Allocation of the Cost of Improvements to Real Property Held in Trust

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Trustees are frequently called upon to make expenditures upon corpora of improved rental or commercial real property trusts. California law regulating the allocation of the cost of such expenditures between income and principal, or more precisely between the beneficiaries entitled to these funds—income beneficiary and remainderman—has been in a state of uncertainty since 1965. As a result trust officers have been reluctant to file accountings for fear of incurring personal liability. The California Legislature in its 1967 session enacted legislation to meet this problem, and adopted a modified version of the 1962 revision of the Uniform Principal and Income Act. This note will first examine the context of the problem and the cause of the uncertain state of the law. Then the relevant provisions of California's Revised Uniform Principal and Income Act will be discussed and evaluated as an effective tool for trustees regarding the allocation of the cost of "improvement expenditures."

The particular expenditures under consideration in this note are those for improvements to trust corpora consisting of rental or commercial real property. These are expenditures which change, alter, or add to the land and which "alter its use or increase its value and productivity." The major problem encountered in allo-

1 "The trust property is sometimes called the trust res, the corpus, the capital, the subject or subject-matter, of the trust." G. Bogert, The Law of Trusts and Trustees § 1, at 3 (2d ed. 1965).
2 "Income is the return in money or property derived from the use of principal ..." Cal. Stats. 1967, ch. 1508, § 2 (operative July 1, 1968 as Cal. Civ. Code § 730.03(a)).
3 "Principal is the property which has been set aside by the owner or the person legally empowered so that it is held in trust eventually to be delivered to a remainderman while the return or use of the principal is in the meantime taken or received by or held for accumulation for an income beneficiary." Cal. Stats. 1967, ch. 1508, § 2 (operative July 1, 1968 as Cal. Civ. Code § 730.03(b)).
4 "Income Beneficiary" means the person to whom income is presently payable or for whom it is accumulated for distribution as income." Cal. Stats. 1967, ch. 1508, § 2 (operative July 1, 1968 as Cal. Civ. Code § 730.01(1)).
5 "Remainderman" means the person entitled to principal, including income which has been accumulated and added to principal." Cal. Stats. 1967, ch. 1508, § 2 (operative July 1, 1968 as Cal. Civ. Code § 730.01(3)).
6 See text accompanying notes 28-53 infra.
9 "Expense and expenditure are not synonyms. An expense is the expiration of value. An expenditure is an outlay of funds or an incurring of obligation. When a building is purchased, there is an expenditure. As it is used up, there is expense." Note, Depreciation as a Trust Expense, 4 U. Fla. L. Rev. 41, 43 (1951); see P. Mason, S. Davidson, & J. Schindler, Fundamentals of Accounting 278-79 (4th ed. 1959).
10 G. Bogert, supra note 1, § 600, at 356. Improvements should be dis-
cating such "improvement expenditures" results from the fact that these improvements depreciate in the course of time. If the entire improvement cost was allocated to trust principal and the interest of the income beneficiary does not terminate before the end of the useful life of the improvement, the remainderman suffers an inequity. Though he has paid the entire improvement cost, he receives an asset at the termination of the income beneficiary's interest worth substantially less than he paid. If, on the other hand, the entire cost of the improvement was allocated to income and the interest of the income beneficiary does terminate before the end of the useful life of the improvement, the income beneficiary suffers the inequity. Though he has paid the entire cost of the improvement, he receives only part of the use. The problem the trustee faces, therefore, is how to allocate equitably the cost of an "improvement expenditure" which depreciates, i.e., for how much of the cost should each beneficiary's interest be responsible?

This problem arises when instruments creating testamentary or unamendable inter vivos trusts contain no expression of the settlor's intent regarding such allocation. The settlor's intent is controlling when expressed; in the absence of such expression, the trustee is faced with the responsibility of allocating the cost of the expenditure in a manner consistent with his duty to treat all beneficiaries impartially.

In the absence of legislative or judicial rules, the trustee would have three possible methods by which to pay the cost of "improvement expenditures" from trust funds. These expenditures could be: (1) paid entirely from principal; (2) paid entirely from income; (3) divided between principal and income in some rational manner. As has been stated above, the first two alternatives may result in inequities. The third method, which divides the cost between the beneficiaries, has gained increasing prominence in statutory enactments as well as the legal literature. This method is depreciation ac-

ting from repairs which "are designed merely to keep the res intact and in its original condition, as nearly as possible." Id.; see 3 A. Scott, Law of Trusts, §§ 176, 233 (2d ed. 1956); Restatement (Second) of Trusts §§ 176, 233 (1959).

11 The trustee must manage the trust "[i]n accordance with the terms of the trust instrument, notwithstanding contrary provisions of this chapter . . . ." Cal. Stats. 1967, ch. 1508, § 2 (operative July 1, 1968 as Cal. Civ. Code § 730.02(a)(1)).

12 Restatement (Second) of Trusts § 232 (1959).


14 Bogert, Uniform Principal and Income Act Revised, 101 Trusts & Estates 787 (1962); Capron, Reserves Against the Depreciation of Real Property Held by a Trustee, 12 Ohio St. L.J. 565 (1951); Dunham, Uniform Revised Principal and Income Act: Discussion of Newly Promulgated Statute, 101 Trusts & Estates 894 (1962); Isaacs, Principal—Quantum or Res?, 46 Harv. L. Rev. 776 (1933); Krasonwiek, Existing Rules of Trust Administration: A Stranglehold on the Trustee-Controlled Business Enterprise, 101 U. Pa. L. Rev. (1962); Nossaman, The Uniform Principal and Income Act, 28 Calif. L. Rev. 34 (1939); Note, Trusts-Powers and Obligations of Trustees—Trustee of Improved Realty Must Set up a Reserve for Depreciation, 63 Harv. L. Rev.
counting, and it must be explained at this point to enable the reader to understand better the subsequent discussion concerning the development of California’s principal and income legislation.

In the context of allocating trust “improvement expenditures,” depreciation accounting would provide that principal be initially charged, but subsequently reimbursed by periodic payments out of income. Modern accounting principles direct that the depreciation charges against income are designed to spread the cost of an asset over its useful life. The periodic deduction of such charges from income and crediting them to principal over the expected useful life of the improvement, returns to principal the improvement's original cost. When the improvement is made, part of the trust principal is transformed—changed from money into the substance of the improvement. Depreciation charges against income are a means by which the principal is again transformed as the improvement becomes less valuable—changed from the depreciating improvement back into money. For example, if the trustee remodels a building held in trust at a cost of $100,000, and the expected useful life of the improvement is 10 years, the trustee, utilizing the straight-line method of depreciation, should deduct from income and credit to principal $10,000 annually during the continuance of the life estate. In this manner, when the trust terminates, the remainderman either receives the entire amount of the original principal, or the difference is made up by the value of the partially depreciated improvement; and the income beneficiary has not received the fruits of the improvement in the form of increased income without bearing a proportionate share of its cost.

California law prior to the adoption of the Revised Uniform Principal and Income Act allocated the cost of “improvement expenditures” wholly to either income or principal, with no provision


The United States Supreme Court has defined depreciation as a “loss, not restored by current maintenance, which is due to all the factors causing the ultimate retirement of the property. These factors embrace wear and tear, decay, inadequacy, and obsolescence.” Lindheimer v. Illinois Tel. Co., 292 U.S. 151, 167 (1934).

The factors to be considered in estimating the amount to be periodically charged as depreciation are the original cost, scrap value, and estimated life of the improvement. The estimated life of an improvement to real property is figured in years, and its intended use and provisions for upkeep are, among others, important considerations. See, H. FINNEY, supra at 356-57.
for dividing the cost between them. California’s Revised Uniform Principal and Income Act, however, does provide for apportionment between the beneficiaries by means of depreciation allowances from income. In order to appreciate California’s new position, an understanding of the prior law and the forces leading to the enactment of the new legislation is required. The development of the prior law will be examined first, followed by a discussion of the forces leading to the adoption of California’s Revised Act.

Development of California Law

Prior to 1941 the case law provided that ordinary, recurring, and regular expenses incurred in the administration of a trust were payable from income and that extraordinary or unusual expenses were payable from principal. California codified the existing case law and made its first statutory attempt to deal with the difficult problems of allocating expenses and receipts between income and principal in 1941. The legislature in that year adopted the Principal and Income Act. It provided in section 12 that all “ordinary expenses” including “ordinary repairs” were to be paid from income; “improvements to real property” and all other expenses not payable from income were to be paid from principal. The Act was a substantial adoption of the 1931 version of the Uniform Principal and Income Act with one change of significance regarding this problem. Section 12(4) of the Uniform Act was omitted from section 12 of California’s Act. This section of the Uniform Act provided that when the cost of an improvement representing an addition of value to the trust property was paid out of principal, the trustee must reserve out of income and add to principal each year a sum equal to the cost of the improvement divided by the number of years of reasonably expected duration of the improvement. The legislature did not adopt any alternative provision to allow a means for dividing the cost of “improvement expenditures” between the beneficiaries, and the entire cost under California’s Principal and Income Act was payable from principal since it was an “improvement to real property.”

In 1953 the legislature repealed the Principal and Income Act and adopted the Principal and Income Law. The latter was also based on the Uniform Act and, like the previous California enactment, did not incorporate section 12(4) of the Uniform Act. Section 730.15 of the Principal and Income Law incorporated the provisions

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16 Cal. Stats. 1941, ch. 898, § 12, at 2483, as amended, Cal. Stats. 1953, ch. 37, § 1, at 673 (CAL. CIV. CODE § 730.15 which is to be repealed July 1, 1968).
18 Estate of Dare, 196 Cal. 29, 235 P. 725 (1925); Estate of Duffill, 188 Cal. 536, 206 P. 42 (1922); Estate of Gartenlaub, 185 Cal. 648, 198 P. 209 (1921).
20 Id.
21 Cal. Stats. 1941, ch. 898, § 12, at 2483.
22 UNIFORM PRINCIPAL AND INCOME ACT § 12(4) (1931).
23 Cal. Stats. 1953, ch. 37, § 1, at 666 (CAL. CIV. CODE §§ 730-30.15, which is to be repealed July 1, 1968).
of section 12 of California's Principal and Income Act. The rule governing the allocation of expenses was, under both of the California enactments, that "ordinary expenses" and "ordinary repairs" were to be paid from income and extraordinary or unusual expenses and "improvements" were payable from principal. It was therefore settled that if an expenditure was for an "improvement," its cost was to be paid entirely from principal.

The Principal and Income Law embodied no provision for depreciation of improvements or other assets, except (1) section 730.09, which provided for maintenance of trust principal used in continuance of a business, and (2) section 730.12, which provided special treatment for property subject to depletion or wasting assets. Since rental or commercial real property had been understood by trust officers not to come within sections 730.09 and 730.12, it was the general practice not to charge a reserve allowance for depreciation against the income beneficiary of a trust consisting of such property unless the trust instrument so provided. The California Legislature included in the Principal and Income Law no express language regarding the application of depreciation accounting as a means of allocating the cost of improvements upon rental or commercial real property between beneficiaries.

Disruption of Established Trustee Practice

Disruption to the settled state of the law came at the end of 1965 with the California Supreme Court's ruling in Estate of Kelley. The principles announced in this decision were unexpected in light of the existing law, and they provided the catalyst for rapidly ensuing statutory changes.

In the Kelley case the decedent's estate included a lot and building which was leased to Roos Brothers as a clothing store. The
property was devised to $T_1$, $T_2$ and his wife, to hold as trustees of four separate trusts which were to pay an undivided 55 percent of income to testator's wife and an undivided 15 percent of income to each of the testator's three children. Upon the death of the wife all trusts were to terminate, and each child was to receive an undivided one-third interest in the entire trust property. The will authorized a majority of the trustees to dispose of any of the trust property and to reinvest the proceeds. The will contained no instructions as to how trust expenses should be allocated between principal and income.31

Upon the expiration of the original lease in 1960, trustees $T_1$ and $T_2$ over the objection of the wife, entered into a new lease with Roos Brothers for a 20-year term. The lease required the trustees to spend $125,000 to remodel the store, and $75,000 to design, purchase, and install new fixtures. The $200,000 was obtained by a loan secured by a deed of trust on the building, repayable, including interest, in 20 years.32

On August 6, 1963, the wife filed a trustee's petition for instructions as to how the cost of the improvements should be apportioned between principal and income. On January 2, 1964, the court entered its order directing (1) that the payments on the part of the loan allocated to fixtures be charged, both as to principal and interest, against current income, and (2) that the payments of the part allocated to improvements and modernization of the building be charged against trust principal to the extent they represent repayment of the loan principal and charged against trust income to the extent they represent interest on the loan.33

All the beneficiaries appealed. The wife contended that the amortization of the part of the loan principal allocated to fixtures was in error because the fixtures were not "ordinary repairs" within the meaning of section 730.15(1) of the Civil Code.34 The remaindermen contended that it was error to apportion any principal payments to them because all the work was within the "ordinary repair" provision of section 730.15(1).35

The Supreme Court of California held that the improvements and fixtures were not "ordinary repairs" within the meaning of the Principal and Income Law and directed that these expenditures be paid from trust principal.36 However, the court unexpectedly went on to require that depreciation deductions be made from income and accredited to principal because such deductions were "ordinary expenses" within the meaning of section 730.15 of the Civil Code.37

31 63 Cal. 2d at 682, 408 P.2d at 355, 47 Cal. Rptr. at 899.
32 Id. at 683, 408 P.2d at 355, 47 Cal. Rptr. at 899.
33 Id. at 684, 408 P.2d at 357, 47 Cal. Rptr. at 900.
34 Id. at 685, 408 P.2d at 356, 47 Cal. Rptr. at 900.
35 Id.
36 Id. at 685, 408 P.2d at 357, 47 Cal. Rptr. at 901.
37 "The improvement generated additional income for the life beneficiary, but if it depreciates in value with the passage of time, it will not benefit the remaindermen unless the trust terminates before the end of the useful life of the improvement. To require the remaindermen to pay the entire cost of a trust activity undertaken for the benefit of all the beneficiaries would contravene both the intent of the testator and the express
The court concluded that the proper manner in which to allocate the cost of the improvements would be for the trustee "to establish a depreciation schedule under which the improvements to the building, including fixtures, [would] be depreciated on a straight line basis over their anticipated useful life."\(^3\)

The decision was based on several grounds. First, it was stated that since trust property used in continuance of a trade or business was depreciable under section 730.09 of the Civil Code, and since rental or commercial property could not be meaningfully distinguished from property used in trade or business, rental and commercial property should be depreciable in a similar manner.\(^3\) Second, it was stated, that unless the testator clearly indicated a contrary intent, the trustee must prevent the impairment of the principal since depletion of the trust principal tends to frustrate the fundamental purpose of the trust.\(^4\) Third, the court cited with approval section 13(a)(2) of the Revised Uniform Principal and Income Act which furnished a method for preventing the impairment of trust principal by providing for a compulsory "allowance for depreciation on property subject to depreciation."\(^4\)

There are several reasons why the principles announced in the Kelley case were unexpected. First, the court's statement that the trustee must administer the trust consisting of rental or commercial real estate as a business, "allocating expenses in accordance with accepted accounting principles" was inconsistent with prior law.\(^4\) The word "business" conveys many meanings, and when used in a statute its meaning depends upon the context as well as the objective of the statute.\(^4\) It is open to doubt whether rental or commercial real property qualifies as "business" within the meaning of section 730.09 of the Civil Code.\(^4\) The court, moreover, did not state that obtaining income from rental or commercial real property was...
"business," but rather that it should be administered in a similar manner since it could not "be meaningfully distinguished from property used in trade or business." Second, the court's statement of the testator's presumed intent, requiring preservation of the principal, was surprising. Previously, the majority of the trust cases which had considered the question had said that from the point of view of intent of the settlor and the equities involved, it was improper, in the absence of a contrary provision in the trust instrument, to reserve a portion of the income for depreciation. And finally, the reliance placed on the provisions of section 13(a)(2) of the Revised Uniform Act was surprising because it was not law in California when Kelley was decided and, indeed, it was inconsistent with established California law and practice.

An equitable principle regarding the allocation of the cost of "improvement expenditures" was announced in the Kelley case. The court stated the principle in this language:

Charging depreciation based on the value of the improvements and calculated over the anticipated useful life of the improvements . . . will allocate the expense between income beneficiary and remaindermen in a manner properly reflecting the benefit to each.

In propounding this principle the court appeared to be more concerned with reaching an equitable result than following established trust practice.

Reaction to Estate of Kelley

The Kelley decision was the first judicial interpretation of the Principal and Income Law as applied to the propriety of using depreciation allowances from income to pay for improvements to trust corpus. It was a great shock to trust officers because it contravened the assumption under which those involved with trust administration had been working, namely, that depreciation would not be charged against the income beneficiary unless the trust instru-

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46 63 Cal. 2d at 687, 408 P.2d at 359, 47 Cal. Rptr. at 903.
47 See material cited note 28 supra.
48 New York, where the majority of cases dealing with the propriety of deducting depreciation allowances from income have been heard, holds that the trustee may not withhold such allowances. See, e.g., In re McCullough's Will, 154 N.Y.S.2d 517 (Sur. Ct. 1956); In re Abeloff's Estate, 108 N.Y.S.2d 39 (Sur. Ct. 1951); In re Ball's Will, 197 Misc. 1047, 36 N.Y.S.2d 201 (Sur. Ct. 1950); In re Edgar's Will, 157 Misc. 10, 282 N.Y.S. 795 (Sur. Ct. 1935). Two cases decided by Surrogate McGarey are contra: In re Kaplan's Will, 195 Misc. 132, 88 N.Y.S.2d 851 (Sur. Ct. 1949); In re Dahlmann's Estate, 95 N.Y.S. 2d 74 (Sur. Ct. 1949). These last two cases hold that the trustee must withhold a depreciation allowance from income for improved real property unless the trust instrument or will specifically directed otherwise. Later New York cases have not followed Surrogate McGarey's rationale.

Most other courts which have dealt with the problem follow the New York rule. E.g., Evans v. Ockershausen, 100 F.2d 695 (D.C. Cir. 1938), cert. denied, 306 U.S. 633 (1939); Nelligan v. Long, 320 Mass. 439, 70 N.E.2d 175 (1946); In re Roth's Estate, 139 N.J. Eq. 588, 52 A.2d 811 (1947). See cases collected: G. BOGERT, supra note 1, § 600 n.61, at 367; 3 A. SCOTT, supra note 10, § 239.4, at 1870.

49 See material cited note 28 supra.
50 63 Cal. 2d at 687, 408 P.2d at 358, 47 Cal. Rptr. at 902.
Trust officers generally did not quarrel with the abstract rationale of the court; rather, they were apprehensive about the implications of the decision in light of established trust practice. The Kelley case by way of dictum stated that depreciation reserves have to be established not only for improvements added by the trustee subsequent to the establishment of the trust, but also for assets which were a part of the original trust principal. Trust officers feared that the decision would apply retroactively to real estate trusts already in existence when the decision was announced, thereby requiring them to account for reserves to date from the time of establishment of such trusts.

The fear of retroactivity was in part caused by the holding in Estate of De Laveaga. In that case the executrix of the life beneficiary of a testamentary trust recovered a judgment for predistribution income (i.e., income earned between the time of death and time of decree of distribution) which had never been paid to the life beneficiary. The judgment was recovered despite 11 prior court-approved accountings. The court held that the decree of distribution and the accountings were res judicata only to those matters specifically stated therein. It was explained that, since neither the decree of distribution nor the accountings stated that all assets were being treated as principal, the claim to predistribution income could be litigated, notwithstanding that it was readily apparent in all the accountings that the entire fund was being treated as principal.

When the principles announced in Kelley and De Laveaga are considered together, the problem that confronted trust officers becomes apparent. The remaindermen of existing testamentary or unamendable inter vivos real estate trusts had these two cases as authority to demand that trustees account for depreciation reserves which had not been established. The trustees could be held liable even though there might have been prior, court-approved accountings containing no provision for such reserves. This liability would result despite the likelihood that the affected trusts were drafted upon the assumption that depreciation allowances were to be charged against income only when expressly provided in the trust instrument. In addition, applying to those trusts the principles announced in the

51 See material cited note 28 supra.
52 "The State's Trust Officers do not necessarily quarrel with the reasoning or the main thrust of the decision, but are seriously concerned at the practical effects resulting from this unexpected change in the law." Memorandum from The State Bar of Calif. to the Comm. on Administration of Justice of the State Bar of Calif., April 6, 1967, on file Hastings Law Library; see 1967-1968 CALIFORNIA BANKERS ASSOCIATION TRUST DIVISION BULL. No. 5.
53 63 Cal. 2d at 689, 408 P.2d at 358, 47 Cal. Rptr. at 902.
54 See material cited note 28 supra.
55 50 Cal. 2d 400, 326 P.2d 129 (1958).
56 Id. at 406-87, 326 P.2d at 132.
57 Id. at 406-88, 326 P.2d at 132-33.
58 Amendable trusts could have been changed to provide that no depreciation reserve shall be established, and thereby escape the holding of Kelley. 63 Cal. 2d at 689, 408 P.2d at 359, 47 Cal. Rptr. at 903.
Kelley case would often be against the settlor's unexpressed intent.\textsuperscript{60}

The fears of trust officers were expressed through the California Bankers Association, which was concerned with the practical effects of the "unexpected change" in the law.\textsuperscript{61} The State Bar of California in cooperation with the California Bankers Association proposed the Kelley bill,\textsuperscript{62} which was introduced into the State Assembly on April 4, 1967.\textsuperscript{63} The bill was intended to protect the trustees from personal liability, and also to allow the continuance of previous practice regarding the nonuse of depreciation reserves in the management of the trusts.\textsuperscript{64} The bill provided:

The trustee of any trust created by will or other instrument shall not be required to set aside a reserve or allowance from trust income for depreciation or depletion on any property held in such trust unless the will or instrument expressly requires such a reserve or allowance.\textsuperscript{65}

The Kelley bill was designed to provide an immediate solution for the trustee. This "stop gap" measure was chosen because "scores, if not hundreds" of trust accountings were being postponed due to the confusion generated by the Kelley decision.\textsuperscript{66} The California Bankers Association knew that the legislature was considering a complete revision of the Principal and Income Law,\textsuperscript{67} but believed that, since the revision was extensive and complicated, passage could not be anticipated soon enough to aid the settlement of accounts.\textsuperscript{68} The Kelley bill met no organized opposition and was enacted into law in only 12 weeks.\textsuperscript{69}

The second piece of legislation affecting this problem came unexpectedly soon. The legislature, a few weeks after passing the Kelley bill, repealed the Principal and Income Law and adopted...
a modified version of the Revised Uniform Principal and Income Act.\textsuperscript{70}

**California Revised Uniform Principal and Income Act**

California’s Revised Uniform Principal and Income Act becomes effective on July 1, 1968. The relevant sections provide that “[e]xtraordinary repairs” or “expenses incurred in making a capital improvement to principal” shall be charged against principal.\textsuperscript{71} However, the trustee in his “absolute discretion” may establish an allowance for depreciation out of income for improvements which are “subject to depreciation under generally accepted accounting principles.”\textsuperscript{72} When the legislature adopted the California Revised Uniform Act, it was changed in one important respect. The modification concerns the use of the depreciation allowances.\textsuperscript{73} The Revised Uniform Act provides that a reserve for depreciation shall be made for property subject to depreciation.\textsuperscript{74} California’s version provides that a reserve for depreciation may, in the “absolute discretion” of the trustee, be made for such property.\textsuperscript{75}

The enactment of the Revised Uniform Act is the first statutory recognition in California of the use of depreciation allowances to allocate and apportion the cost of “improvement expenditures” between successive beneficiaries. The cost would be initially allocated to principal, and the trustee, acting pursuant to the grant of “absolute discretion,” can provide for depreciation allowances from income.\textsuperscript{76} These allowances may be utilized to apportion “improvement expenditures” between the beneficiaries. On the other hand, the trustee has discretion to refrain from deducting such allowances from income when conditions, in his judgment, make it inequitable or undesirable to do so. The “absolute discretion” granted the trustee modifies the prior law as established in the *Kelley* case. The *Kelley* case held that depreciation allowances were required, whereas California’s Revised Uniform Act provides that such allowances are not required, but are merely discretionary with the trustee.


\textsuperscript{71} Cal. Stats. 1967, ch. 1508, § 2 (operative July 1, 1968 as Cal. Civ. Code § 730.13(c) (3)).

\textsuperscript{72} Cal. Stats. 1967, ch. 1508, § 2 (operative July 1, 1968 as Cal. Civ. Code §§ 730.13(c) (3), 730.13(a) (2)).

\textsuperscript{73} The State Bar of California and the California Bankers Association were largely responsible for the modification and the resulting provision granting the trustee “absolute discretion.” The provision of the Revised Uniform Act was inconsistent with prior trust practice in the State and the Bankers Association and the State Bar did not favor changing California law to the extent suggested in the mandatory depreciation provision of section 13 (a) (2). Letter from C.P. Von Herzin, member Calif. Comm. on Uniform State Laws, to the author, Oct. 24, 1967, on file Hastings Law Library.

\textsuperscript{74} UNIFORM PRINCIPAL AND INCOME ACT § 13(a) (2) (revised 1962).

\textsuperscript{75} Cal. Stats. 1967, ch. 1508, § 2 (operative July 1, 1968 at Cal. Civ. Code § 730.13(a) (2)).

\textsuperscript{76} Section 730.14 of California’s Revised Uniform Principal and Income Act assimilates the provisions of the *Kelley* bill, but restricts its application to enumerated provisions. Cal. Stats. 1967, ch. 1508, § 1 (operative July 1, 1968 as Cal. Civ. Code § 730.14).
To evaluate adequately the merits of California’s new method of treating the allocation of “improvement expenditures,” the alternative methods available to the legislature must be examined. Such alternatives are found in the Restatement (Second) of Trusts and in the Revised Uniform Principal and Income Act.

The Restatement treats the problem of allocating “improvement expenditure” between successive beneficiaries under two different sections: one dealing with allocation of expenses and the other with wasting assets. Section 233 in dealing with allocation of expenses provides that: (1) “ordinary repairs” are payable from income, and (2) “improvements” are payable from principal, except “temporary improvements” which are to be amortized from income. The rationale of this provision is that, if the improvement is “permanent,” it merely represents a change in the form of the principal which the remainderman will receive when the interest of the income beneficiary terminates. The remainderman is therefore not harmed by having the “improvement expenditure” paid from principal. The income beneficiary bears a share of the cost to offset the increase in income, since he loses income which would have been earned from that portion of the principal which was expended for the improvement. If the improvement is not permanent in character, but is of limited duration, the income beneficiary will probably receive the full benefit and he, not the remainderman, should be required to bear the cost. The result is that, if the trust terminates before the end of the estimated life of the “temporary improvement,” the income beneficiary, by means of periodic payments into principal, will have paid a share of the improvement cost proportionate to the benefits received. “If the trust does not terminate before the end of the estimated life of the improvement, the entire cost will be paid from income.”

Amortization is the operation of paying off an indebtedness by installments. An amortization plan, in the context of this problem, refers to the method by which the principal of a trust is reimbursed from income for an expenditure initially charged against the principal. The amount of each installment is determined by the cost of the asset and the length of the period within which such cost is to be repaid. An amortization plan may utilize any period within which to effectuate the repayment. A depreciation plan, on the other hand, utilizes the estimated life of the asset as the repayment period. When an expenditure is required to be “amortized” from income, it is clear that the one charged with such duty is not required to utilize a depreciation plan, but is free to use any installment method which will spread the cost over a period of time. See generally H. Finney, supra note 15, at 352-58; P. Mason, supra note 15, at 483-503.

The income beneficiary will also bear a share of the cost if the improvement is paid from nontrust capital. The interest on the borrowed funds is an “ordinary expense” and payable from income.

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77 Restatement (Second) of Trusts §§ 233, 239 (1959).
78 Uniform Principal and Income Act § 13 (revised 1962).
79 Restatement (Second) of Trusts § 233 (1959).
80 Id. § 239, at 556.
81 Amortization is the operation of paying off an indebtedness by installments. An amortization plan, in the context of this problem, refers to the method by which the principal of a trust is reimbursed from income for an expenditure initially charged against the principal. The amount of each installment is determined by the cost of the asset and the length of the period within which such cost is to be repaid. An amortization plan may utilize any period within which to effectuate the repayment. A depreciation plan, on the other hand, utilizes the estimated life of the asset as the repayment period. When an expenditure is required to be “amortized” from income, it is clear that the one charged with such duty is not required to utilize a depreciation plan, but is free to use any installment method which will spread the cost over a period of time. See generally H. Finney, supra note 15, at 352-58; P. Mason, supra note 15, at 483-503.
82 Restatement (Second) of Trusts § 233, Comments i-l (1959).
83 The income beneficiary will also bear a share of the cost if the improvement is paid from nontrust capital. The interest on the borrowed funds is an “ordinary expense” and payable from income.
84 Restatement (Second) of Trusts § 233, Comments i-l (1959).
85 Id. § 233, Comment l, at 561 (emphasis added).
Under section 239 of the Restatement, which deals principally with wasting assets, the trustee may be required to make provision for amortization of buildings or other improvements to real property if held as part of the original trust principal. Comment h to this section deals with “improvement expenditures” and states that where “the trustee acting within his powers erects a building or makes improvements, the cost is payable out of principal, but the trustee is ordinarily under a duty to set up a reserve for depreciation.” Thus, comment h indicates that buildings and improvements erected by the trustee are “ordinarily” depreciable.

The principle announced in comment h to section 239, however, is contradicted by the implications of section 233. Under section 233 most buildings and many other improvements erected by the trustee are treated as “permanent improvements” and, therefore, are not amortizable or depreciable under the provisions of this section. A great deal of the confusion encountered in attempting to reconcile these two inconsistent sections results from the incidental treatment which the principles of depreciation accounting receive in the Restatement. It appears that either the draftsmen could not agree on the proper function and applicability of depreciation accounting or that it was an afterthought of a principle which was not fully developed when the Restatement was drafted and was merely “tacked on” to these sections.

Not only is there inconsistency within the provisions of the Restatement, but the widely utilized tests for allocating expenses embodied in section 233 are not easily applied. It has been difficult for the courts to distinguish “repairs” from “improvements,” and when “improvements” are required to be further distinguished on the basis of permanency (as either “permanent” or “temporary”) for the purpose of apportioning “improvement expenditures” between income beneficiary and remainderman the task becomes even more difficult. Professor Bogert has noted the difficulty encountered in attempting to apply such standards to actual fact situations, and

86 Id. § 239, Comment h, at 591.
87 Id. (emphasis added).
88 See Krasnowiecki, supra note 14, at 530.
89 See Id. at 524.
91 Krasnowiecki, supra note 14, at 526, and cases there collected.

Professor Bogert and Professor Scott seem to feel that in determining what is “permanent” the duration of the improvement should be compared with the duration of the trust. G. Bogert, supra note 1, § 601, at 382; 3 A. Scott, supra note 10, § 233.3, at 1759.
has concluded that the courts do not consider as binding the label or name attached to a particular expense. 92

The Restatement in sections 233 and 239 has attempted to provide for the equitable allocation of improvement expenditures between the beneficiaries, but has done so at the cost of economically efficient trust management. The chance for disagreement as to the classification of an improvement, as either "temporary" or "permanent," seems great, and troublesome, expensive litigation may often be required to settle the dispute. 93 The provisions of the Restatement are not well suited for statutory guidelines which will enable trustees to act pursuant to them with confidence and certainty.

The second alternative is found in section 13(a)(2) of the Revised Uniform Principal and Income Act which California modified. Section 13(a)(2), which provides for mandatory depreciation deductions from income, was not adopted by the National Conference of Commissioners on Uniform State Laws without a great deal of argument. 94 Many draftsmen were opposed to the creation of such depreciation reserves because they felt such a practice would be contrary to well-established law as well as the settlor's usual intent. 95 This provision attempts to bring existing law into conformity with modern accounting principles and business practice which require such reserves. This section has been adopted by nine of the 11 states which have adopted major portions of the Revised Uniform Act. 96

The Revised Uniform Act was designed to aid the "simplicity and convenience of administration" of the trust and, although considered, "fairness to all beneficiaries" was not given equal importance. 97 The administrative and semantic problems encountered with the Restatement's rules have been avoided in section 13(a)(2) of this Act. Section 13(a)(2) is a rigid and mandatory rule, however, and it appears that the balance between simplicity and fairness has been heavily weighed in the favor of simple administration. The rigidity of the provision could at times work a hardship on the income bene-

92 Professor Bogert's exact language was: "Admittedly the decisions regarding the sources from which expenses shall be paid are not all reconcilable on the grounds of logic or consistency. The courts seek to work out substantial justice between income and capital on the basis of the facts and circumstances of each case, without feeling bound to follow precedent in all instances or being controlled by the name given to the particular item of expense under consideration." G. Bogert, supra note 1, § 802, at 139.
93 See material cited notes 90, 91 supra.
95 Id. at 788.
96 The following state statutes embody section 13(a)(2) of the Uniform Principal and Income Act (revised 1962): COLO. REV. STATS. ANN. § 57-4-2 (1963); IDAHO CODE ANN. § 68-1013 (1949); KAN. STATS. ANN. § 58-912 (1965); LA. REV. STATS. § 2156 (1961); MD. ANN. CODE art. 75B § 11 (1957); MICH. COMP. LAWS ANN. § 555.63 (1967); MISS. CODE ANN. § 672-183 (1942); S.C. CODE ANN. § 67-517 (1962); WYO. STATS. ANN. § 34-386 (1957).
ficiary since the depreciation deductions from income must always be made, and no latitude is given for alternative action which could be necessitated by peculiar or unforeseen circumstances. This is true especially where the trust principal is small and the income received therefrom is also relatively small.\textsuperscript{98} One writer in the field has stated that there are undoubtedly many cases where such a depreciation reserve should be established; but that in many others it would place undue hardship upon the life beneficiaries; and that it should not be too difficult for a trustee to determine when such a reserve should be made.\textsuperscript{99} Professor Scott, speaking about buildings and depreciation reserves, has observed that rigidity is not desirable:

Where the trust estate includes a building . . . it would seem that it should depend on the circumstances whether the trustee can properly set aside a part of the income of the trust estate as a reserve for depreciation . . . . Even though the character of the building is such that ordinarily the trustee would be under a duty to set aside a reserve for depreciation, it would seem that circumstances may arise under which he might refrain from setting aside such a reserve.\textsuperscript{100}

The method adopted by California to allocate and apportion “improvement expenditures” appears to have incorporated the best aspects of both of these alternatives. The advantages offered by the Restatement (Second) of Trusts, i.e. equitable treatment of successive beneficiaries, can be achieved without sacrificing efficient trust management. California does this by giving the trustee “absolute discretion” concerning the use of depreciation allowances. The Revised Uniform Principal and Income Act contributed depreciation accounting principles to California’s new Act, and these principles have been assimilated without the undesirable rigidity.

Discretionary power in the trustee gives flexibility which is needed to ensure the equitable allocation of the cost of improvements in conformity with existing conditions. When confronted with an “improvement expenditure,” the trustee faces factual problems. California’s provision allows the trustee to deal with the factual problems from a position close to all the factors and circumstances which should be considered. The trustee is ordinarily familiar with the wants and needs of the beneficiaries as well as the settlor’s intent, and with this knowledge he can fulfill the needs of the beneficiaries in a manner consistent with the settlor’s desires. The opportunity to review periodically the depreciation rate and the size of the fund should aid in ensuring a just result for all beneficiaries.

Guidelines for Trustees

The trustee will be required to operate under the new law which gives him “absolute discretion” in the use of depreciation allowances, but he is not told the nature and extent of his power. In order to ensure equitable treatment of the successive beneficiaries and efficient trust management, the trustee must be apprised of what con-

\textsuperscript{98} See 3 A. Scott, \textit{supra} note 10, § 239.4, at 1870-74 (giving specific instances where such reserves should not be established).

\textsuperscript{99} Capron, \textit{Reserves Against the Depreciation of Real Property Held by a Trustee}, 12 Ohio St. L.J. 565 (1951).

\textsuperscript{100} 3 A. Scott, \textit{supra} note 10, § 239.4, at 1874.
stitutes legitimate exercise of this "absolute discretion."

Under California case law and statute it has been established that actions pursuant to "absolute discretion" conferred upon the trustee by a trust instrument cannot be judicially reviewed on the basis of unsoundness of judgment. The trustee's action can be reviewed only on the basis of "fraud or bad faith," or where it is found that he acted "in a state of mind not contemplated by the settlor."

The absolute discretion granted by California's Revised Uniform Act should be governed by the same principles. There is no generic difference between this discretion when granted by trust instrument and when granted by statute. Judicial acceptance of the application of the above principles to the "absolute discretion" granted by California's new statute would have a desirable effect upon trust administration. Fear of judicial reversal and personal liability could otherwise inhibit the equitable management of a trust and also negate, to some extent, the benefit and flexibility derived from the discretionary power. The possibility of a threatened suit for breach of discretion might cause the trustee to select a course of action with respect to apportionment of "improvement expenditures" which would not be objectively determined nor equitable to all beneficiaries.

The branch of trust law which regulates the allocation of "improvement expenditures" between income beneficiary and remainderman does not lend itself to the application of technical rules or standards. It lends itself, rather, to the application of equitable principles. The Supreme Court of California in Estate of Kelley applied the equitable principle of apportioning the cost of an "improvement expenditure" according to the benefit received. This principle provides a general guideline which the trustee, within the "absolute discretion" granted by California's Revised Uniform Act, can follow in the use of depreciation allowances to allocate "improvement expenditures."

This principle should be relied upon in two distinct stages: first, to determine whether the trustee should utilize depreciation allowances, and second, if he does utilize such reserves, to determine the nature of the depreciation schedule established. In apportioning

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102 "A discretionary power conferred upon a trustee is presumed not to be left to his arbitrary discretion, but may be controlled by the proper court if not reasonably exercised, unless an absolute discretion is clearly conferred by the declaration of trust." CAL. CIV. CODE § 2269.
105 Interview with C.E. DeRochie, Vice President and Operations Officer for Trusts, Bank of America, in San Francisco, Dec. 4, 1967.
106 There are four major depreciation methods. The straight-line method provides for constant depreciation charges throughout the estimated useful life of the asset. The use or production method provides for varying charges for assets which are not used uniformly. The declining-balance method and sum of the years digits method provide for large initial charges which grad-
an "improvement expenditure," the trustee should measure the value of the increase in income against the value expected to accrue to the remainderman.\textsuperscript{107} He should then provide an apportionment or allocation of the cost in proportion to these benefits by means of a depreciation allowance. Depreciation allowances from income ordinarily should be made in order to ensure that each beneficiary pays his proportionate share. Occasionally, however, by analyzing the personalities and objectives involved, the particular trust corpus, and the external economic conditions, the trustee might decide that such a deduction should not be made.\textsuperscript{108} As observed by Professor Scott:

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.\textsuperscript{109}

"[S]ettlers have not always foreseen the multitude of problems which may have to be faced and even draftsmen have found it difficult to foresee all possible kinds of receipts and disbursements."\textsuperscript{110} The task of equitably allocating "improvement expenditures" is left to the trustee with the tools of California's Revised Uniform Act and the guidance of the equitable principle of the Kelley case to point the way.

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\textsuperscript{108} 3 A. Scott, supra note 10, § 239.4, at 1874.
\textsuperscript{109} Id.
\textsuperscript{110} Commissioners' Prefatory Note to \textit{Uniform Principal and Income Act} (1931), 9B \textit{Uniform Laws Ann.} 586 (1966).
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