable obligation thus establishing the "use". A system developed wherein the legal estate was in one person, and a second person, designated as the cestui que use, had the whole beneficial right.¹

Many abuses developed. The use became the device whereby the creditor was defrauded of the extent of his debt, the lord of his escheat and the wife of her dower. These misapplications of uses in land transactions resulted in the passage of the statute of Uses in 1534.²


The effect of the statute was to vest legal title, as well as beneficial use, in the cestui que use. The law courts construed certain uses as being outside the statute. A use upon a use was void at law; transfers for a term of years were not recognized; the statute concerned itself only with realty and not personalty. Transfers of these types became known as "trusts".  

The present law of trusts developed out of the English courts of chancery, or equity. Since common law courts would recognize only legal owners as having rights in property, neither the donor or the cestui could find a remedy against an unfaithful trustee in a court of law. Chancery courts were an outgrowth of the Englishman's privilege to appeal to the King's conscience. This function of the King was delegated to his Chancellor and later grew into a system of chancery courts manned largely by ecclesiastics. The equitable interest of the cestui was recognized by these courts of equity and his rights were enforced. Trusts still remain as a branch of equity jurisprudence thus giving the courts power to enjoin or direct performance.

(Boston, Little, Brown and Co., 1920, hereinafter cited as: Perry, Trusts, p. 4, and ibid.
3Perry, Trusts, p. 5, and Bogert, Trusts, p. 5.
The development of equity jurisdiction was not well established when colonization of America began. There was only irregular administration of equity in the colonies prior to the Revolution. The system of equity jurisdiction grew slowly and did not develop fully until the Nineteenth Century. By that time there was a well formed body of precedent in England and the system of trusts which developed in the United States benefited from it.

The first corporate trustee in this country was The Farmers Fire Insurance and Loan Company which was authorized to perform as a trustee by the State of New York in 1822. This firm, now known as The Farmers Loan and Trust Company of New York, is still actively engaged in the trust business. The number of corporate trustees was relatively small at the turn of this century. Despite the protests of some states, national banks were authorized to act as trustees by the Federal Reserve Act of 1913. Today the trust corporations dominate the field.

Definitions

A trust, as defined in the Restatement is:

...a fiduciary relationship with respect to property, subjecting the person by whom

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5Perry, Trusts, pp. 10-11, and Bogert, Trusts, p. 6.
the property is held to equitable duties
to deal with the property for the benefit
of another person, which arises as a result
of a manifestation of an intention to cre-
ate it.7

The relationship here imposed is more than an ordinary
business one. The fiduciary nature of the relationship
places a greater duty on the trustee with respect to his
obligations to the beneficiary and his care of the prop­
erty.8

Customarily, three persons are involved in every
trust: the donor, the trustee and the beneficiary.9

The donor is the party who, having title, vests that
title, in trust, in another person.10 The donor, some-
times called the creator, or trustor, may designate him­
self as trustee thus reducing the number of persons con­
cerned to two.11 The possible involvements of this ac­
tion need not be considered here.

It is essential to a private trust that there be
a named beneficiary.12 This requirement does not follow
in the case of a charitable trust.13 The rights of the

7American Law Institute, Restatement of the Law of
Trusts (St. Paul, Minn.: American Law Institute Publish­
ers, 1936, hereinafter cited as: A.L.I., Trusts; p. 6.
8Bogert, Trusts, p. 1.
9Grange, et al.,ills, p. 271.
10Ibid., p. 272. A constructive trust is created by
the courts, in which case there is no donor. Bogert,
Trusts, p. 77; Deity v. lngremen Exploration Co.,
22S N.Y. 380, 336, 339, 122 A.E. 373. This ramifica­
tion is of no consequence in this study.
11Perry, Trusts, p. 38; Brandau v. McCurley, 124 A.d.
13Perry, Trusts, p. 587.
beneficiary, or cestui que trust, vary according to the instrument. The present beneficiary is referred to as the life beneficiary or life tenant. The future beneficiary is called the remainderman. The interests of these two parties may be in sharp conflict.

A trust presupposes the existence of trust property, the title to which rests in the hands of the trustee. The trustee's duties with respect to the property also vary according to the terms of the particular trust. He is, in general, charged with the duty to possess, protect and prudently invest the property entrusted to his care. In the same manner, the responsibilities of the trustee to the beneficiary will vary according to the terms of the instrument. He has a duty of loyalty to the beneficiaries, fairness in all dealings with them and fully accounting for all actions. The beneficiaries, despite a lack of privity, may enforce performance.

Statement of the Problem

The trustee is under obligation to act impartially between the life beneficiaries and the remaindermen. He must not permit any act which would give an advantage to one and prejudice the other. Since the usual trust arrangement is for a present beneficiary or beneficiaries

15 Perry, Trusts, pp. 401-37.
16 Ibid., p. 539.
to derive the benefit of the income from the trust property and a future beneficiary to receive the capital, or corpus, at a later date, the trustee must carefully distinguish which receipts and disbursements are properly classed as income transactions and which are principal transactions. Because of the great variety of transactions occurring in modern business, many difficult questions may arise. Incorporated in this study will be only those problems associated with real estate held in trust.

At the beginning of a trust relationship there is the necessity of determining the principal of the trust. This entails the establishing of a value to be placed on the properties as well as discovery of the asset itself. Concurrently, the question of accrual arises with respect to real estate taxes and other liabilities. Most of these problems can be resolved by agreement at the time an inter vivos, or living, trust is established. However, when the trust is created under a will this is not entirely possible. Even the most careful planning and drafting cannot obviate all future questions.

Then the trust is in operation, the trustee must make a distinction between income and principal to

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determine the proper credit for moneys received or the charge for moneys disbursed.\textsuperscript{19} Cost reimbursement activity creates no difficulty. Insurance premium payments present a question since preservation of principal as well as income is the underlying purpose. Because of capital gain and loss transactions, allocation of income taxes is a problem to be considered. Classification and apportionment of charges for maintenance and repair work done to real property become a major problem due to the conflict of interests between the income beneficiary and the remainderman. General accounting rules must be considered in the light of relevant legal decisions. In the case of testamentary trusts, the problem is particularly acute since the donor is not available to make his wishes known. The trustee, and the courts, must strive to infer the testator's intent.

A major area of investigation is the treatment of non-cash costs. Depreciation of real property held in trust is a subject which has received relatively little examination.\textsuperscript{20} Three different points of view need to be considered in the study of this cost. First, the accounting profession has developed a well-defined concept of depreciation for industrial accounting purposes.

\textsuperscript{19}Ibid.; also Grange, \textit{et al.}, \textit{Wills}, \textit{p}. 531 ff.

It is only proper that this view be examined in the light of the requirements of trusteeship accounting. The accountants’ concept may, or may not, be useful for this purpose.

Secondly, depreciation must be approached from the standpoint of the various courts’ views on the subject. Accountants are prone to deplore the lack of understanding of depreciation exhibited by some court decisions. An attempt will be made to determine whether or not the courts are developing a sound and consistent concept of depreciation for trust purposes. Thirdly, depreciation must be considered as it is viewed by trustmen. The prevailing practice with respect to keeping accounts, making allocations and distributing moneys is examined. An effort will be made to determine what the usual recommendations are when new trust instruments are drafted.

The federal income tax rules relative to real estate held in trust will be investigated, particularly with respect to depreciation. The effect of these rules on the present beneficiaries, both those receiving distributions and those for whom income is accumulated, as well as the remaindermen will be studied. The necessity of intelligent estate planning, with the aid of the cooperative efforts of trustmen, life underwriters, attorneys and accountants, will be noted.
In short, the following chapters will point out some of the salient problems inherent in accounting for real estate held in trust. A reconciliation of accounting, legal and tax views will be attempted in an effort to clarify some beclouded areas so that trustmen, accountants and attorneys together may more effectively serve the needs of their clients.
Chapter II
Determination of Corpus

The determination of a value at which realty held in trust can be carried on the accounting records of the trustee is the first problem to be met. Generally accepted accounting practice is to record assets acquired by purchase at their cost. Trustees affiliated with corporate trust companies will only occasionally purchase real estate as a trust investment. Most trust officers prefer to invest trust funds in securities which are more convenient, and generally less expensive, to manage. In those instances where realty is purchased, cost is used as the carrying value in the trust accounts.

Perhaps the most usual way for a trustee to acquire real estate is by devise in trust. Here the trustee's problem of determining valuation is essentially the same as that of the executor preparing an inventory, whether the trustee is acting in that capacity or not. Less likely to occur, but not unusual, is an inter-vivos transfer into trust. These two situations present different problems with respect to valuation and will be discussed separately. The effect of related liabilities will also be considered in this chapter.
Testamentary Trusts

Upon the death of a testator, title to real property vests in a specific or residuary devisee at the time of death.1 Real estate passing into a testamentary trust comes into the hands of the trustee without passing through an executor. In some instances an executor may enter on such realty to manage, collect rents and even force sale.2 However, realty specifically devised is one of the last funds to be entered upon for payment of the decedent's debts.3

Most state laws require an inventory to be made of the assets of a decedent's estate. Even though the executor does not take title to real property he is typically required to include it in the estate inventory. For example, the law of the State of Ohio provides:

Within one month after the date of his appointment...every executor or administrator shall take and return on oath into court a true inventory of the real estate of the deceased located in Ohio and the chattels, moneys, rights, and credits of the deceased which are to be administered.

2 Notably for payment of debts; cf. New York Surrogate's Court Act, sec. 232, 234 and Ohio Revised Code, sec. 2127.02.
3 Livingston v. Livingston, 3 Johns Ch. 148; Chase v. Lockerman, 11 N. & J. 186; but see Perry, Trusts, p. 565, fn. For majority view that specific legacies and specific devises are charged ratably with payment; Baker v. Baker, 319 Ill. 320, 150 N.E. 234; Holcomb v. Bullin, 167 Ark. 622, 268 S.W. 32.
and which have come to his possession or knowledge.¹

The basis of valuation for such an inventory is generally the "fair market value" at the time of the testator's death. The law of the State of New York is as follows:

Whenever by reason of the provisions of any law of this state it shall become necessary to appraise in whole or in part the estate of any deceased person, the persons whose duty it shall be to make such appraisal shall value the real estate at its full and true value, taking into consideration actual sales of neighboring real estate similarly situated during the year immediately preceding the date of such appraisal.⁵

Similarly, in Ohio: "Such inventory is to be based on values as of the date of death of the decedent."⁶

In general, the federal laws governing the determination of basis of assets for income tax and estate tax purposes also require the use of fair market value at the time of death.⁷ However, an alternative valuation is permitted if the executor so elects.

There would appear to be sufficient consistency in both the various state laws and the federal statutes prescribing valuation of a decedent's assets to eliminate any difficulties in arriving at an acceptable figure.

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¹Ohio Revised Code, sec. 2113.02.
²New York Decedents Estate Law, sec. 122.
³Ohio Revised Code, sec. 2115.02.
⁴1954 I.R.C., sec. 1014 (a) and 2031 (a).
for use in the trustee's accounting records. Such is not the case.

**Fair Market Value**

A distinct problem exists in the determination of a fair market value. An excellent definition of this term was given in a ruling of the Advisory Tax Board:

"Market value" is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. It implies the existence of a public of possible buyers at a fair price.\(^8\)

Many courts have at various times defined fair market value in similar terms.\(^9\) Three essential elements seem to exist in any definition:

1. A willing buyer with a reasonable time and opportunity to find a seller.
2. A willing seller, also with a reasonable time and opportunity to locate a purchaser.
3. The absence of compulsion for either party.\(^10\)

Establishing a defensible figure for fair market value is a difficult thing to do. Both the fields of

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\(^8\)T.B.R. 57, C.B. 1, p. 40.

\(^9\)Walls v. Commissioner, 60 F.(2) 347; Hitchcock v. Commissioner, 4 B.T.A. 273, 276; O'Meara v. Commissioner, 34 F.(2) 390; Helvering v. Calbridge, 70 F.(2) 883; Metropolitan Street Railway v. Walsh, 197 Mo. 392, 94 S.W. 860.

income taxation and estate taxation have seen much litigation over this question. The burden of proof is on the taxpayer to show fair market value.\textsuperscript{11} The methods of establishing fair market value which are most used are:

(1) By comparison with similar property which has been sold within a reasonable time prior to valuation.

(2) By estimating the cost of replacing the property at current costs (less observable depreciation).

(3) By capitalizing the earnings of the property.\textsuperscript{12}

Further discussion of these methods is outside the scope of this study.

The courts and the executors should exercise great care in obtaining the services of qualified appraisers. The valuation of real estate in particular should be in the hands of men well acquainted with local valuations.\textsuperscript{13} Once an amount is arrived at by the appraisers and approved by the court it will usually stand undisturbed.

As an example, the Ohio probate code provides that when the required inventory has been approved by the probate court, the appraisement of the real estate shall be

\textsuperscript{11}Kinney v. Commissioner, 30 F.(2) 563; Lyman v. Commissioner, 83 F.(2) 311.


\textsuperscript{13}Chase A. Davies, PAGE'S OHIO REVISED CODE ANNOTATED (Cincinnati: The N. H. Anderson Co., 1954), sec. 2113.03, comments.
conclusive for all purposes except inheritance tax unless a reappraisal is ordered by the court.14

The valuation arrived at for purposes of probate is likely to be acceptable for estate and income tax purposes.15 Federal taxing authorities are by no means bound to accept such a valuation however. In many instances it has been set aside.16

Trustee's Records

Because of the likelihood of the trustee who holds real property also being the estate's executor, he is apt to be involved in these questions of valuation. Further, since the trustee must arrive at a basis for depreciation of the trust realty for income tax purposes, he is interested in obtaining a figure for value which is acceptable to the Internal Revenue Service as well as usable for court administration. The possibilities for change in value are manifold.

The trustee may begin by recording the real estate

14 Ohio Revised Code, sec. 2115.17.
16 Powell, 10 B.T.A. 166(A); Rosenbaum, T.C. Memo. 8-29-44; Florsheim, B.T.A. Memo. I-22-40. In certain Ohio counties, the county auditor, who is charged with the responsibility of making an appraisal for inheritance tax purposes, will use the value at which the property is carried on the tax duplicate for real estate tax purposes. This is clearly unusable for estate tax purposes since properties are generally on the duplicate at approximately fifty per cent of market. In this area the Internal Revenue Service ignores the value so established.
in his accounting records at the figure established by the executor's appraisal. He may then find it desirable to use the alternative valuation for estate tax purposes. This, in turn, may be set aside by the Internal Revenue Service and another figure substituted as a compromise. An entirely different value may be set by the state's department of taxation for use in computing the state inheritance tax. Meanwhile, the trustee has been calculating depreciation for federal income tax purposes using the original appraisal as his basis. This, too, may be challenged by another division of the Internal Revenue Service and a new valuation, different from all the rest, may be arrived at for this use. From this plethora of possible valuations the trustman must make his choice.

Trustees, in the performance of their duties, are responsible to a court of equity in whose jurisdiction they are located. This probate court, or surrogate's court, is charged with the duty of supervising the administration of the trust and settling questions between the parties to the trust. There is no compulsion in the federal tax laws to cause the trustman to keep his records on the same basis of valuation that he uses for

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17Bogert, Trusts, sec. 142 and cases cited therein. 18Ibid., and Ohio Revised Code, sec. 2101.24.
reporting either income or estate taxes. Neither is there any reason why an amount arrived at, usually by compromise, for tax purposes should be considered as particularly valid or useful for accounting purposes. The primary concerns of the trustee are satisfaction of legal requirements in the state of probate and fair and equitable administration for the benefit of all trust beneficiaries, both present and future.

Use of the court appraiser's valuation for realty held in testamentary trusts should, if realistic, best serve the trustee's needs. This valuation, therefore, is quite commonly used. Differing valuations, necessary for tax purposes, are used for tax reporting and are maintained in memorandum form with other related tax matters but do not enter into the accounts. Periodic accountings made to the courts include the original appraised valuation.

The real estate tax valuation is used by a few trust officers. This would seem, on the surface, to be justifiable since such assessments are typically required to be for true value or market value. However, it is common knowledge that real estate assessments only rarely approximate the value of realty in the market.

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20Ohio Revised Code, sec. 5713.03.
In those instances where the estate is large enough to require the filing of an estate tax return, trustees will usually adjust their records to bring them into agreement with the values used for the estate tax return. As a result, some bank trust departments seem to be using two different bases of valuation for bookkeeping depending on the size of the estate. Adjustment of the records to estate tax values is usually justified by the fact that it is the most carefully made appraisal and presumably the best measure of market value.

Inter Vivos Trusts

Determination of the carrying value of real estate transferred by a donor into an inter vivos, or living, trust presents entirely different problems from those encountered in testamentary trusts. The difference stems from the fact that the grantor, or donor, of the trust is living at the time the trust is established. He is in a position to advise the trustee at the time of the creation of the trust and to furnish necessary information. Unlike a testator, who must give his directions often many years before the trust becomes operative under the will, the grantor is able to discuss the problems of trust administration and valuation with the trustee at the time the trustee takes over the assets and their management.

The same courts which have jurisdiction in
testamentary matters typically have the power to direct and control fiduciaries administering living trusts.21

The valuation placed upon real estate or other assets transferred to a living trust is not a matter with which the local courts are concerned. The responsibility for ordering an appraisal rests on the court only in the case of a decedent.22

Federal tax considerations may involve the determination of two different sets of values. The federal gift tax is measured by the value of the property at the date of the gift.25 For purposes of determining depreciation allowable under the federal income tax law, the fair market value is of no consequence.24

The federal gift tax is an excise imposed on the transfer of property by gift and is to be paid by the donor of the gift.23 The trustee who receives the gift in trust is obliged to file an information return but not to pay the tax. The corporate trustee, simply as a matter of rendering a service to its client, may assist in the preparation of gift tax returns. This will entail the determination of a value to be declared. The regulations which were in effect for the Internal Revenue

21 Cf. Ohio Revised Code, sec. 2115.24(a).
22 Ohio Revised Code, sec. 2115.05.
23 1954 I.R.C., sec. 2512(a).
24 See infra, p. 21.
Code of 1939 established rules governing valuation for gift tax purposes which were essentially the same as those for the estate tax. The term "value" used in the gift tax is no different than "fair market value" as used in the estate tax. The trustee may become liable for payment of the gift tax out of the trust where the donor fails to pay. The trustee may also represent the trust beneficiaries who have a similar secondary liability.

The donor of a living trust is concerned with the gift tax only where the transfer in trust is irrevocable. The creation of a living trust where the donor retains a right to revoke, repossess or control does not result in a gift. In the absence of a valid gift, no gift tax is imposed and there is no necessity for a determination of fair market value.

Income tax considerations are of considerably greater importance to the trustee. Whether the income derived from the property, and correspondingly, the

26Gift Tax Regulations 108, sec. 86.19.
271954 I.R.C., sec. 651(a)(1) and Fletcher Trust Co. v. Commissioner, 141 F. (2d) 56, affirming T.C. Memo. 798, cert. den. 323 U.S. 711.
28Mississippi Valley Trust Co. v. Commissioner, 147 F. (2d) 185, affirming T.C. Memo. 6-19-43.
30Distribution of income from a revocable trust constitutes a gift to the beneficiary. The grantor of the trust is subject to the gift tax; the beneficiary has a secondary liability. I.T. 2145, C.B. 6-25, p. 43.
depreciation deduction, is reported by the grantor, the beneficiary or the trust, a basis for the property must be determined. The basis for calculating depreciation on property acquired by gift or by transfer in trust is the same as in the hands of the donor. In the event the donor acquired the property by gift, the basis after the transfer by gift is the same as that of the last preceding owner who did not acquire it by gift.

The basis may be adjusted in those cases where a transfer in trust resulted in some recognized gain or loss to the grantor.

If the accounting records for real property transferred to a living trust were kept on a basis consistent with the trustee's needs for income tax requirements, the carrying value of such property would be the donor's cost less depreciation allowable prior to the creation of the trust. The most usual practice among trust companies is to use the donor's cost as their carrying value. This figure typically is not adjusted for prior depreciation. In some places realty held in living trusts is carried at the value assessed for real estate taxes. Either of these bases requires that separate memorandum records be maintained for income tax purposes.

Revocable trusts which become irrevocable at the

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31954 I.R.C., sec. 1015.
32Ibid.
death of the donor, and in some instances, irrevocable trusts which may be deemed to have been gifts in contemplation of death, will be included in the deceased grantor's estate. In such cases a revaluation is necessary in order to comply with the probate court requirements. Most trust companies will adjust the carrying value of the property on their books at the date of death. The new figure may be either the probate appraisal or the estate tax appraisal, if such was made. The adjustment will be made consistent with the trustee's practice in testamentary trusts.

Related Liabilities

Transferring realty into a living trust creates no special problems relative to liabilities. Debts which may have been accrued prior to the transfer, such as real estate taxes, will be paid in accordance with the wishes of the grantor. The grantor may want to assume certain obligations himself, or he may want the trust to make payment. Care must be exercised to assure that sufficient liquid funds are placed in trust to meet any obligations which may become due before the real property is productive of income. Trustmen are cautious when accepting trusts and will not take on a trust for administration unless enough free funds are available to meet

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all foreseeable obligations.

Real estate devised to a testamentary trust passes as of the date of death; realty does not become a part of the decedent's estate. In the instance where the real estate is subject to a mortgage, the trust will assure the obligations of the mortgagor unless a contrary provision is expressed by the testator in words of the will. Variations appear among the states, as in Ohio, where the mortgagor must consent to the taking, in order that the estate may be relieved of the liability.

Similarly the liability for real estate taxes which may attach to property coming into a trust will vary from state to state. For example, in Ohio real estate passing into a testamentary trust comes subject to all taxes and assessments which are a lien against such realty unless otherwise provided in the will. Ohio real estate taxes become a lien on the property as of January first approximately eleven months before the taxes become due and payable. It has been held in New York, however, that those taxes which become payable after the death of the testator are a liability of the devisee.
A careful study of the applicable local law is necessary to determine in any particular situation whether the executor is responsible for the payment of taxes out of the estate or if the trustee must pay the taxes out of the trust assets. Taxes paid by the trustee are usually charged against the income account as an ordinary expense.\(^{40}\)

**Summary**

Among trust departments considerable variation exists in the carrying values used for real estate. In testamentary trusts the most commonly used figure is an appraisal as of the date of death. Either the executor's valuation or the estate tax valuation may appear in the books. The donor's cost, unadjusted, is generally the amount recorded in living trusts, although in some cases the real estate duplicate figure is used.

Apart from the possibility of surcharge, there is no real need for an established value. Fair market value, as now used, is the best basis for recording property in a testamentary trust. However, there seems to be little justification for carrying the donor's cost, a meaningless figure, in living trusts. Trustees might better use a value which would meet tax requirements and eliminate at least one discrepancy between

\(^{40}\) Matter of Corbin, 101 App. Div. 25; Deraismes v. Deraismes, 72 N.Y. 154; but see infra, pp. 44 ff.
the ledger and the tax records.

The donor's cost, adjusted for prior depreciation and other changes as required by the federal income tax laws, could be used as the carrying value.
Chapter III
Principal and Income - Receipts

The management of real estate held in trust involves a number of questions which are peculiar simply because the property is held in a fiduciary capacity. The conflict of interests mentioned earlier between the life beneficiary of the trust and the remaindermen makes it necessary to distinguish carefully between principal and income when analyzing business transactions. The trustee has a fiduciary relationship to all parties to the trust which places upon him the burden of complete impartiality. Accounting procedures which he uses must conform, not only to accepted accounting principles as generally applied, but must also be in conformity with applicable state laws and legal decisions which have distinguished principal and income.

Principal Defined

The term "principal" has been defined in many ways. Dodge and Sullivan offer this: "The property of which the deceased dies seized and possessed at the time of his death."\(^1\) More apropos to all trusts, whether testamentary or inter vivos, is the definition given by Grange: "The entire body of assets constituting the

\(^1\)Dodge, et al., Estate Adm., p. 386.
trust property, as it exists at the time of the creation of the trust.\textsuperscript{2}

A carefully worded definition of the term is found in the Uniform Principal and Income Act:

\textbf{Principal...means any realty or personality which has been so set aside or limited by the owner thereof or a person thereto legally empowered that it and any substitutions for it are eventu­ally to be conveyed, delivered or paid to a person, while the return thereof or use thereof or any part of such return or use is in the meantime to be taken or received by or held for accumulation for the same or another person.}\textsuperscript{3}

The Uniform Act is more inclusive and of wider scope than the definitions typically found in legal or accounting textbooks. It should be noted that the principal of a trust is not unchanging, but that "...substitutes for the original trust res which are here changes in form are to be considered trust capital."\textsuperscript{4}

All of the preceding definitions are general statements which control in the absence of any clear statement in the trust instrument. The intention of the trustor, as expressed in the trust agreement, is the real determin­ining factor in distinguishing principal and income.\textsuperscript{5}

The instrument may give the trustee power to allocate

\textsuperscript{2}Grange, et al., \textit{ills}, p. 352.
\textsuperscript{3}Sec. 1.
receipts to principal or income at his discretion. 6

Income Defined

The Uniform Principal and Income Act defines income simply as "...the return derived from principal." 7 Money paid for the use of the trust property and any benefit received as a gain from the employment of that property is to be treated as trust income" according to Bogert. 8 The usual definition uses the terms "return", "use" and "earned" without qualification. The Restatement is more specific: "Ordinary, current receipts of money or other property received by the trustee for or in use of the principal of the trust property are income." 9

This latter definition brings in the idea of distinguishing between recurring and non-recurring transactions, a distinction with which the accountant is quite familiar. 10 It must be admitted, however, that even in the field of industrial accounting the distinction is not always simple and accountants are not in complete agreement on the subject. 11 Nevertheless, the concept is of importance in fiduciary accounting.

As noted previously in this chapter, the trust instrument is the controlling factor. The creator of

6 Dumaine v. Dumaine, 16 N.E.2d 625.
7 Sec. 1.
8 Bogert, Trusts, p. 431.
the trust may designate certain items as relating to
income which normally would be considered as principal.\textsuperscript{12}
Such stipulations must not violate any rules of law.\textsuperscript{13}

**Sales of Productive Property**

There are many interesting questions in the field
of trust accounting relative to the allocation of re­
cceipts, such as whether to amortize bond premium pur­
chased and the treatment of stock dividends and extra­
ordinary dividends. But these are outside the scope
of this study since they are not directly related to
holdings of real estate in trust. There are a number
of situations in which the receipts are related to real
estate transactions and questions of allocation arise.

If the trust instrument directs, or permits, the
trustee to sell productive real property which is part
of the trust corpus, any gains or losses arising from
the sale should be credited or charged to principal.\textsuperscript{14}
This is consistent with the established rule that in­
creases in the value of the trust capital belong to
principal.\textsuperscript{15} Similarly, decreases in the value of the
trust capital should be reflected as decreases in

\textsuperscript{12}Chase National Bank v. Greed, N.Y.I.S. 5-50-44,
p. 1241.
\textsuperscript{13}In re Loris' Estate, 301 A. 20, 131 A. 577.
\textsuperscript{14}Latter of Sherman, 154 Misc. 283.
\textsuperscript{15}In re Lilert's Estate, Cal. App., 21 P. (2) 630;
Robison v. Elston Bank and Trust Co., Ind. App., 48 N.E.
(2) 181; Wood v. Davis, 169 Ga. 504, 148 S.E. 330.
principal. The gain which thus benefits the remainderman when he takes possession may also be beneficial to the life tenant in that he will realize a greater income on an increased amount of invested principal. The losses suffered by the remainderman may also result in a loss to the life beneficiary through a loss in income from the reinvested amount.

In the instance where the asset sold was acquired as an investment of accumulated income, gains would be properly credited to income. The attitude of most trustees toward investment in real estate would probably preclude the use of accumulated income for purchases of realty by corporate trustees.

Similar to a sale of real property is the matter of condemnation. Payments received by a trust in a condemnation proceedings are considered to be a substitution for the real estate in the trust corpus and as such become credits to principal. Any interest accrued prior to the date of decree is also a principal item; interest for the period from the date of decree to the date of payment is income.

Sales of Unproductive Property

The conversion of unproductive real estate held in

16 Sternbergh's Estate, 208 Pa. 546, 37 A. 714.
18 Estate of Isabella Baird, N.Y.L.J., 1-3-30; also Matter of Wacht, 32 N.Y.3d (2) 871.
a testamentary trust gives rise to special problems. There is a series of court cases which held that the proceeds of a sale of unproductive realty should not be apportioned between the income beneficiary and the remaindermen of the trust unless the will required it.19 However, later cases have applied the rule of apportionment to situations where the property was productive at the time of the execution of the will and then later became unproductive so that the trustee was obliged to dispose of it.20 The line of reasoning employed is that the testator generally is primarily concerned with the well-being of the life tenant and intends no delay in providing him the income. This is particularly true where the realty was productive at the time of the writing of the will.

In Matter of Newland,21 this thought was extended by the Court of Appeals. In this case the property was productive at the execution of the will and was still productive at the time of the testator's death. The court said that "...it would be at least as reasonable to assume an intent that the power (of sale) would be...

21 273 N.Y. 100, reversing 135 Misc. 828.
imperative as to property known to be productive but which later becomes unproductive.22 Although the court indicated that its decision was based on facts peculiar to the case and that there was no intent to lay down a general rule, it would seem that a trustee has a duty to act promptly to save the income beneficiary any loss when that income beneficiary is the primary object of the testator's concern.23 Now widespread this case will become as precedent is a matter of conjecture.

The general rule of apportionment was set forth in Hope v. Earl of Dartmouth.24 When the residuary estate passes into the hands of a trustee he is obliged to convert into suitable trust investments. The apportionment of the proceeds from the sale of the original assets is made to provide the life beneficiary with income from the date of death by finding an amount which, invested at the date of death at a reasonable rate of return, would equal the proceeds of the sale; this amount is principal and the balance of the proceeds is income.25

The manner of apportionment can best be shown by formula. Let \( S \) equal the sales price received for the property, let \( C \) equal the costs of sale and carrying charges prior to the sale, let \( R \) equal the rate of

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22Ibid. at p. 108.
247 Ves. 137.
25Lawrence v. Littlefield, supra, p. 31.
return, reasonable for trust investments, and let $T$ equal the time the property has remained unproductive. Then:

$$\text{Principal} = \frac{S - C}{1 + (R \times T)}$$

And then:

$$\text{Income} = (S - C) - \text{Principal}$$

As an example, suppose unproductive property sold for $3130,000 and the carrying charges before the sale amounted to $20,000. Further, the usual rate of return is assumed to be $5\%$ and an equitable conversion worked two years prior to the sale. Then:

$$\text{Principal} = \frac{3110,000}{1 + (.05 \times 2)} = 3100,000$$

$$\text{Income} = 3110,000 - 3100,000 = 10,000$$

Two comments on this formula are in order. The time used will be from the time the property should have been made productive until the property was sold. Under the doctrine of equitable conversion, where there is an imperative direction to change the form of the investment, the interests of the parties are to be determined as of the moment their interests were created.  

Secondly, whether the formula should use simple interest, as stated above, or whether the interest should be compounded, is a matter of judgment. No fixed rule

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25 Perry, Trusts, sec. 448.
can be stated.

In the application of the apportionment rule a reasonable time is allowed the trustee in which to make the conversion. Unless the will provides otherwise, a year is usually allowed.27

**Insurance proceeds**

Insurance proceeds received by a trustee are another type of receipt to be considered. The trustee has an insurable interest in the real properties contained in the trust.28 Since the trustee is charged with the responsibility of exercising such care and skill in administration as a man of ordinary prudence would in handling his own property,29 and further, the practice of insuring property is so wide-spread in ordinary business, the trustee would very likely be liable for damages because of negligent action if he failed to insure.

The proceeds received because of the total destruction of insured real estate are to be considered as a conversion of realty into personalty belonging to the remainderman, or trust principal.30 Unless the trustee is specifically authorized to do so by the trust

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27 Lawrence v. Littlefield, supra, p. 51; Furniss v. Cruikshank, supra, p. 31.
28 Perry, Trusts, p. 555.
29 A.L.I., Trusts, pp. 41 ff.
instrument, he cannot rebuild. 31

Receipts of insurance moneys for partial destruction should be applied to repairs as a preservation of the trust corpus. 32 In any event, if the trust instrument specifies particular action to be taken, the terms of the agreement will prevail.

Rents

If real estate upon which rents are earned passes into a testamentary trust, any rents due and payable prior to or on the date of death are principal. The common law rule is that rents are not apportionable. 33 The rule is not necessarily a good one, or even equitable. Professor Scott in his excellent work states the rule and then devotes much space to a discussion of why the rule should not be. 34 He does not cite any cases in support of his position however.

One early case favoring apportionment was Botte's Appeal 35 in Massachusetts where the word "use" in the will was interpreted as including "the regular income of it as long as the legatee lived." The court apparently presumed to be interpreting the intention of the testator; the case was not accepted even in that

31 Ibid., and in re Miller, 52 N.J. Eq. 764, 49 A. 149, 67 N.J. Eq. 431, 58 A. 383.
32 Perry, Trustees, p. 355.
33 Greene v. Huntington, 73 Conn. 106, 46 A. 883;
34 Scott, Trustees, sec. 1290.
35 22 Pick. 235.
jurisdiction as a precedent. 36

In cases where apportionment was permitted the courts seemed to rely on their sense of propriety and equity rather than precedent. 37 The only Ohio case bearing on the question is Darbourg v. Gallagher 38 where the court said "the rentals of the real estate would become due day by day and would be apportionable."

No discussion or citation was given.

Failure to apportion can create serious inequities. A devisee may find himself in the position of having to bear the expense of current operation of the property, such as maintenance, janitor service and utilities, without the benefit of any revenue. The confused situation which exists in common law states could be mitigated by statute.

Statutory modifications of the general rule typically apply only to successive beneficiaries. 39 In the Estate of Grace L. Johnson 40 advance payments of rentals had been made to an estate having two life beneficiaries. The trustee made an equal division of the rentals in his accounting to the surrogate even though one life

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37 Morgan v. Morgan, 41 N.J. Eq. 235, 5 A. 63; Smith v. Allstar, 5 Phila. 115.
382 C. App. 205, 55 0. C. C. 433.
39 As in New York, Surrogate's Court Act, sec. 204, N.Y.L.J., 5-24-32.
beneficiary died shortly after the lease was made. The court rejected the account and said that, without a clause in the will prohibiting apportionment, an apportionment was required under New York statutes. 41

There a sum of money is paid to a trustee for surrender and cancellation of a long-term lease, the amount received is to be paid over the life of the original lease in annual installments to the parties then entitled to receive payments according to New York law. 42 In this holding, the possibility existed that the trust might terminate prior to the expiration of the lease. It was necessary, therefore, to preserve the possible right of the remainderman to receive future rents. The law varies between jurisdictions, as in Missouri where the common law rule is in effect and payments are considered income immediately distributable to the life tenant. 43 This same rule was followed by the Circuit Court in a tax case. 44

The New York view is the most logical of the two rules. The life of the trust in many cases may terminate prior to end of the lease. Failure to apportion can

41 See also In re Juliard's Will, 258 N.Y. 469, 144 N.E. 772 which held stipulation could be made against apportionment of any income.
43 Lang v. Missouri Valley Trust Co., 343 Mo. 1198.
44 Salcom v. Commissioner, 97 F.(2) 381.
work an inequity toward the remainderman who may have a
future interest in the rents.

Summary

General rules in any broad area always lack appli­
cability in some circumstances. This is true, of course,
for any rules stated for the classification of receipts.

Receipts which are mere substitutes for the original
trust capital are to be considered as principal. Appre­
ciation in the value of principal, as well as loss in
value, is to be absorbed by the corpus of the trust.

Receipts which are ordinary, recurring payments for
the use of the trust principal are income. Allocation
between successive interests should be made on a basis
consistent with any apportionment of expenditures.
Chapter IV
Principal and Income - Costs

The management of investment capital obviously will require certain expenses. It is generally accepted accounting practice to match expenses against the revenues produced by the efforts which those expenses represent, insofar as the application is practical and the results are significant to management. It is well established law that a trustee must keep trust funds separate from his own property\(^1\) and separate from property held in other trusts.\(^2\) To achieve these ends the trustee will carefully segregate the expenses chargeable to each trust.

In instances where two or more trusts are co-owners of property, expenses of the property must be allocated to each trust. While it would be much simpler accounting-wise to first determine the net return from the property and then make a single allocation, a trustee normally cannot do this. Because the trustee is under obligation to maintain accurate accounts for each trust\(^3\) an allocat-

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\(^1\)McLellan's Estate v. McLellan, 3 Cal.(2) 49, 63 P.(2) 1120; Matter of Sarbeck, 142 Misc. 57, 254 N.Y. 312.
\(^2\)Lannin v. Buckley, 256 Mass. 78, 152 N.E. 71; St. Paul Trust Co. v. Kittson, 92 Minn. 403, 65 N.W. 74; Smith v. Reddish, 113 Fla. 20, 151 S. 273.
\(^3\)Libbey v. Maultsby, 71 N.C. 345; In re Gaston, 55
tion must be made of each receipt and disbursement.\(^4\)

Within a single trust the trustee has no clear obligation to determine the net return from each and every piece of investment property. However, a trustee does have a duty to make trust property productive of income\(^5\) and a further duty to use ordinary prudence and all care and skill in his management.\(^6\) It is inco-

\(^4\)There can be no question as to the duty of a trustee to keep regular and accurate accounts during the whole course of his trusteeship, from which it can be ascertained what property has come into his hands, what has passed out, and what remains therein, including all receipts and disbursements in cash, and the sources from which they came, to whom paid and for what purpose paid." Lyle v. Bushnell, 277 Ill. 431.

\(^5\)Chemical Bank & Trust Co. v. Ott, 248 App. Div. 406, 289 N.Y.S. 228. But, "We know of no authority which compels us to fasten a greater degree of care on a fiduciary who happens to have more than the average experience with mortgage and real estate values. The legal standard is not applied proportionately but equally to all fiduciaries." Smoczynski's Estate, Pa. O.C., 29 D. & C. 200.
ceivable that a careful business man would not attempt to determine the return on each parcel of property. In most instances trustees will maintain such records as are necessary to determine the net income of individual pieces of real estate.

As with receipts, there are many instances in which allocations must be made between income and principal. Those situations which are most likely to occur in real estate management will be discussed in this chapter.

The Accounting Basis

It is well established that the income of a trust estate must bear the ordinary expenses of administration. This rule covers most situations involving expenditures which, from an accounting standpoint, would be considered as periodic or recurring charges. Many refinements of measuring the amount of expense properly chargeable to a particular accounting period, which are necessary for periodic income determination in commercial enterprises, are unnecessary for trust accounting. So-called "accrual accounting," generally accepted as it is among accountants, is rarely used by trustees. The usual trust practice is to account on a "cash basis," that is, in terms of receipts and disbursements actually taking place within the period and without regard to the accountants' concept.

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7 Buttenbaugh's App., 98 Pa. St. 351; Rothschild v. Weinthal, 131 Ind. 85, 151 N.E. 917; In re Brooklyn Trust Co., 92 Misc. 874, 157 N.Y.S. 547.
of "realization."

The use of cash basis accounting by trustees is not due to any lack of understanding, or lack of appreciation, of the benefits of accrual accounting. Rather, it is because the cash basis better fits the needs of the trustee in executing his responsibilities under the common law. A trust is created, in most instances, in order to preserve a body of assets for someone's future use and to permit the benefits derived from the present use of those assets to be enjoyed by someone else. As assets come into the trustee's possession as a return on the trust investments he is typically under a burden to pass those assets on to the present beneficiary. Costs which arise in the administration of the trust must be paid, normally with the funds received as income. The beneficiary is not primarily interested in determining his "net income" from the trust as the accountant might measure it; he is interested in the amount of funds available for distribution to him for his enjoyment. The use of the cash basis of accounting by the trustee is most effective and most useful in meeting common law requirements.

The use of an accrual basis of accounting would involve the trustee in more detailed record keeping. Most trust officers working in jurisdictions where there is no accounting statute feel that the absence of such
a law is no hardship. They believe that their present practices are adequate and fair to all beneficiaries. Further, they are well aware of the tribulations of a transition period should such a law be enacted. However, there are some situations where accrual accounting, not required under common law, would give fairer results.

**Real Estate Taxes**

The ordinary real estate tax is construed to be an operating expense of the trust to be paid out of income. The problems of apportionment relative to taxes occur at the beginning and at the end of the life of the trust. That is, if a testator dies and land passes into a testamentary trust, will the taxes be apportioned between the deceased’s estate and the trust? And, if a life beneficiary dies, will the taxes be apportioned between the life beneficiary’s estate and the remainderman under the trust?

In the first instance, where the property owner dies leaving the real estate in testamentary trust, the trustee must pay all the tax under Ohio law. Some variations exist between the states as to whether the liability extends from the date for payment or the lien date, but in any case the unpaid liability attaches

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9 Ohio Revised Code, sec. 2113.52.
10 Supra, p. 24.
to the property. Any delinquent taxes paid by the trustee would be a charge against the corpus of the trust.¹¹ Equity would seem to demand an apportionment of current taxes between principal and income in certain circumstances.

To illustrate it is necessary to consider the various dates involved in tax collection. In Ohio, as an example, January first is the lien date for real property taxes, October first is the date when the duplicate is delivered to the county treasurers for the purpose of collection, and the tax is payable in two installments on December twentieth and the following June twentieth.¹² Assume the testator dies December 31, 1956: the tax bill rendered against the property in June, 1957, for the second half of the 1956 taxes, should be paid entirely out of principal since both the lien date (January 1, 1956) and the certification date (October 1, 1956) both passed prior to the testator's death. The bill rendered in December, 1957 should be entirely charged against income since it is the tax charge for the first half of 1957. The income beneficiary had the use of the property for the entire period and the taxes became a lien on the property the day following the devise.

¹¹Ohio Fiduciaries Research Association, Bulletin 26, 6-29-48, p. 4.
¹²Ohio Revised Code, sec. 5719.01, 519.28 and 523.12.
Secondly, assume the testator dies on May 1, 1957: the tax bill rendered in June, 1957 is a charge against principal since it relates to the second half of 1956 during which time the testator was living and enjoying the benefit of using the property. The bill received in December, 1957 should be apportioned by charging the principal account with two-thirds and the income account with one-third since the estate benefited from four months use of the property prior to the testator’s death and the income beneficiary of the trust benefited from only two months use. The tax bill rendered in June, 1958 would be charged entirely against income. Neither the lien date nor the certification date should control. The controlling factor should be the time of use in order that the cost may be matched against the revenues produced.

At the termination of the trust, much the same situation prevails. At this point an apportionment between the life beneficiary (or his estate) and the remainderman is desirable. There is strong support for apportionment to be found in the Restatement:

except as otherwise provided by the terms of the trust, if property is held in trust to pay the income to a beneficiary for a designated period and thereafter to pay the principal to another beneficiary, expenses which would have been chargeable to income if they had been incurred with respect to a period wholly within the designated period are apportionable when they
are incurred with respect to a period
only partially within the designated
period, and
(a) such portion thereof as was in-
curred with respect to the designated per-
od is chargeable to income, and
(b) such portion thereof as was not
incurred with respect to the designated
period is chargeable to principal.13

Such apportionment is without clear legal precedent
in Ohio. The Ohio Revised Code at section 3719.19 states
that the liability for the property tax is on the person
"seized" for life. Since a life beneficiary has an equit-
able estate rather than a legal estate, with which seizin
is always associated, it is possible that Ohio distin-

13Sec. 237.
14Foulkes v. Talbott, 74 App. 281, 58 N.E.(2)
790, 29 O.O. 434; Robinson v. Bowler, 18 L.O.N.O. 372,
aff'd 88 O.S. 614.
16Sec. 237.

guishes between the two and could have a different rule
for each. At present no apportionment is permitted be-
tween a legal life tenant and a remainderman.14 The
status of an equitable tenant for life is by no means
the same as that of a legal tenant for life.15 The
responsibilities of a trustee are greater than those of
a legal life tenant. The manner of apportionment described
above might well be applied at the termination of a trust.

The probable ruling of Ohio courts is a matter of
conjecture. In the light of a Darke County Court of
Appeals decision in Shoppe v. Ortlen,16 and decisions

21 Abs. 11, concerning special assessments.
rendered favoring apportionment in New York,17 Massachusetts,18 Pennsylvania19 and other states, it is possible that such an apportioning would be looked upon with favor by the courts.20 Logical reasoning would seem to require that the interest which benefits from the receipts should be charged with the related costs. It is not unusual to find trustees apportioning rents21 but failing to apportion taxes. This results in a mismatching of revenues and costs for which there is little justification.

Special Assessments

Although seemingly closely related to taxes, special assessments require an entirely different accounting approach. Special assessments made against land for improvements such as streets and sewage facilities are generally considered as contributing to an increased value for the property. As such, the accepted accounting treatment of these levies is to increase the land cost by a charge to the asset account.

The Uniform Principal and Income Act22 considers

21 See supra, op. 35 ff.
22 Sec. 12 (4).
special assessments as a proper charge against the income of the trust and provides that, when such payments are made from the principal fund, the trustee shall reserve income each year and in effect pay back the amount to principal. Bogert\textsuperscript{23} flatly states that special assessments are a charge against the trust corpus where the improvement will probably outlast the income beneficiary's interest. He cites both a Massachusetts and a New York case in support of his position.\textsuperscript{24} In a note, he criticizes the Uniform Act and observes that Connecticut, Maryland, Oklahoma and Oregon omitted that section upon adoption of the Act. Those who advocate a charge against principal maintain that both the income beneficiary and the remainderman share in the assessment, the one through a smaller capital upon which to receive a return and the other through a reduced remainder interest.

The weight of authority seems to favor an equitable apportionment of special assessments between the life tenant and the remainderman.\textsuperscript{25} This position is well stated in a Rhode Island case:

Thus if an improvement for which a special assessment is levied is of such temporary character, requiring renewal

\textsuperscript{23} Bogert, \textit{Trusts}, 410.
\textsuperscript{25} Perry, \textit{Trusts}, p. 947.
from time to time, that the life tenant may be said to reap substantially all the benefits and the remainder is not enhanced in value, the life tenant should bear the expense; but where there is a permanent improvement, increasing the value of the remainder, the assessment should be paid by the remainderman or be borne ratably by the life tenant and the remainderman.

Where the nature of the improvement is such that the benefit is likely to be exhausted during the existence of the life estate, the courts have directed the payment to be made entirely out of income.

Where the improvements are likely to outlast the interest of the life beneficiary the trustee is faced with the problem of determining the benefit to be derived by both the life beneficiary and the remainderman.

The Ohio position, as stated by both statute and court decision, probably requires apportionment of special assessments according to the benefit received by each party. The Ohio Revised Code provides:

When a special assessment is made on real estate subject to a life estate, the assessment shall be payable by the tenant for life, but upon application by the life tenant to a court of competent jurisdiction, by action against the owner of the estate in fee, such court, may apportion the cost of the assessment between the life tenant and the owner in fee, in proportion to the relative value of the improvement of their estates, respectively, to be ascertained and determined by the court on principles.

27 Eyburn v. Wallace, 93 N.J. 326, 3 S.E. 482.
Appeal of Jordin, 71 Conn. 531, 42 A. 639.
of equity. 28

Although this section appears in the chapter on municipal assessments, in a case involving farm lands, a decision was rendered in 1955 favoring apportionment in the interest of equity. 29 It is uncertain whether this decision and the statute cited would apply to the equitable life tenant of a trust as well as a legal life tenant. However, an apportionment made, where the facts and circumstances would seem to justify it, would probably be a safe method for the trustee to follow.

The method of apportionment, in order to determine the amount chargeable to each interest, is an extension of the problem. The degree of care will vary from court to court. In some cases purely arbitrary allocations have been made. 30 In another case, 31 the court carefully deducted current necessary upkeep charges from the cost of the improvement and apportioned the difference on the basis of mortality tables. The circumstances of the case, the general attitude of the local probate court and the relative dollar size of the assessment

28 Sec. 743.50.
29 Chipple v. Ortleff, supra, p. 46.
30 Crawford v. Crawford, 4 O. Sec. Rep. 138; a $2500 street improvement was charged one-third to the life tenant, although she was 65 years of age at the time and the court noted that she probably would benefit very little from the improvement.
31 Chipple v. Ortleff, supra, p. 46.
will influence the trustee's action on apportionment. The procedure recommended in the Uniform Act seems to be reasonable and fairly easy to apply.

**Insurance Premiums**

Premiums on fire insurance have almost universally been regarded as a charge against the income of a trust. The trustee can reasonably be expected to insure the trust property against fire and similar losses. This expense is considered to be an ordinary and recurring cost of operating the trust. On this theory the outlay is a proper income charge.

Although some authors have indicated that apportionment might be desirable, such thinking, as Scott indicates, probably grew out of cases involving successive legal estates rather than trusts. Because of the trustee's duty to preserve the trust property and the general rule that the expenses of so doing are to be borne by the income, there seems to be little justification for apportionment.

Neither is there any apportionment problem as such at the termination of a life interest. If the succeeding

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52 Sec. 12(1); supra, p. 47.
54 Supra, p. 34.
55 Perry, Trusts, p. 944; Uniform Principal and Income Act, sec. 12(1); A.I.I., Trusts, sec. 233 (c).
56 Scott, Trusts, sec. 892; Orange, et al., Ills, p. 355.
interest wishes to carry the same insurance coverage, he may re-insure while the former life tenant, or his estate, cancels the first policy, or the insurance may be transferred by purchase if the insuring company agrees. The latter course is more advantageous for either insured and, if a trustee is able to make the transfer, this is the usual treatment accorded such situations.

Under certain circumstances a trustee is entitled to indemnity from the trust for torts committed. Actions charging negligence are not uncommon against property owners. The trustee would be held blameless where he was not personally at fault or the tort occurred as a normal incident of a proper trust activity. The Uniform Trusts Act permits action to be brought against the trustee in his representative capacity thus recognizing the trustee as a juristic person separate from the trustee as an individual. Reasonable prudence would seem to require the purchase of liability insurance coverage where the trust contains real property used for rental purposes. As a cost incurred in the interest of preserving the trust estate this would be an income charge.

38 Bogert, Trusts, p. 508.
39 Sec. 14.
Carrying Charges on Unproductive Realty

The preceding discussion of taxes, assessments and insurance was predicated on the assumption that the realty was income producing. Unless the trustee is specifically instructed in the instrument to retain unproductive property he is under obligation to convert such property into an income-producing investment. The matter of apportioning the proceeds has already been discussed in Chapter III. During the time the trustee is holding unproductive realty, expenses, such as these discussed earlier in this chapter, will continue to run, but the treatment of these costs is by no means the same as where they relate to productive properties.

There is considerable confusion in this area. A Pennsylvania court described the situation this way:

"We can place the burden of carrying unproductive property on either income or principal and be fully justified by the authorities. The decided cases and the legal literature represent absolute chaos. Respectable authorities can be found on both sides of the question and even in the same jurisdiction the cases have been decided both ways."

Certain definite statements can be made. The intentions of the trustor are controlling in any determination of what to do with carrying charges. If the

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40 In re Nirdlinger's Estate, 531 A. 135, 200 A. 356.
41 Old Colony Trust Co. v. Walker, 65 N.E. (2d) 690;
Creed v. Connelly, supra, p. 31; In re Spring's Estate,
162 Misc. 204, 293 N.Y.S. 1014.
will or trust instrument directs that the carrying charges go against either income or principal, that direction will be honored. The more usual situation is for the instrument to give no specific instructions for handling such expenses.

It is also generally improper for the carrying charges on property held in one trust to be charged against the income of another trust. The integrity of each trust should be preserved and considered separate and distinct from every other trust.

The accounting doctrine of materiality applies to this area of trust accounting. If the unproductive property constitutes only a relatively small part of the total corpus, and the taxes and other carrying charges are not of material amount relative to the total income, such charges may be made against the income account. This practice has received judicial approval.

In all areas of trust accounting, and particularly with respect to problems such as unproductive assets, the trustee, after a careful consideration of the people and circumstances involved, must use his good judgment and strive for a solution equitable to all parties. In cases of dispute, the judgment of the court will be

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42 In re Lichtenberg's Estate, 114 Misc. 89, 185 N.Y. 913.
43 Matter of Wellbrock, N.Y.L.J., 10-8-38.
substituted. It is impossible to say what is proper in all trusts at all times. But, it is possible to outline what is probably the best course in the majority of situations.

Since the trustee is usually under an obligation to convert the unproductive property, the matter of carrying charges is only a temporary one. Payment may be made out of either income or principal wherever the funds are available, provided adjustment is made at the time of sale. Principal is usually charged. Any carrying charges paid out of income should be paid back prior to the application of the formula described in Chapter III. The use of the formula, in which the carrying charges are deducted from the sales price, gives the same result as though the entire sales price was apportioned and then both principal and income charged proportionately with the carrying charges. The logic underlying the formula is not primarily to apportion the carrying charges, however, but rather to give the income beneficiary the return he would have enjoyed if the property had been converted at once.

It must be understood that the apportionment of carrying charges by means of the formula cannot be universally applied. There may be circumstances

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44 Grange, et al.,ILLS, p. 533; Bogert, TRUSTS, p. 121; Dodge, et al., ESTATE ADM., p. 440.
requiring an entirely different approach. Basically, the decision to apportion or not depends on whether an equitable conversion is to be construed. In those instances where the trustee is under no duty to convert the property, income may bear the carrying charges. In any case, the trustee should be protected if his decision is in accordance with an agreement reached with all beneficiaries. The effort required to obtain an agreement may be well worthwhile if, by so doing, the trustee can avoid future litigation.

Chapter V  
Principal and Income - Costs (continued)

Expenditures made for repairs to realty held in trust can create many accounting problems for a trustee. Although rules can, and have been from time to time, promulgated by the text writers and by the courts, the real difficulty lies in fitting a particular activity into the rules. Each situation must be considered separately by the trustee to determine how the repair is to be classified.

Initial Renovation

Trustees under a will sometimes find themselves coming into possession of a piece of property which is in such poor condition that it would not produce a reasonable return as an investment. Repairs made to property taken in an untenantable condition would be considered, under generally accepted accounting procedures, as a capital expenditure properly chargeable to the asset account. Similarly, such expenditures have been held to be principal charges. Where the trustee had a discretionary power to sell but chose to retain the property and make extensive repairs it was...
considered to be a new investment of principal. In one case this reasoning was extended to the construction of entire new buildings.

The general rule covering the situation is well stated in the Restatement:

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.

Provided that the trustee is empowered by the instrument, or has a clearly implied power, to make such repairs, the problem of accounting for them is simple and well settled.

Ordinary Repairs

The trustee's responsibility for ordinary repairs stems from his general duty to maintain and preserve the trust property. Failure to do so when funds are available may result in surcharge. The trustee's implied authority extends to such maintenance and repairs as are recurrent in nature. Although such repairs may
involve replacement of parts they are to be distinguished from replacements of major units. Ordinary repairs, which from the standpoint of commercial accounting would be expense charges, are those which will not materially increase the property value or prolong its life.

Income will bear the charge for ordinary repairs and maintenance in most cases.\(^7\) The courts have permitted charges to principal for such repairs where the income of the trust was insufficient.\(^8\) In any event, the trustor's directions in the instrument will be the controlling factor.\(^9\) Trust instruments prepared in cooperation with present-day corporate trustees will generally contain as broad discretionary powers with respect to repairs as the grantor, or testator, will permit. Trustmen recognize from their experience the impossibility of foreseeing all contingencies and prefer that the testator be willing to rely on the judgment and integrity of the trust administration.

**Extraordinary Repairs**

Extraordinary repairs, such as complete overhauls of building equipment, and replacements require a

\(^7\)In re Gretzman, 30 O. On. 5; In re William's Estate, 148 Misc. 14, 226 N.Y.S. 422; In re Van kiper's Estate, 90 N.J.Eq. 217, 107 A. 35; In re Nichol's Trust Fund, 228 N.J. App. 438, 68 S.2d (2) 917; Shittingham v. Schofield's Trustee, supra.

\(^8\)First National Bank v. Davley, Ark., 182 S.W.2d 194; Byrne v. Byrne, 123 N.J.Eq. 5, 195 A. 848.

\(^9\)Stamford Trust Co. v. Lack, supra, p. 54.
different accounting treatment. The usual practice where a replacement is recorded is to remove the cost of the old unit from the asset account, relieve the depreciation reserve of the accumulated depreciation and recognize the resulting loss. The new unit is then recorded in the asset account at its full cost. Extraordinary repairs typically involve much replacement of small parts, and in theory, should be recorded in the same manner in the accounts. The more usual method of recording such repairs, however, is to charge the cost against the accumulated depreciation. Although this does not produce precisely the same results and ignores the question of a revision of depreciation rates, it is regarded as accounting and certainly affords a more practical approach to the problem. This method of recording is literally impossible in a trustee's accounts since depreciation reserves are almost never maintained.\textsuperscript{10} The trustee will class extraordinary repairs with improvements in his determination of a proper accounting.

**Improvements**

The distinction between improvements and replacements is simply that an improvement involves replacement of an old unit of property with a better unit, such as a tile roof for wooden shingles, or copper siding for galvanized. The mechanics of recording either in the

\textsuperscript{10}See Chapter VI, infra.
accounts are the same.

The trustee has no power to make permanent improvements without special authority.\(^\text{11}\) To make improvements without authority runs the risk that the costs may be disallowed in an accounting.\(^\text{12}\) The following have been held to be improvements: installation of gas ovens,\(^\text{13}\) elevators,\(^\text{14}\) fire escapes,\(^\text{15}\) enlarging hotel facilities,\(^\text{16}\) making structural alterations\(^\text{17}\) and paving a street.\(^\text{18}\)

A trustee may make improvements to the trust property where the instrument authorizes him to do so. Careful drafting, done by the trustor's attorney in close cooperation with the trustees, can be the means of avoiding much difficulty at a later date. The corporate trustee's wealth of experience in the field of trust management should not be ignored. In the absence of authorization by the trust instrument, the trustee may find it advisable to fully inform all the beneficiaries and get their consent. If permission is obtained from beneficiaries, they are estopped from later protesting.

\(^\text{11}\) Grayson v. Hughes, 165 Ark. 173, 255 S.W. 838; Booth v. Bradford, 114 Iowa 562, 97 N.W. 685; Haynand v. Columbus, supra, p. 58; In re Parry's estate, 144 Pa. 93, 20 A. 413.

\(^\text{12}\) Cases cited supra, note 11.


\(^\text{16}\) In re Parry's estate, supra, note 11.

\(^\text{17}\) Matter of Parr, supra, note 15.

the trustee's action.\textsuperscript{19} This course may often be closed to the trustee simply because of the personalities involved in the trust or, in other cases, because the beneficiaries are not available to discuss the problem.

Here there is no specific authority for improvements and an agreement cannot be made with the beneficiaries, the trustee may apply to the probate, or surrogate, court for an order. The cases are numerous where courts have permitted deviation from the terms of the instrument because of impossibility of performance,\textsuperscript{20} violation of public policy\textsuperscript{21} and exigencies which were not, or could not have been, contemplated by the trustor.\textsuperscript{22} If the trustee makes improvements without first obtaining permission, and the improvement appears to have been appropriate and to the benefit of all concerned, the court may subsequently approve the expenditure upon an accounting.\textsuperscript{23}

Accounting for improvements necessitates a determination of the nature of the improvement. The outlay

\textsuperscript{19} Goodrow v. Right, 82 Cal. 232, 22 p. 1118; In re Catanach's Estate, 273 Pa. 363, 117 A. 178.

\textsuperscript{20} Cf. Stout v. Stout, 192 Ky. 504, 235 S.W. 1057, direction to operate distillery impossible because of prohibition.

\textsuperscript{21} Cf. Colonial Trust Co. v. Brown, 105 Conn. 261, 135 A. 555, restrictions placed on length of leases permitted and types of buildings found to be improper.


\textsuperscript{23} Subsequent approval of the expenditure in this case was equivalent to prior authorization." In re Catanach's Estate, supra, note 19.
may increase the value of the trust assets so that the
remainderman, upon termination, will receive a greater
value than that originally placed in trust. Where the
improvement is of such permanent nature the monies for
it should be taken from other principal funds. In
this way the improvement is construed to be little more
than a change in the nature of the trust investments.

If the expenditure is made for the purpose of pro-
ducing income for the life beneficiary and the nature of
the improvement is such that it will add only a temporary
value, the income account may be charged. The improve-
ment may be a capital expenditure from the standpoint
of general accounting, i.e., income may benefit for a
number of years, but, for trust accounting purposes,
the charge may be made against the income of a single
year. In trust administration the "accounting period"
of greatest significance is the lifetime of the bene-
ficiary; arbitrary allocations within that period have
little usefulness.

Perhaps the most usual situation is for the im-
provement to benefit both the life beneficiary and the
remainderman. The improvement may have an economic
usefulness which could possibly extend beyond the life

24 Stevens v. Mecner, supra, p. 51; In re Ardley's
Bill, 252 N.Y. 105.
25 Appeal of Bordeau, supra, p. 41; Brodie v. Farnsen,
N.Y., 64 S.F. 423.
of the present beneficiaries. The life beneficiary derives a greater income because of the improvement and, at the termination of the trust, the remainderman takes over an asset of greater value. Under these circumstances an apportionment of the cost is in order.\footnote{26}{Peck v. Sherwood, 56 N.Y. 615; Smith v. Keteltas, supra, p. 58; Orr v. St. Louis Union Trust Co., 291 Mo. 383, 236 S.W. 642.}

Apportionment can be most equitably achieved by initially paying for the improvement with principal funds. Then, as the income beneficiary derives benefit from the use of the improvement, the cost should be amortized and charged against the income account.\footnote{27}{See A.L.I., Trusts, sec. 235 (1).}

This charge must be accompanied by a transfer of funds from income to corpus. This procedure results in a systematic "payback" to principal. If the life beneficiary's interest extends beyond the useful life of the asset, he will have borne the complete cost and derived the full benefit. If the trust terminates prior to the end of the improvement's useful life, the remainderman takes over the asset at a net cost to him approximately equal to the value remaining in the asset.

Although the courts have at times wrestled with the question as to whether a particular improvement was temporary or permanent, this is actually a useless distinction. It is of little importance whether the
improvement is likely to outlast the trust if systematic amortization is carried out. This reasoning has been adopted in several cases.23

This manner of amortization resembles depreciation in its effect on income. In fact, the rate of amortization may be that which would have been used if the asset were to be depreciated for commercial accounting or the rate used for depreciation for federal income tax purposes. However, a funding operation is necessary at the same time, and this is rarely found in ordinary accounting practice.Trustmen seldom refer to this technique as depreciation but are more inclined to think in terms of a principal investment being gradually converted back into cash for reinvestment.

**Additions**

Purchase or construction of additional real property may take place after the trust has been placed in operation. Although real estate is seldom considered an approved investment in those states where trustees are restricted by statute,29 authority for such investment may be included in the instrument.30 The purchase of

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23 Matter of Nesmith, 143 N.Y. 599, 35 A.2d 942; In re Adler's Estate, 299 N.Y.S. 542; In re Robert's Estate, 27 Cal. (2) 70, 152 P. (2) 461.
29Cf. Ohio Revised Code, sec. 2109.57 and 2109.571.
30In re Reed, 170 App. Div. 651, 654, 156 N.Y.S. 500. Where the instrument grants discretion to the trustee, and it is intended to permit the trustee to invest outside the legal list, it should be specifically stated that his authority does extend beyond the statute, lest
new assets should be handled in the same manner as improvements, i.e., making payment from principal funds and then amortizing the cost against income over the useful economic life expected of the asset. In this manner the interest of the remaindermay be maintained intact while the present beneficiary will benefit from the income earned on the new investment and bear his share of the cost of producing that income.

Miscellaneous Repairs

In cases where improvements or repairs have been required by governmental authorities no question of apportionment arises. The cost of conforming to health and safety regulations are chargeable to the principal of the trust. No distinction is made with regard to the type of repair or length of useful life.

Remodeling, changing store fronts and other alterations to suit a building to the needs of a tenant present a problem in the light of the court decisions. In some instances such costs have been held to be income

the courts construe the wording to mean merely good judgment within the list. In re Carnell's Will, 260 App. Div. 237, 21 N.Y.S.(2) 376 aff'd 284 N.Y. 624, 29 N.E.(2) 935.


charges and, in other cases, principal charges. The more reasonable interpretation would seem to be a charge against principal with amortization out of income for a period not to exceed the life of the lease.

Restoration of the premises at the termination of a lease is chargeable against income. This seems proper since the income beneficiary has derived the earnings from the property over a period of time and should be obliged to restore the principal to its original state.

Summary

A number of different problems have been examined in these two chapters on costs. In some matters the current weight of authority seems reasonable from an accounting viewpoint, in others, it does not. There should be an increased emphasis in the field of trust accounting on matching of costs and revenues. The necessity of maintaining the trust corpus intact while at the same time disbursing, or at least earmarking, the trust income makes it advisable to be sure that all the current costs of producing revenue are borne by the income account. This requires a more extensive application of accrual procedures than is common at the present time.

33 Last v. Wilder's Trustee, 140 Ky. 767, 131 S.W. 793; Shirks v. Walker, 298 Mass. 251, 10 N.E.(2) 192.
34 Good v. Amos, supra, p. 65; Matter of Heroy, 102 Misc. 305; In re Hurry, 169 N.Y.S. 1032.
35 Matter of Farr, supra, p. 61.
Good legal authority has come to recognize the desirability of apportioning long-term expenditures between principal and income by means of amortization. This technique is used rather extensively by trustmen, but it is by no means universally used. The general use of this means of apportionment is to be desired.
Chapter VI
Principal and Income - Depreciation

When the corpus of a testamentary trust includes income producing buildings among the original trust assets, a problem is present with respect to depreciation. In a revocable living trust no such problem exists. Where an irrevocable trust is created by a living donor the situation is much the same as a testamentary trust, except that the trustee should be in a position to resolve such questions before the trust becomes operative. This is not always done.

In the computation of the net income of a business, the inclusion of depreciation as a cost has become generally accepted accounting procedure. There may be a wide divergence of views among accountants about the amounts calculated or in the method of charging, but the propriety of including the depreciation charge is seldom questioned. Depreciation has become recognized as a cost in statutory, administrative and judicial law. But, in the field of trust administration, depreciation, as a cost, is generally ignored. Two reasons

1 In some states it is of major importance whether the assets are included in the original trust property or subsequently acquired. See Scott, Trusts, sec. 239; also see discussion of "Additions" in preceding chapter.
2 See discussion, infra, p. 70.
might be suggested as underlying this situation. The courts are prone to follow the doctrine of *stare decisis*, formulating their decisions in the light of early cases which were decided prior to the general recognition of depreciation as an actual cost. Secondly, and perhaps of greater importance, trustees are not primarily interested in measuring "business income". As was mentioned earlier, the cash basis of accounting is more generally used for trust purposes. Recognition of depreciation, as a cost, is not always desirable.

Commercial accounting is a system of recording, summarizing, reporting, and interpreting the financial history of an enterprise, thereby providing the means of establishing control over the business activities and properties and furnishing a basis upon which to formulate future policies. The emphasis is upon judging past progress and future prospects of earning. The trustee, on the other hand, is primarily interested in an accounting to show whether his duties have been properly discharged. It is sometimes felt that this difference in purpose exempts the fiduciary from the application of generally accepted accounting principles.

The decisions of the courts have shown their

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4 *Supra*, pp. 41-43.
understanding of the nature of depreciation to be different from present-day accounting concepts. Typical of the judicial view is the statement of the Supreme Court in 1933: "Depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property." The idea that depreciation constitutes a loss of value has come to be generally accepted by most legal writers.

In one of the leading treatises on trusts this statement is found:

"where there is no likelihood of loss in value as long as kept repaired the trustee would not seem to be under a duty to set aside income as a reserve for depreciation."

The expression is typical.

In a few instances the courts have expressed a view more compatible with accounting concepts. In a minority opinion on a utilities case, one justice wrote:

"It [the depreciation charge] serves to distribute equitably throughout the several years of service life the only expense of plant retirement which is capable of reasonable ascertainment - the known cost less the estimated salvage value."

The accounting profession considers depreciation as the cost of the exhaustion of usefulness.

The engineering approach to depreciation is one of

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6 *Scott, Trusts*, sec. 239.4.
evaluating present usefulness. This approach has often been taken in the courts. The reasonableness of this concept in public utility cases is not questioned here. The accounting approach to depreciation is one of cost amortization, and this is the more useful concept when attempting to define income. The trustee of a testamentary trust has a dual obligation; preservation of the trust corpus for the remainderman and payment of income to the life beneficiary in accordance with the wishes of the testator. The attempt to maintain a balance between two conflicting interests has resulted in varying accounting methods.

The General Rule

The traditional position of the courts in cases involving depreciable trust assets has been to allow no charge against income for depreciation. "That the trustee has no duty to set aside a reserve for depreciation, and is not liable to the remainderman for failing to do so, seems to be indicated by the decisions."9 This general rule is by no means inflexible. Deviations from it have been fairly frequent.

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Many arguments have been put forth in favor of the usual practice of disallowing depreciation as a charge against the income beneficiary. The actual calculation of the amount of depreciation cannot be made with any great accuracy in many cases. Thus both the trustee and the court are fearful of doing an inequity. This reasoning is difficult to appreciate. It would hardly seem more equitable for a cost to be ignored while depreciation in fact does occur. In a New York Surrogate Court in 1935 the fear was expressed that too high a depreciation rate would charge income with more than the cost of a building. The occupant of the bench that day obviously was not well versed in accounting procedures.

Another contention often encountered is the proposition that since any appreciation in the value of the corpus benefits the remainderman, he should suffer the loss from depreciation. This argument expresses the "loss of value" idea of depreciation which was mentioned earlier. Any decrease in the value of trust property due to changes in the purchasing power of the dollar, changes in surrounding properties, population shifts, etc. (the factors which could result in appreciation if favorable) will be borne by the remainderman.

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10 Matter of Chapman, supra, p. 70.
12 See Evans v. Ockershausen, supra, p. 72.
One trust officer interviewed in the course of this study stated that, in his experience, the average trust lasted approximately only twenty years. He felt that the long run trend in real estate prices was sufficiently favorable to offset any loss in value resulting from obsolescence or wear and tear.

One of the strongest arguments for not charging depreciation against income is that the testator probably never intended such a thing. In the absence of any stimulation in the instrument the courts must attempt to infer the intention of the trustor. It is, of course, impossible to know precisely what the trustor had in mind when the will or trust instrument was drafted. Most trust officers are of the opinion that the testators are usually concerned chiefly with the well-being of the life beneficiary. The remainderman is most often thought of as getting "what's left." Since ignoring depreciation in the accounts will result in greater benefits to the life beneficiary that is the usual course.

**Deviations from the General Rule**

Although Professor Scott makes the statement that, "It has not been the practice of trustees in administering trusts to apply the principles which are applied by businessmen in the conduct of their business," where the trust assets consist of a business, depreciation

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13 Scott, Trusts, sec. 238.4.
may be considered as an ordinary business expense. In a 1946 Connecticut case\(^1\) it was held that under such circumstances it would be reasonable to infer that a depreciation charge was proper as an ordinary expense. Such an inference could have been made on two grounds. The law texts typically say, "where the trust property consists wholly or in part of a business...the net profit arising from sales in such a business is income."\(^{15}\) The Uniform Principal and Income Act\(^{16}\) provides that the "net profits" shall be deemed income. Net profits may be understood to mean the net income of the enterprise as computed in accordance with customary business practice.\(^{17}\) This, in most instances, would include a charge for reasonable depreciation.

Another basis for allowing depreciation of business assets could come out of the particular court's understanding of the term "wasting assets." English law had developed the doctrine that wasting assets must be sold and the proceeds reinvested to protect the remainderman.\(^{18}\) Present-day law in this country\(^{19}\) gives the trustee the alternative of providing for amortization.

The general rule referred to above obviously does not

^{15}A.I.I., Trusts, sec. 235.
\(^{16}\)A.I.I., Trusts, sec. 235.
\(^{17}\)Ibid., sec. 7 (1).
\(^{18}\)Ibid., sec. 7 (5).
\(^{19}\)Howe v. Earl of Dartmouth, supra, p. 52 and chapter III, supra.
\(^{19}\)A.I.I., Trusts, sec. 239.
consider depreciable property, such as a building, as wasting assets. Such has been suggested however. "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."20 The Restatement describes wasting assets as including "...interests in things which are worn out by use such as machinery and farm implements."21 The wording there is identical with Professor Scott's treatise22 and reflects his editorial influence. It can hardly be said that such a view of wasting assets is widespread.

In New York it seems to be established that depreciation may be charged in those cases where the trustee holds a minority interest in an incorporated business.23 However, in another case,24 where the corporation was owned entirely by the trustee and the buildings involved constituted the only assets, the corporation was disregarded and no depreciation allowance was permitted. This holding was in spite of the fact that depreciation had been charged during the lifetime of the testator.

In two other cases depreciation charges were

20 Note, 60 Harv. L. Rev. 952.
21A.L.I., Trusts, sec. 259.
22Scott, Trusts, sec. 259.
23Beach v. Sales, 102 N.Y.L.J. 1901; Matter of Cornell, 95 N.Y.L.J. 1738.
24Matter of Adler, supra, p. 72.
permitted because of the wording of the instruments.

Where a testator designated that a building "...be held
together for the benefit of my entire estate," the
court held that this direction implied a funded depre-
ciation reserve. The fund was created by periodic charges
to income.

In *Fidelity Union Trust Co. v. McGraw* it was
provided in the will that "...with respect to any real
estate which the trustees may hold as part of the prin-
cipal of any of the trusts, my Trustees shall be empowered
to make such provision for obsolescence with regard
thereto as in their judgment may be wise." The court's
interpretation allowed a fund to be established.

Charitable trusts create peculiar circumstances
since they may operate without regard to the rule against
perpetuities. In the *matter of Girard* a trust of
buildings was established for the purpose of earning
income to be paid to a charity "forever." The court
held that the trustee must set up a reserve for depre-
ciation. The testator apparently intended depreciation
to be charged since failure to do so would have eventu-
ally depleted the trust corpus. Various trust officers
have expressed their opinion to the author that failure
to make a provision for future replacement of the realty,

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26 *Supra*, p. 72.
or other investment, would be a violation of the intent of the testator to provide the charity with a perpetual source of income.

Other instances have been suggested where the use of a depreciation reserve is optional. "The rules as to setting aside a reserve for depreciation should not be hard and fast rules, but should be subject to reasonable limitations in the light of all existing conditions."28 If a building held as a trust asset is used as a residence by the life beneficiary, a depreciation charge may not be proper.29 The suggestion is that the building is more in the nature of a res than of a quantum which must be preserved for the benefit of the remainderman.30

If a building produces so little income that a depreciation charge to income would reduce the return to the life beneficiary below that which is normal on trust investments, it may be that no depreciation should be charged. Accountants, accustomed to thinking of depreciation as a fixed cost regardless of return, are at first shocked by such a suggestion. But peculiar circumstances exist in the case of a testamentary trust. If the property is not producing a normal return, it would be classified as unproductive property. As such, the trustee is under an obligation to dispose of it.

28 Scott, Trusts, sec. 239.4.
29 Ibid.
30 Cf. 46 Harv. L. Rev. 786-89.
If the loss resulting from such a sale would cause a greater loss to the remainderman than the failure to provide for depreciation, then the trustee is justified in computing income without regard to the depreciation charge.

This flexibility with regard to depreciation was expressed by the surrogate in the Kaplan case where it was pointed out that depreciation reserves are not irrevocably allocated to corpus when allowed. "Disposition of depreciation reserves as between income and principal is expressly reserved for determination until such time as the trust has been terminated, or upon earlier application when the facts shall warrant such a determination."

Delaware has authorized, by statute, the setting up of reserves for depreciation:

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.

Since the trustee is given a discretionary power, an accumulation of income for a depreciation fund, in all probability, could be challenged by a beneficiary only where the instrument specifically prohibited the use of

31 Matter of Elias Kaplan, 88 N.Y.S.(2) 851.
32 Delaware Laws, 1939, ch. 150.
such a device.

Funding the Reserves

In a commercial operation the charge made against revenues for depreciation is simply a "book charge," i.e., there is no effect on the business funds directly resulting from the recording of depreciation. Where the business revenues of a period exceed the out-of-pocket costs incurred during that same period, a net accumulation of funds occurs as a result of operations. To the extent depreciation is charged, this accumulation is not reflected in the accounts as income or surplus. The effect is one of a gradual transfer of invested funds from fixed assets to working capital. Since working capital is only rarely segregated in a separate "depreciation fund," the funds accumulated by operations are reinvested in a variety of ways and they cannot be identified as specific assets.

For trust accounting purposes, funding must take place if depreciation is to be recognized in the accounts. A transfer of income cash into uninvested principal is necessary. The depreciation charge cannot be offset by a credit to the asset or its related reserve since these are principal accounts; the credit to the principal account cannot be offset by a debit to expense because the expenses are a part of the income accounts. A transfer of assets is essential.
This procedure will not result in a depreciation reserve in the accounts unless a credit is made to a special account rather than directly to principal. In view of the situation this would seem to be desirable. The reserve account so created should not be confused with so-called "income reserves," such as those typically used for taxes and insurance, but should be recognized as a part of the trust corpus. The cash transferred to principal should be available for investment as any other principal funds.

Admittedly, this recommendation goes one step further than present practice. Where amortization is recorded, the usual practice is to simply credit the principal control account. The effect is to give an appearance of a gradually increasing principal balance since no decrease takes place in either the asset or the offsetting invested principal account. Use of a separate reserve would have three advantages:

(1) Extraordinary repairs could be charged against the reserve thereby giving a more complete picture of that particular phase of operations.

(2) In the event of any subsequent need for information relative to the realty, all amortization entries would be segregated from other principal entries, thereby avoiding time-consuming recapitulation.

(3) If it was deemed desirable, in order to
convey the facts of wear and tear and loss of value, the reserve balance could be deducted from the asset balance thus avoiding any appearance of an increasing principal amount.

Applicability

Income should be charged with depreciation, and income cash reduced, where the assets involved have been purchased or constructed out of the principal funds of the trust subsequent to its creation. The income beneficiary is deriving the benefit from the use of the invested funds and should, therefore, be required to bear the cost. Further, the trust capital should not be required to stand a loss in value that results from usage of the asset.

In the case of charitable trusts which have been established with the purpose of perpetually providing income to some institution or group, depreciation and funding should take place. Only by so doing can the trust achieve its perpetual life. Failure to set aside income for eventual replacement would result in a gradual depletion of the corpus of the trust.

Where the depreciable property is a part of the trust estate at its inception an entirely different situation exists. Here, too, failure to charge depreciation will eventually deplete the interest of the remainderman while benefiting the life beneficiary.
However, this may be precisely what the trustor desires. Attorneys who draft trust instruments must be aware of this situation and should attempt to explain it to prospective trustors. Then, in drafting the instrument, a clause should be written specifying exactly the wishes of the testator or donor. This is not, at present, a common practice; the typical trust instrument is silent on the matter of depreciation. Yet, this appears to be the only practical solution.
Chapter VII

Income Taxes

The federal income tax is a subject of wide scope about which many volumes have been written. A complete discussion of that tax, even limited to its application to estates and trusts, is beyond the scope of this study. Briefly, the theory of income taxation of trusts is that income earned by a trust is to be taxed only once. Allocation of income may be made so that a portion is taxable to the beneficiaries and a portion to the trust. As was stated by the courts, "The receipt by the trust of money distributable to a beneficiary is for purposes of taxation receipt by the beneficiary." 1 Exceptions and limitations appear in the law, but basically single taxation is the goal.

Since the area of study undertaken here concerns transactions involving real estate held in trust, only those portions of the federal income tax law relating to such transactions will be discussed. Those areas in which the tax rules differ from the general practices of trust accounting will receive greatest attention. The law relative to depreciation of trust assets is of particular interest.

Basis

The basis for assets acquired by reason of death in a testamentary trust is generally the fair market value at the time of death.\(^2\) An alternative valuation may be used if the executor of the estate chooses to do so. The purpose of allowing a basis other than fair market value at the date of death is to mitigate hardship in those instances where the estate assets suffer shrinkage soon after death.\(^3\)

The Internal Revenue Code\(^4\) provides for the value at the date of disposition to be used as the basis in those cases where the property is sold or otherwise disposed of within a year after death. Despite the lapse of time involved between death and disposition, this section does provide a means of obtaining an objective determination of fair market value for estate tax purposes. Further, for income tax purposes, the use of this alternative valuation will result in no gain or loss being recognized upon disposition. Obviously, the executor will elect to use the alternative valuation or not depending on which will afford the greatest tax saving.

In the case of property not disposed of within a year following the date of death the executor has the

\(^2\)1954 I.R.C., sec. 1014(a), 2031(a).
\(^3\)Mass v. Higgins, 312 U. S. 443.
\(^4\)Sec. 2032(a).
option of using fair market value at the time of death or as of one year after the death of the decedent. Decreases in value caused by mere lapse of time are not allowed. Income earned during the year following death does not enter into the optional valuation, nor does such income have any effect on the amount of accrued income to be included in the decedent’s gross estate.

Fair market value at the date of death, as was observed in Chapter II, is the usual figure for carrying value in testamentary trusts. No conflict appears between general practice and tax requirements on this point. Where the alternative valuation is used this consistency does not exist; separate memorandum tax records must be maintained outside the general ledger.

The basis of assets acquired in an irrevocable living trust is the same as the basis in the hands of the donor or the last preceding owner who did not acquire the property by gift. In the event that the donor’s basis is greater than the fair market value at the date of the gift, the fair market value shall be used as a substituted basis for the purposes of determining any loss on disposition. It was pointed out in

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5 Ibid.
7 Sloane, T. C. Memo., 6-5-44, aff. dismissed.
8 1954 I.R.C., sec. 1015; but for gifts prior to 1-1-21 the basis is fair market value at the date of gift.
9 Ibid.
Chapter II that the most common carrying value for such property is the donor's unadjusted cost. If the donor has been allowed any depreciation prior to making the gift, it is necessary to maintain a separate record in memorandum form for tax reporting.

The same situation prevails in the case of a revocable living trust. Where the grantor retains the power to revoke he shall be treated as the owner of the trust assets and income. There are certain exceptions which are beyond the scope of this study. As in the case of irrevocable living trusts, there are generally separate tax records kept apart from the ledger.

Gains and Losses

Real property held in trust typically will qualify as a capital asset or as a section 1231 asset to be treated as a capital asset where a gain is recognized. A trust, as well as an individual, may use the installment method of reporting gains.

Any portion of a gain on disposition which becomes a part of the trust corpus is taxable to the trust. If the gain is properly distributable to a beneficiary it is taxable to the beneficiary and deductible by the trust. Capital losses are generally deductible by

101954 I.R.C., sec. 676.
11Old Colony Trust, Executor, 38 B.T.A. 828.
121956 P-H Tax Sv., sec. 15,126 et seq.
the trust unless, under the terms of the instrument such losses are not chargeable to corpus. In such a case the losses will reduce the income taxable to the beneficiary.

Further discussion of gains and losses will follow later in the chapter after an examination of the problem of depreciation.

**Income and Expenses**

In general the computation of the net income derived from real estate held in trust will not differ from that to determine adjusted gross income for tax purposes. The Internal Revenue Code specifically names rents as includable in gross income and permits the deduction of expenses such as interest, taxes and other management costs. As a general rule, trust accounts are kept on a cash basis and the tax returns are filed on the same basis. Some discrepancies between the ledger and the tax records will be necessitated because the full amount of certain expenditures will not be allowed as a deduction in one year even though the cash basis is employed. A very common example is the requirement to pro-rate prepaid insurance premiums over the periods to which they relate rather than take the deduction in the year paid. Similarly, payments to agents for

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13 Beatty, 28 B.T.A. 1236.
14 Alexander, 36 B.T.A. 929.
15 G.C.M. 25387, 1943 C.B. 213; Commissioner v. Boylston Market Ass'n, 131 F.(2) 966.
services rendered in obtaining lease agreements should be pro-rated over the life of the lease.\textsuperscript{16}

One area of real estate operations in which disagreements between the agents of the Internal Revenue Service and the trustee will almost inevitably appear is that of repairs and improvements. The problem, however, is by no means peculiar to trusts but is a common one in almost any field. As stated earlier\textsuperscript{17} improvements made to property held in trust are usually considered as chargeable against corpus. The propriety of such charges, if questioned, will be adjudicated by a court of equity.

In like manner, expenditures for improvements are not considered to be a deduction for income tax purposes.\textsuperscript{18} Ordinary repairs are properly charged against income in the trustee's records and are deductible in a single year in computing adjusted gross income. The problem lies in distinguishing ordinary repairs and capital improvements. There may not be acceptance of the fiduciary's accounting by the Internal Revenue Service, and the trustee is not bound to accept the ruling of the Service for his own accounting purposes. Again, supplementary tax records will be necessary.

The taxable income of an estate or trust is computed in the same manner as taxable income of an

\textsuperscript{16}1956 P-H Tax Sv., sec. 6069.
\textsuperscript{17}Supra, pp. 60 ff.
\textsuperscript{18}1954 I.R.C., sec. 263.
individual with only a few exceptions. Apart from being able to apportion depreciation and amortization between the trust and the beneficiaries, these special rules do not have any application to the holding of real estate.

**Depreciation**

In general, a trust may depreciate its assets in the same manner as an individual except that an apportionment is required. The 1951 Internal Revenue Code provides:

In the case of property held in trust, the allowable 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.\(^{19}\)

Legal ownership is not a prerequisite to the right to a deduction for depreciation.\(^{20}\) "The test is whether the claimant to depreciation is in such a position as to suffer an economic loss as a result of the decrease in value of the property due to depreciation."\(^{21}\) For a number of years there were conflicting decisions as to whether a life beneficiary did suffer an economic loss. Most decisions were that the life beneficiary could not deduct depreciation.\(^{22}\) The Revenue Act of 1928 added

\(^{19}\) Sec. 167(g).
\(^{21}\) Edith Henry Barbour, 41 T.A. 1117.
\(^{22}\) U.S. v. Blow, 77 F。(2) 141; Francis L. Drake, Executor, 30 B.T.A. 461; Roxburgh v. Burnett, 58 F。(2)
substantially the same provision as was quoted in the preceding paragraph. This resolved the question in favor of permitting the deduction by the life beneficiary.

The apportionment of the depreciation deduction between the trust and the various beneficiaries is based on the amount of "trust income allocable to each" unless otherwise specified in the instrument or will. The regulations state that:

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 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.23

Where a trust includes both depreciable and non-depreciable property, it would be good tax planning to consider the tax status of the several beneficiaries when the instrument is drawn. If non-taxable beneficiaries, such as charitable institutions, could receive the income from non-depreciable property and high-bracket beneficiaries receive the income from depreciable property an overall tax savings could be effected. The full depreciation deduction should be channeled to the beneficiary who can benefit most from it. The phrase


23T.D. 6182, 3-7-56, sec. 1.167(g)-1(b).
"irrespective of any provisions in the trust instrument" is new to the regulations. This addition would seem to preclude ear-marking of specific income for particular beneficiaries. However, the same effect can be achieved through the use of multiple trusts.

In determining the amount of trust income allocable to each beneficiary, the terms of the instrument, or the local law, will govern. Then the state courts have not decided whether certain income is distributable, the federal court must make their decisions in terms of what they believe a state court would hold. The federal decision is not res judicata in a subsequent state court proceeding.

If the trustee maintains a fund for depreciation, i.e., actually withholds distribution of an amount of income designated as depreciation, the deduction for depreciation is allocated to the trustee to the extent of the income set aside. The fund so created by the trustee must be "directed" by the instrument or local law or result from the exercise of a discretionary power granted by the instrument. Where a trustee accumulates a fund for depreciation without authority of the trust

24 Freuler v. Helvering, 26 U.S. 55; Commissioner v. Lewis, 141 F.(2) 221.
26 T.D. 6182, 6-7-53, sec. 1.167(g)-1(a).
27 Ibid.
instruments or court orders, but by agreement of all beneficiaries to the trust, the trust would be denied the deduction if a strict interpretation of the regulation was made. The overall effect on total taxable income would be nil, however, whether the deduction was taken by the trust or by the beneficiaries. It is doubtful if a deduction by the trustee would be challenged by the Internal Revenue Service unless there was an appearance of deliberate tax evasion by a high-bracket trust.

**Effect on Remainder Interest**

A peculiar situation results from the tax rule permitting the life beneficiary to take a deduction for depreciation when the entire amount of income is distributable. Not only does the remainderman suffer any loss that occurs because of physical depreciation of the corpus, but in addition he is subjected to a tax penalty because the prior depreciation will lower his basis and increase his taxable gain when he disposes of the property.

For federal income tax purposes a gain or loss is measured by the difference between the proceeds of the sale and the adjusted tax basis. The effect of depreciation was explained in the Regulations for the 1939 Internal Revenue Code:

The deductions allowed or allowable under section 23(1) and section 23(m), (now section 107), both to the trustee and to the trust beneficiaries, constitute an adjustment to the basis of the property not only in the hands of the trustee, but
but also in the hands of the beneficiaries and every other person to whom the uniform basis is applicable.28

Assume a depreciable asset is held in a testamentary trust where the trustee is under no direction to provide for depreciation before distribution income from the property. The life beneficiary will enjoy the income from the trust property without it being diminished by depreciation. At the same time, he will be permitted a tax deduction for the depreciation that occurs thus rendering some of his income tax free. The remainderman, however, suffers any loss in the resale value due to depreciation, but is not allowed a tax deduction for it. If he is fortunate enough to realize a gain upon disposal, the past tax deductions, from which he did not benefit, now cause him to pay a larger tax. Should the life interest cease after the property has become fully depreciated the remainderman will take title to a piece of property with a zero basis. Continued management of the property will result in an abnormally large tax bill since he will have no depreciation deduction. Sale of the property means an immediate loss of twenty-five percent of his proceeds as a capital gains tax.

Only one solution to this dilemma appears. First, deny any deduction for depreciation to the life beneficiary. Secondly, allow the trustee a deduction only to

28 Reg. 111, sec. 29.113(a)(5)-1(e).
the extent of his accumulation of income in a depreciation fund. Lastly, the basis to the remainderman should be adjusted by only the amount of depreciation actually allowed the trustee and therefore funded to the remainderman's benefit. This is a patently wrong answer.

Such a revision of the tax laws would have dual effects, and both would be undesirable. The life beneficiary would be either deprived of income as it was reserved to maintain the dollar value of the corpus, or he could receive income which was expensive tax-wise. The loss of the depreciation deduction, if no reserve was set up, would increase the cost of tax cost. His net cash return would be reduced below that which the testator had been realizing from the property and probably had intended the life beneficiary to have.

The remainderman would come to benefit by either taking a high basis property which could be disposed of nearly tax-free, or possibly with a tax loss, or, if the depreciation had been taken, he would come into possession of a presumably liquid depreciation fund. If the will happened to provide that, upon termination of the trust, reality passed to one remainderman and personally to another, the courts would be hard put to find that a depreciation fund probably consisting of high grade securities, was reality. Moreover, as most trust officers have observed, the testator is primarily concerned
with the well-being of the life beneficiary, not the remainderman, in most cases. Such tax revisions would frustrate the average testator's wishes. All facets of the question considered, the law is better as it now stands.

Summary

Differences between tax requirements and the usual trust accounting practices make it necessary for the tax men in trust departments to maintain quite complete records apart from the trust ledgers. Outside the area of real estate transactions, many more situations exist where the tax reports require information not ordinarily segregated in the accounts, such as distinguishing tax-exempt interest from other interest, capital dividends on mutual stocks and certain types of exempt income for state tax computations. The author has found in his own experience and in talks with tax men in various trust departments that it is quite common to keep a complete duplicate set of records for tax purposes. In some places the so-called supplementary tax records provide a more complete and intelligible documentation of the trust activities than do the general ledger accounts. This is particularly where the trust holdings are varied and the transactions often complicated. In other, more simple, trusts the general ledger records may be adequate for tax reporting. Where punched card
records are used the coding system must be made to conform to the tax section's requirements and sub-totals can be summarized for court accountings and reports to beneficiaries.

Allowance of a depreciation deduction to the life beneficiary of a trust may work a hardship on the remainderman. The greater benefit to the cestui is usually desirable. As was pointed out before, the testator should be acquainted with the problem by his counsel and care should be exercised in drafting to fulfill the testator's desires.

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29 Supra, pp. 82-83.
Chapter VIII
Conclusions

Accounting for trust operations is complicated by the framework of law within which the trustee must perform. The law is not a rigid, unchanging pattern of rules. Neither can it be said that the law is capricious. Among the maxims that have developed since the days of English chancery is that equity regards substance rather than form. As applied to questions of construction in testamentary matters, the judgment of the courts, while following well established precedents, must strive for an application of the principles of equity to the specific problem at hand. Every effort must be made to interpret the trust instrument or the will as the court believes the creator intended. A body of law has developed which, though it be logical and consistent in the majority of cases, cannot be universally applied to all circumstances.

Accounting for trust operations is further complicated by the individuality of each trust. Just as no two individuals are alike, so no two trusts will be exactly alike. Each trust is designed to care for a particular group of assets accumulated by an individual in his own manner, and prior to the creation of the trust, managed in his own way. In most instances, the
donor or testator desires the trust to be managed in a manner that will conform to his own previous handling of the properties and will make specifications in the instrument directing this as far as practicable. The relationships of the beneficiaries to the trust will also vary. The matter of individual personalities often become a major problem to the trustee. In maintaining the fine line of balance and equity between the cestui and the remainderman the trustee may encounter strong pressures from one party or the other. In all cases, the provisions of the instrument must control unless the courts rule a change.

Another complication in accounting for trust operations is the necessity of compliance with the tax statutes and regulations. The discrepancies which exist between the usual trust accounting practices and tax requirements are probably no greater than in any business operation. They do exist, however, and, as in any business, do create problems in record keeping and in tax reporting. It must be remembered that a trustee is required to file a separate federal income tax return and separate state tax returns for each trust under his administration. In the case of a corporate trustee this may mean several hundred returns, all due at the same time, and each one requiring a reconciliation between the ledger and the tax return.
All of these factors combined create a state of affairs which is apt to appear somewhat confused. The average industrial accountant placed in the trust department of a bank would probably feel that the situation was nothing less than chaotic. The simple fact is that a trust department is not a business; it is several hundred businesses managed by a relatively small number of people. Each trust is a separate endeavor, operating under the terms of its own charter, so to speak, and involving entirely different personalities.

Consistent patterns of accounting have developed in some situations. This is due to considerable study and experimentation in some cases. It is simply the result of following the path of least resistance in others. Trust officers contacted in the course of this study generally seemed anxious to compare their practices with those of other institutions. Most were quite willing to discuss their problems with the author. In normal business intercourse between trust departments in a given city, exchange of experiences is often limited because local circumstances would identify individuals and risk violation of a confidential relationship with the beneficiaries. This tends to slow down any movement toward uniformity in treatment of accounting problems. Reported court cases are available and, as far as there is applicability of the facts, suggest possible solutions.
The requirement of the local probate courts tend to make some uniformity in reporting.

The value at which real estate is carried in the accounts has given no great concern to trustees. The possibility of surcharge is of little practical consideration although it is a source of some concern to a few trust officers. The real criterion for establishing a carrying value should be its usefulness to the trustee in his future reporting. From this viewpoint, taxation is by far the most important consideration.

Because of tax requirements, as well as the statutory requirements enforced by the probate courts, an appraisal of property is necessary for testamentary trusts. An appraisal is needed for purposes of the state inheritance tax, the federal estate tax and, later, for federal income tax determination. The best possible appraisal should be obtained by using qualified appraisers and exercising care that all the factors which enter into the determination of fair market value are considered. When such an appraisal has been accomplished this will provide the trustee with the most useful figure for accounting purposes.

There is no need for an appraisal at the time realty is placed in an inter vivos trust. If usefulness in reporting is to be the criteria here, tax considerations will again be foremost. The donor's tax basis will be
carried forward into the trust and would appear to be the best of the many possible valuations. The donor's cost, unadjusted, as is often used, affords the trustee's tax department little help except as a starting point. The use of the real estate tax duplicate valuation as a carrying value has nothing to commend it. Equally poor is the practice of carelessly obtaining a "cost" from the donor's memory and failing to allocate between land and buildings. Then this is done the tax department must necessarily search for a documented cost, properly adjusted for subsequent capital expenditures and depreciation. Too often, this information never finds its way into the trust ledger but remains in the trustee's tax files.

Accounting for receipts and expenditures requires a careful distinction between income and principal. In general those receipts which are but substitutes for the original trust capital are considered as principal. In like manner, those expenditures which are merely charges in the form of the permanent capital are principal charges. Receipts which represent payments for the use of trust capital constitute income. Expenditures made for ordinary, recurring costs in connection with the management of the trust principal are chargeable against the income from the trust.

Although the cestui que trust is naturally interested
in obtaining the maximum benefit from the trust, fairness to the ultimate remainderman requires care in the determination of periodic income. The revenues recognized in a given period should be such revenues as result from transactions definitely established by the occurrence of an event or existence of a condition measurable in terms of monetary value. The ascertainable costs incurred must be assigned to the revenues with which they are associated. Recognition of expenses does not necessarily come in the period in which the expenditure is made, but rather in the period in which a contribution was made to the production of income. Since no product is produced in a real estate operation assignment of costs and revenues is on a basis of time. The general acceptance of accrual accounting among industrial enterprises is testimony of the desirability of looking beyond the mere flow of cash to determine periodic income.

Trust accounting practices should be adopted which take more cognizance of the need for accrual procedures. This is particularly necessary at the inception of a trust and again at its termination. At these points there is a separation of interest and need for clear distinction of rights to revenues and responsibilities for costs.

Right to revenue should vest in the life beneficiary of a trust as of the creation of his interest. Income
should be credited with that portion of a receipt which bears the same percentage relationship to the total receipt as the time during which the beneficiary has the right bears to the total period over which such revenue accrues. Rents from real property would be an example of revenue to which the rule should be applicable.

A proration of rent receipts at the inception of a testamentary trust would require that as much of the receipts as a 1/2 to the period prior to the death of the testator be included in his estate, if applicable, in the corpus of the trust. At the termination of the trust rents accruing to the date of termination would be credited to income distributable to the life beneficiary or his estate, while rents accruing after the date of termination would be credited to principal. Advance payments on long term leases should not become immediately distributable. Rather, income should be credited as the revenue is earned by the trust. Unearned income should then be credited to principal if the interest of the life beneficiary should cease before the expiration of the lease.

At common law rents were not apportionable. Because of this, common law states need legislation sanctioning apportionment. The courts cannot be expected to approve a practice for which there is neither statute or local precedent.
The same rules of apportionment should apply to regularly recurring expenses of operating the trust which are payable at stated intervals. As this relates to real estate transactions, included in the rule would be expenses such as interest on mortgage indebtedness, real estate taxes, track rents and water charges. Again legislative action would be desirable. The courts may distinguish individual cases to allow or disallow apportionment. If the statutes of the state require apportionment much confusion could be eliminated.

However, there is danger in mandatory statutes. In any event the donor, or testator, should be able to prohibit apportionment under the terms of the instrument and be assured that his prohibition would be honored. Where the trustee is directed to use discretion, it should be reasonable to expect apportionment to be enforced unless circumstances, such as immateriality, clearly justified the use of a cash basis of accounting.

In the area of repairs certain practices have developed which are commendable. Some trustees, in situations where the bulk of the trust income is derived from real estate operations, will withhold income distributions to provide funds for necessary and foreseeable ordinary repairs. No accounting entry is absolutely required to record this. However, for a clear showing in the accounts, income should be charged and a credit
placed in an appropriately named account as an income reserve. Such accumulations cannot be had for the purpose of improving the property or offsetting obsolescence, but only to provide funds for repairs which are properly chargeable to the income account.

Because of basic differences, the trustee must carefully distinguish between depreciable assets acquired as part of the original corpus and those which have been subsequently acquired by purchase under a discretionary power to invest. If a trustee invests corpus funds in high grade bonds, the investment will have, after a span of years, the same principal value. If, however, a trustee exercises his discretionary power to invest by the purchase of a building, time will take its toll. After a period of time physical depreciation and obsolescence will have caused a wasting of the principal. The manifest injustice done the remainderman can be rectified by the creation of a funded reserve for depreciation. This account, unlike the reserves mentioned in the preceding paragraph, should be considered as trust corpus. There is no justification for the life beneficiary to receive the income undiminished by depreciation to the detriment of the remainder interest.

A different situation prevails where the depreciable assets come into the trust under a will. If the instrument
is silent on the matter of depreciation, and virtually all are, it can be reasonably assumed that the testator was aware that physical depreciation would take place. It can be inferred that in maintaining silence he anticipated such decrease in value as falling against the remainderman while having primary concern for the well being of the life beneficiary. This position is so generally accepted that it is difficult to refute.

Any statutory requirement to make depreciation mandatory would create havoc in trust administration. Wholly apart from the problems of trusts already in operation which might or might not be affected by legislation, would be the many instruments already executed but still inoperative. To require depreciation would frustrate the wishes of many people who have already drawn wills and would probably pass on unaware that legislation had deprived their loved ones of intended income.

A more reasonable, and more practical, answer is possible. Through publications available to estate planners an awareness of the problem can be created. The solution lies in determination of the intent of the testator, while he is still alive to express it, and careful draftsmanship in the preparation of the instrument.

A grey area exists in the form of assets purchased subsequent to the creation of the trust under a mandatory
direction to so invest. If the testator directs investment in realty, the same assumptions would apply as with assets willed to the trust. Depreciable property purchased because of specific directions in the will or trust indenture should not be subjected to mandatory provisions either requiring or prohibiting depreciation. Here again it is necessary to have the testator’s wishes carefully spelled out in the instrument.

In connection with drafting depreciation instructions the tax aspects of the problem should be carefully considered. The present tax laws are such that the life beneficiary has a distinct tax advantage. The deduction for depreciation is generally available to the life beneficiary even though he has no legal estate, whereas the remainderman takes property at a future date after it has lost its tax basis. One trust officer who remarked, "No one ever became poor paying the capital gains tax," reflected the typical reaction. Trustmen in general feel no need to crusade for tax reform in this area. The situation has prevailed for a long time and any testator who wants to provide more for the remainder interests under his will should know the facts and proceed accordingly. As has been observed before, the remainderman is seldom the chief object of the testator’s concern.

Some of the problems concerning real estate held in trust can be solved by changes in accounting techniques.
A closer tie-in should exist between the general ledger and supplementary tax records. A better application of generally accepted accounting procedures is desirable. A greater use of accrual accounting is particularly needed. Often a more extensive use could be made of income reserves to achieve greater stability in distributions. Legal precedents prevent rapid changes, in some cases any change at all, and legislation may be necessary in some jurisdictions before certain accounting techniques can be used.

The problem of depreciation cannot be resolved by the blind application of generally accepted accounting principles. The estate planner, whether attorney, accountant or trust officer, must be aware of the depreciation question in his planning. The attorney who drafts the instrument should obtain accounting assistance to be sure that the trust will accomplish the creator's wishes. The trustee will always encounter varying treatments of depreciation in the many trusts under his administration. This is but another indication that each trust is a separate, or distinctive, business operation. It is no more reasonable to expect standardized accounting procedures for every trust administered in a trust department than it would be to expect identical accounting procedures for a billion dollar corporation and a corner grocery store.
Appendix A

List of Banks Visited

The Central Trust Company, Cincinnati, Ohio
The City National Bank, Columbus, Ohio
The Cleveland Trust Company, Cleveland, Ohio
The Fifth Third Union Trust Company, Cincinnati, Ohio
First National Bank, Akron, Ohio
First National Bank, Cincinnati, Ohio
The Huntington National Bank, Columbus, Ohio
The National City Bank, Cleveland, Ohio
The Ohio National Bank, Columbus, Ohio
The Toledo Trust Company, Toledo, Ohio
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Autobiography

I, Clayton Roald Grinstad, was born in Fond du Lac, Wisconsin, on March 20, 1923. I was educated in the public schools of Wisconsin and Florida, graduating from Eustis High School. My undergraduate training was obtained at Rollins College, Winter Park, Florida, from which I received the degree Bachelor of Music in 1947. I received the degree Master of Business Administration from the University of Florida in 1948. I was appointed an instructor in accounting at the University of Connecticut and held that position until 1953. I received an appointment as instructor in accounting at The Ohio State University in 1953 and have held that position to the present time while completing the requirements for the degree Doctor of Philosophy.