

AICPA

***PRACTICE GUIDE
FOR
FIDUCIARY (TRUST) ACCOUNTING***

***A Guide for Accountants Who Perform Fiduciary
Accounting Services***

December 2007

AICPA Tax Division

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The Practice Guide for Fiduciary (Trust) Accounting is designed to provide information on subjects covered for "best practice" guidelines, and is not the final authority. We encourage the user to consult the resources provided in the Appendix of this guide.

The effectiveness of any of the strategies described or referred to in this document will depend on the user's individual situation and on a number of complex factors. The user should consult with his or her advisers on the tax, accounting, and legal implications of proposed strategies before any strategy is implemented.

All examples, numbers and projections in the guide are based on hypothetical data. Any discussion in this guide relating to tax, accounting, regulatory, or legal matters is based on our understanding as of the date of this guide. Tax rules, federal and state, as well as "local trust laws" in these areas are constantly changing and are open to varying interpretations. If specific tax advice or other expert assistance is required, the services of a competent professional person should be sought.

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Practice Guide for Fiduciary (Trust) Accounting

A Guide for Accountants Who Perform Fiduciary Accounting Services

Table of Contents

| | |
|---|-----------|
| Preface | v |
| Acknowledgments | vi |
| Executive Summary | 1 |
| | |
| I. Introduction | 2 |
| | |
| II. Definition and Background of Fiduciary Duties | 3 |
| | |
| A. Introduction to Fiduciary Duties | 3 |
| B. The Concept of Fiduciary Duties | 3 |
| C. The Evolution of Fiduciary Duties | 3 |
| D. Separation of Title in Fiduciary Entity | 4 |
| E. The Fiduciary Relationship and its Fundamental Obligations | 4 |
| 1. Duty of Management | 5 |
| 2. Duty of Loyalty or Preference | 5 |
| 3. Duty to Account | 6 |
| 4. Duty to Disclose (to Beneficiaries) | 6 |
| F. How Does Fiduciary Duty Arise? | 7 |
| G. The Characterization of the CPA/Client Relationship | 7 |
| 1. The CPA as the Advisor to Tax and Accounting Clients | 7 |
| 2. The Importance of the Engagement Letter | 9 |
| 3. The CPA as Advisor to the Fiduciary | 10 |
| 4. The CPA Acting as Fiduciary | 11 |
| 5. Fiduciary Indemnification | 12 |
| 6. Fee Considerations | 12 |
| 7. Conflicts of Interest | 12 |
| H. Statutory Guidance and Authority for the Fiduciary | 13 |
| 1. Grantor's Intent | 14 |
| 2. The Role of State or Local Law | 14 |
| 3. Investment Planning | 14 |
| 4. Fiduciary Accounting | 15 |
| 5. Duty to Inform and Report under the Uniform Trust Code | 16 |
| 6. States Not Adopting the Uniform Trust Code | 16 |
| I. The New Principal and Income Act | 17 |
| J. Clarification and Changes in the Existing Rules | 17 |
| K. Conclusion | 18 |

| | |
|--|-----------|
| III. Fiduciary Accounting Income Defined | 19 |
| A. Introduction to Fiduciary Accounting Income | 19 |
| B. Review and Relevance of the Governing Documents/Authority | 19 |
| C. Situs | 20 |
| IV. How the 1994 Uniform Prudent Investor Act Affects the 1997 Act and the Unitrust Option | 21 |
| A. Investment Standards for a Trustee in a Trust – Overview of the 1994 Uniform Prudent Investor Act | 21 |
| B. The 1997 Uniform Principal and Income Act and the 1994 Uniform Prudent Investor Act | 23 |
| C. Coordination with the Uniform Prudent Investor Act | 23 |
| D. 1997 Act Section 104 – Trustee’s Power to Adjust | 24 |
| E. Conditions Precedent to the Adjustment Power | 24 |
| F. Factors to be Considered | 25 |
| G. Situations Where the Trustee May Not Adjust | 25 |
| H. Trustee’s Duty of Impartiality under Section 103(b) of the 1997 Act | 26 |
| I. Situations in Which a Trustee Might Consider the New Trustee’s Power to Adjust Under 1997 Act Section 104 | 27 |
| J. Implementing the Trustee’s Power to Adjust | 28 |
| K. Prong 1 – Uniform Prudent Investor Act | 28 |
| L. Prong 2 – Uniform Principal and Income Act | 29 |
| M. Prong 3 – Intent of the Trust Prong – 1997 Act Section 103(a) | 31 |
| N. Income Tax Aspects of the Power to Adjust | 31 |
| O. GST Tax Issues | 31 |
| P. The Unitrust Conversion Option | 31 |
| Q. Conclusion | 34 |
| V. Statutory Accounting Rules | 35 |
| A. Article 1 – Trustee’s Power to Adjust | 35 |
| 1. Section 104 – Trustee’s Power to Adjust | 35 |
| B. Article 2 – Decedent’s Estate or Terminating Income Interest | 35 |
| 1. Section 201 – Determination and Distribution of Net Income | 35 |
| 2. Section 202 – Distribution to Residuary and Remainder Beneficiaries | 36 |
| C. Article 3 – Apportionment at Beginning & End of Income Interest | 36 |
| 1. Section 301 – When Right to Income Begins and Ends | 36 |
| 2. Section 302 – Apportionment of Receipts and Disbursements when Decedent Dies or Income Interest Begins | 37 |
| 2. Section 303 – Apportionment When Income Interest Ends | 38 |
| D. Article 4 – Allocation of Receipts During Administration of Trust | 39 |
| 1. Part I. Receipts from Entities | 39 |
| 2. Section 401 – Character of Receipts | 39 |
| 3. Character of Receipts – in Simple Terms | 40 |

| | |
|--|-----------|
| 4. Issues Arising from Application of this Section | 40 |
| 5. Section 402 – Distribution from Trust or Estate | 41 |
| 6. Section 403 – Business and Other Activities Conducted by Trustee | x42 |
| 7. Part II. Receipts Not Normally Apportioned | 42 |
| 8. Section 404 – Principal Receipts | 42 |
| 9. Section 405 – Rental Property | 43 |
| 10. Section 406 – Obligation to Pay Money | 43 |
| 11. Section 407 – Insurance Policies and Similar Contracts | 44 |
| 12. Part III. Receipts Normally Apportioned | 44 |
| 13. Section 408 – Insubstantial Allocations Not Required | 44 |
| 14. Section 409 – Deferred Compensation, Annuities, and Similar Payments | 45 |
| 15. Section 410 – Liquidating Asset | 46 |
| 16. Section 411 – Minerals, Water, and Other Natural Resources | 46 |
| 17. Section 412 – Timber | 47 |
| 18. Section 413 – Property Not Productive of Income | 48 |
| 19. Section 414 – Derivatives and Options | 48 |
| 20. Section 415 – Asset-Backed Securities | 49 |
| E. Article 5 – Allocation of Disbursements During Administration of Trust | 49 |
| 1. Section 501 – Disbursements from Income | 49 |
| 2. Section 502 – Disbursements from Principal | 50 |
| 3. Section 503 – Transfers from Income to Principal for Depreciation | 50 |
| 4. Section 504 – Transfers from Income to Reimburse Principal | 51 |
| 5. Section 505 – Income Taxes | 52 |
| 6. Section 506 – Adjustments Between Principal and Income Because of Taxes | 54 |
| | |
| VI. Relationship of Fiduciary Accounting Income, Distributable Net Income, and Taxable Income | 56 |
| | |
| A. Introduction to Relationship of Fiduciary Accounting Income, Distributable Net Income, and Taxable Income | 56 |
| B. Fiduciary Accounting Income | 56 |
| C. Distributable Net Income (DNI) | 56 |
| D. Taxable Income | 56 |
| E. The Updated Trust Income Tax Rules | 57 |
| 1. Approval of Powers to Adjust and Certain Unitrust Distributions | 57 |
| 2. Allocation of Gain(s) to Income | 58 |
| F. Flow Chart – When can Capital Gains be Included in DNI? | 59 |
| | |
| VII. Reporting Requirements | 60 |
| | |
| A. Introduction to Reporting Requirements | |
| B. When is an Accounting Required? | 60 |
| C. Format of Accounting | 61 |
| D. Accounting Standards | 61 |
| E. What if All You Prepare is a Tax Return? | 62 |

| | |
|--|------------|
| VIII. Examples | 63 |
| A. Example of Columnar Approach to Preparation of a Fiduciary Accounting | 63 |
| B. Sample Formal Accounting | 222 |
| Appendix – Practice Aids | 230 |
| A. Checklist for Trust Instrument Provisions (Content) | 230 |
| B. Matrix/Chart of States, UPIA, Power to Adjust, and Unitrust Option or Total Return Trust/Statutory Ordering Rule for Unitrust Payments | 242 |
| C. Publications Available as Reference Resources on Fiduciary (Trust) Accounting | 245 |
| D. Websites for Fiduciary (Trust) Accounting References | 247 |
| E. Articles on FAI Written by Members of the AICPA Fiduciary Accounting Income Task Force and AICPA Trust, Estate, and Gift Tax Technical Resource Panel | 249 |
| F. Columnar Approach Excel Template | 250 |
| G. Sample Adjusting Journal Entry Excel Template | 256 |
| H. Summary of Trust Agreement Template | 258 |

Preface

The AICPA Trust Accounting Income (TAI) Task Force was established to provide guidance in performing trust and estate accountings and related tax services. The AICPA Tax Division's Trust, Estate and Gift Tax Technical Resource Panel (chaired by Roby Sawyers (2004-2005), and then Steven Thorne (2005-2006 and 2006-2007) and Justin P. Ransome (2007-2008) appointed and provided direction and oversight to the Task Force. The tools and best practices for preparation of a fiduciary (or trust) accounting and understanding the fiduciary duty are included in the Practice Guide to help CPAs provide better fiduciary accounting services.

The practice guide was developed specifically for CPAs, but will be a useful tool for anyone with fiduciary accounting responsibilities. It will provide members with a better understanding of this ever evolving and very technical subject.

Because the basis of fiduciary accounting is found in the governing instrument and promulgated by statute (i.e., the Uniform Principal and Income Act which some states have adopted or are considering adopting in whole or in part) one must review several sources to understand the principles of fiduciary accounting. As described in the practice guide, the Uniform Principal and Income Act (1997), as amended in 2000, was drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) to provide the states with a comprehensive model for codifying their own Principal and Income Act. Since it would not be practical to provide a guide taking into account each state's individual principal and income statute, the guide is written based upon NCCUSL's Uniform Principal & Income Act. A copy of this Act, as well as a Summary Matrix of State Adoption of the Code is provided in the Appendix to this guide.

The practice guide emphasizes the importance of understanding the statutory considerations, as well as the terms of the governing instrument, before a fiduciary accounting can be properly prepared. Additionally, the guide gives the practitioner an understanding of some of the challenges posed when dealing with the Uniform Act's "power to adjust" and the "unitrust" provisions adopted by several states.

There are "statutory" differences between "fiduciary accounting income" (FAI) and Federal and state taxable income. The guide provides guidance to allow the practitioner to understand these differences. The guide emphasizes that the tax adviser should obtain the fiduciary's computation of accounting income, when it is used to determine the amount distributable to an income beneficiary to properly complete the Form 1041 (fiduciary tax return) and Schedules K-1 for the trust.

As this area continues to evolve, the AICPA encourages adoption of standards in fiduciary accounting reporting and adoption of consistent statutes in the various jurisdictions. Achieving such goals will enable accountants to provide better accountings, which will benefit both fiduciaries and beneficiaries. Practitioners are strongly advised to exercise professional judgment when performing fiduciary accounting and related tax services. It is also suggested that practitioners seek advice from legal counsel and other authorities when appropriate. The practice guide includes examples and diagrams to illustrate these responsibilities and procedures. An appendix includes examples and references. It is available to members electronically at <http://tax.aicpa.org/Resources/Trust+Estate+and+Gift/>.

Acknowledgments

This guide was developed as a volunteer effort by the AICPA Tax Division's Trust, Estate, and Gift Tax Technical Resource Panel's Trust Accounting Income Task Force. It was reviewed by the Trust, Estate, and Gift Tax Technical Resource Panel and its Tax Executive Committee Liaison.

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**PRACTICE GUIDE FOR
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A Guide for Accountants Who Perform Fiduciary Accounting Services

EXECUTIVE SUMMARY

WITH MORE NEED FOR CONSISTENT AND COMPETENT FIDUCIARY ACCOUNTING SERVICES, CPAs and other fiduciary advisors need a Practice Guide to help gain an understanding of the relevant issues. With the number and size of trusts and estates growing, the professional's demands and responsibilities in the accounting profession are increasing.

FIDUCIARY TAX RETURN PREPARERS must realize that taxable income and fiduciary accounting income are not the same. Accountants who unwisely prepare tax returns using only Forms 1099 and a check register face undaunted malpractice exposure to trustees and beneficiaries. Recent IRS regulations recognize changes in fiduciary accounting concepts in tax return reporting.

READING AND UNDERSTANDING THE TERMS OF THE TRUST INSTRUMENT AND/OR WILL is the initial step in preparing a fiduciary accounting. The instrument overrides local law (e.g. statutes in the state of the trust's or estate's situs).

ACCOUNTANTS WHO PERFORM FIDUCIARY ACCOUNTING SERVICES need to be knowledgeable of the Uniform Acts and Model Codes as adopted in the state of situs because these provisions and case law provide guidance as to local law if the trust or will is silent or poorly drafted. Seeking advice or counsel from knowledgeable attorneys can also be helpful and resourceful.

LACK OF UNIFORM REPORTING STANDARDS makes it difficult for the accounting profession to gain acceptance of their accountings by attorneys and the court. The development of professional standards of fiduciary accounting principles and reporting on a consistent basis would be very rewarding to accountants and users of the accounting.

I. Introduction

While some accountants may serve in the role of fiduciary, most provide tax and accounting services. The challenges facing accountants who provide accounting and reporting services for trusts and estates include:

Lack of familiarity with estates, trusts, and fiduciary accounting principles.

Lack of a uniform presentation format that meets the needs, expectations, and requirements of the users (i.e., the trustee(s), beneficiaries and the courts).

Lack of authoritative and consistent guidance relating to accounting and reporting for estates and trusts.

Lack of consistency among the 50 states because each has its own statutes and legal interpretations vary from state to state.

Possible variations and more detailed resources for readers to consult are referenced in the Appendix at the end of the Guide.

Furthermore, because a fiduciary, including an executor, trustee or conservator, acts for the beneficial interest of others, the fiduciary holds a position of trust and is accountable for his/her stewardship. A fiduciary often engages an accountant to prepare the fiduciary accounting in a presentation that is acceptable to interested parties.

A fiduciary accounting may be presented in many formats depending on the requirements of the engagement and the potential users. The laws of most jurisdictions regard the fiduciary's accounting as a reporting of the transactions and events that have occurred during the accounting period. The presentation of the accounting is an essential process by which the fiduciary seeks to discharge his/her responsibility for the assets being safeguarded and to obtain release of liability (after certain statutory time limitations) for the transactions and events adequately disclosed in the accounting.

Throughout this guide, accountants, and other advisors of fiduciaries, should always remember that the term "beneficiary" includes both "income" beneficiaries (those entitled to current distributions of fiduciary accounting income) and "remainder" or "residual" beneficiaries (those entitled to the remaining principal assets, or "corpus," remaining after the expiration of the income interests or at the termination of the trust).

II. Definition and Background of Fiduciary Duties

Introduction to Fiduciary Duties

It is essential that the scope of fiduciary duties be understood as it pertains to professional advisors, more specifically in the context of the accountant or CPA. The role of fiduciary has an old and valued place in our society and refers to a relationship that is based on loyalty and confidence. Those who traditionally serve in a fiduciary capacity include trustees, personal representatives, guardians, conservators, ERISA Plan trustees, directors, officers, attorneys, and managing general agents and partners. Accountants, auditors, investment advisors and bankers can also have fiduciary duties, depending on the nature of their activities. In the wake of litigation involving accounting irregularities by large corporations, the allegation of breach of fiduciary duty has increasingly become a “clone claim” and professional liability insurers are experiencing more of these claims as a result of scandals involving large accounting firms, financial institutions and corporations.

The finding of a fiduciary relationship can have dramatic legal consequences. Where litigation is involved, expert testimony may not be required to establish a breach of fiduciary duty as it is necessary to prove breach of the standard of care for negligence. Additionally, the establishment of a fiduciary duty shifts the burden of proof to the fiduciary to prove not only that the fiduciary fulfilled his or her duties but that their conduct was above reproach. The defenses of comparative or contributory negligence are not available to the defendant/fiduciary because breach of fiduciary duty is not grounded in negligence. Extraordinary remedies are available for breach of fiduciary duty that includes disgorgement of fees and profits as well as removal of the fiduciary. Additionally, the beneficiary need not prove causation of damages where the beneficiary seeks disgorgement of fees, profits, etc.

The Concept of Fiduciary Duties

A fiduciary has a duty to act solely for the benefit of another on matters within the scope of the fiduciary relationship and is therefore strictly accountable for this stewardship. In a fiduciary relationship, the fiduciary takes possession of property for the benefit of the beneficiary(ies) and accepts a duty of undivided loyalty and confidence. The fiduciary undertakes the obligation, either expressly or implicitly, to act in the best interests of another, and is “entrusted” with a power to affect such interest. If a fiduciary participates in self-interested behavior, equity will intervene to protect the beneficiary(ies).

The Evolution of Fiduciary Duties

As society has undergone modernization, fiduciary law has evolved to accommodate the relationships that have emerged. The modernization of society has been characterized by the separation of complicated structures into specialty structures that perform a specific function. An example of this process would be the family unit. Historically, traditional family units were large, multigenerational and multifunctional. The family was responsible for production, employment, education and socialization functions. But as society has undergone modernization, the family has outsourced many of these functions and duties to specialty structures. The corporate institution has taken over many of the production and employment functions, formal education provides schooling,

and the government has taken over numerous health, safety and welfare responsibilities. As this specialization has evolved, individuals and institutions have been forced to rely on others and entrust power and discretion over their affairs to them. Thus, the entrustor has become increasingly vulnerable in the event that this power is abused. Fiduciary duty has evolved to safeguard and maintain the integrity of the trust relationship. The judiciary clearly regards the fiduciary relationship as worthy of protection and as such, has shown a willingness to expand the scope of fiduciary obligations in order to maintain this integrity. Additionally, the law of fiduciary duty embodies, more than any other part of the law, the layperson's understanding of "fairness" and "equity" in interpersonal dealings. Because fairness and equity are fundamental, the core principals of fiduciary duty have a long history of both use and abuse. Throughout various cultures and over various periods of history, fiduciaries have been confronted by these principals and obligations.

The law of fiduciary duty draws heavily from both the law of contract and the law of tort, and is in many ways an intermediary between these two branches of civil law. However unlike contract and tort law, the law of fiduciary duty is not as well developed or systematic in its overview and this has created uncertainty and confusion as to its principles and scope.

Separation of Title in Fiduciary Entity

One of the distinguishing qualities of a fiduciary entity is the separation of title into legal and equitable title. The fiduciary holds legal title to the assets in the trust and has all the rights of an absolute owner subject to the equitable rights of the beneficiary(ies). This is a very powerful type of ownership. The beneficiaries hold equitable title, which is the right to the use and enjoyment of the assets as described and limited by the governing instrument or state law. The fiduciary is personally liable as an owner to non-beneficiaries such as contract creditors, tort creditors, and the federal, state and local governments in the same way and to the same extent as if the property were owned by the fiduciary individually. Moreover, the fiduciary is personally liable in equity to the beneficiaries for any breach of fiduciary duty. Subject to a right of indemnity or exoneration for certain liabilities, the fiduciary is vulnerable on both fronts when it comes to personal liability.

The Fiduciary Relationship and its Fundamental Obligations

Fiduciary duty may arise in a variety of ways. In the relationship between the parties, only the fiduciary has the duty with respect to the beneficiary or "cestui" and to certain property (the "res"). This duty has a specific scope and entails certain obligations until the duty is either discharged or breached. Where the duty is breached, the law will generally impose a remedy on the fiduciary in favor of the beneficiary(ies). Four fundamental obligations constitute fiduciary duty. They are:

The duty of management;
The duty of loyalty or preference;
The duty to account; and
The duty to disclose.

Duty of Management

The first and fundamental obligation of the fiduciary is to use reasonable care to deal prudently and competently with the property or “res” so as to preserve it for the beneficiary(ies). This is the duty of management and is well understood by any party that contracts with another. The fiduciary must make absolutely certain that the fundamental duty of proper management is discharged. Failure to discharge this duty defeats the whole purpose of the fiduciary’s duty. The purpose of having a fiduciary in the first place is to enlist his skill in the management of the trust’s property. This duty may be breached negligently or intentionally, though more often breach of the duty of management is negligent rather than intentional. While this duty is fundamental, it is the least psychological of all the fiduciary duties and often receives the least attention. A fiduciary must exercise reasonable care and prudence in the discharge of his management duties. Even if a trustee is given discretion, the exercise of duty must be without caprice or arbitrariness and in the exercise of the trustee’s best judgment. The exercise of the trustee’s discretion is reviewable for bad faith and for gross neglect.

A fiduciary must be zealous to preserve and protect the trust property or “res”. Thus, there is a duty of loyalty within the management arena. It involves constancy and persistence in protecting the trust property. A trustee is required to use reasonable and prudent efforts. A professional trustee, however, is held to the higher standard of “best efforts.”

The court will not second guess the fiduciary if the fiduciary makes decisions which, at the time made, were reasonable and in good faith. The mere fact that another decision would have been better will not render the fiduciary liable.

The duty of management can be limited in three ways:

- By the terms of the instrument;
- By agreement between the fiduciary and the beneficiaries; and
- By court decree.

Duty of Loyalty or Preference

The second fundamental obligation of a fiduciary is to set the beneficiary’s interests ahead of the interests of any other party (including his/her own) in dealing with the fiduciary assets. This translates to the duty of loyalty or the duty of preference. This involves the duty to abstain from taking any advantage of the beneficiary in any dealings with the trust. The duty to set the interests of the beneficiary ahead of third parties translates into the duty to defend the trust and to remain loyal to it.

In a trust situation, the fiduciary is referred to as trustee and is under a duty to follow the directives in the governing instrument. The trustee must be absolutely loyal to the trust, must act solely in the interest of the trust, and any behavior on the part of the fiduciary that compromises the fiduciary entity is subject to judicial sanction. The fiduciary can take no benefit from ownership of trust assets, nor deal with them for personal profit or for any purpose unconnected with the trust, or otherwise detrimental to the beneficiary.

Duty to Account

The third fundamental obligation of a fiduciary is the duty to account and is more focused than the duty of disclosure. This is the duty to provide relevant information to the beneficiaries. The duty stems from the fact that the fiduciary does not really own the “res”, but holds it for the benefit of the beneficiary. The duty to account concerns itself with all the financial or other quantitative features of the “res”. Therefore, the fiduciary is obligated to keep records of all transactions affecting the trust and make them available to the beneficiary either on request or at a scheduled time. It is an affirmative duty and requires that the fiduciary do more than merely be “honest”. Rather, the fiduciary must keep records that prove honesty. This includes separating the fiduciary assets and not commingling them with the fiduciary’s personal property. If the fiduciary does not render proper reports regarding the “res”, he has not fulfilled his whole duty. His silence can create concern in the beneficiary regarding the condition of the property and this itself is a breach of fiduciary duty. The accounting rendered by the fiduciary must be complete and must cover all transactions from the beginning of the relationship to the end, or for a shorter interim period. It is not the beneficiary’s job to ferret out the facts and figures or to discover any deficiencies in the fiduciary’s accounts. The fiduciary’s duty to account periodically is an ongoing and continuous obligation. Sending the beneficiary copies of checks and other evidences of receipts and disbursements as they occur does not constitute a proper accounting. The timing of a rendering of an accounting can be:

- Regular in nature;
- On demand by the beneficiary;
- Interim or final; or
- On the termination of the fiduciary relationship.

Many state statutes now require the rendering of an accounting on an annual basis to the beneficiaries of a trust. Additionally, state law may allow for the beneficiaries to waive their rights to an accounting on a periodic basis. Sometimes the governing instrument itself waives the requirement of an accounting. In these cases some states have rendered this direction by the settlor to be null and void only allowing the beneficiaries to waive the requirement of an accounting.

Duty to Disclose (to Beneficiaries)

The final fundamental obligation of a fiduciary is an extension of the duty to account and is the duty to disclose. This duty runs to all information - not just financial information - and cannot be delegated in the way that the duty to account can be. The fiduciary has a general duty to disclose to the beneficiary all material facts concerning the administration of the trust. This involves not only transactions that have occurred and would be part of the accounting provided to the beneficiaries, but also involves transactions that might take place in the future. The duty of disclosure exists for two reasons:

All information regarding the “res” is viewed as an aspect of the “res” and since the fiduciary manages the “res” for the benefit of the beneficiary, the information regarding the “res” belongs to the beneficiary as much as it belongs to the fiduciary.

And

The beneficiary has a right to make decisions and to act in reliance on the information he receives from the fiduciary. If the beneficiary can prove that his or her actions would have been

different if the fiduciary had disclosed more than he did disclose, then an action will lie for breach of this duty.

The duty to disclose is a developing area of the law and therefore is inherently unclear. However, both the duty to account and duty to disclose provide protections to the fiduciary when the duties are carried out properly. Proper accounting and disclosure can, in some states, serve to limit the duration of the statute of limitations for bringing an action for breach of trust against the fiduciary.

How Does Fiduciary Duty Arise?

Fiduciary duty may arise by explicit agreement when one party expressly undertakes such a duty towards another. No fiduciary duty can arise without some type of agreement. A trust instrument is such an agreement and the existence of the trust implies the existence of fiduciary duty.

The Characterization of the CPA/Client Relationship

An important question then arises in regard to the characterization of the CPA/client professional relationship and the imposition of fiduciary duty on the CPA either intentionally or inadvertently. The response to whether or not the CPA owes a fiduciary duty to his client centers on the particulars of the engagement. It is therefore helpful to characterize the following types of CPA/advisor relationships where fiduciary duty may arise:

- The CPA as the advisor to tax and accounting clients;
- The CPA as advisor to the fiduciary; or
- The CPA acting as fiduciary.

The CPA as the Advisor to Tax and Accounting Clients

Case law has generally held that with regards to CPAs, independence is fundamentally inconsistent with the finding of a fiduciary relationship.¹ In audit engagements, the independent auditor assumes a public responsibility that transcends any employment relationship with the client. By certifying the public reports that collectively depict a corporation's financial responsibility, the independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

However, as the scope of services that CPAs offer their clients expands, the question of fiduciary responsibility must be revisited and some cases, such as *Arthur Young v. Mariner Corporation*, have found that a fiduciary relationship does exist when the CPA offers services that extend beyond the normal accounting boundaries.² In this case, a Florida statute exempted CPAs from liability for fraudulent misrepresentations in leveraged buyouts. The court, however, held that the brokerage services provided by the CPA firm were not connected with the regular practice of its profession and therefore the firm was not exempt under the statutory exclusion.

¹ *Franklin Supply Co. v. Tolman*, 454 F.2d 1059(9th Cir. 1971); *Shofstall v Allied Van Lines, Inc.*, 455 F. Supp. 351 (N.D> Ill. 1978).

² *Arthur Young v. Mariner Corporation*, 630 So.2d 1199 (Fla.App. 1994)

A fiduciary relationship is found to exist whenever a client justifiably puts trust and confidence in an accountant to act in the client's interest. Because this is an emerging area, there is no well-developed summary of the law available on the subject. However, in a survey of cases in the United States and Canada, there is a developing pattern indicating recurring factors that demonstrate the imposition of a fiduciary relationship on the CPA advisor. Below are several case examples that are both instructive and indicative of a pattern where courts have found fiduciary duties exist between clients and advisors in a professional relationship. In *LAC Minerals Ltd. v. International Corono Resources Ltd.*, although not an accounting case, the Supreme Court of Canada was instructive in stating three factors to consider when determining whether a fiduciary duty exists:

The fiduciary exercises some discretion or power over the client's affairs;³

The fiduciary can unilaterally exercise power or discretion so as to affect the client's legal or practical interests;⁴

The beneficiary is peculiarly vulnerable to or at the mercy of the fiduciary who holds discretion or power.⁵

In *Cafritz v. Corporation Audit Co.*, the court imposed a fiduciary duty on the accountants where a substantial portion of control over the client's business had been entrusted to the accounting firm.⁶ The court also indicated that the defendant accountants' fiduciary duty included a responsibility to account for property and money entrusted to them.

Allen Realty Corporation v. Holbert involved the hiring by a realty company of a CPA firm to provide accounting services, business advice, and to assist in the sale of real property. The CPA firm did not disclose all offers on the real estate that were made to the detriment of the realty company. The Virginia Supreme Court found that a "special confidence had been reposed in the advisor who in equity and good conscience is bound to act in good faith and with due regard for the interests of the client";⁷

In *Stainton v. Tarantino*, the court imposed fiduciary duty on the CPA because the CPA was also acting as a business partner.⁸ The defendant was an attorney, CPA and business partner in several real estate partnerships with the plaintiffs. The court held that the defendant was a fiduciary, not because of his status as an attorney or a CPA, but because he was the plaintiff's business partner.

Dominguez v. Brackey Enterprises, Inc. follows a trend of the court finding fiduciary duty where a long association in a business relationship exists between the client and the CPA, where the client is accustomed to being guided by the judgment or advice of the CPA, and the client is justified in placing confidence in the belief that the CPA will act in the client's best interest.⁹ The defendant was a CPA who rendered tax services and business advice to the plaintiffs. The CPA advised the client to invest in a particular entity where the client ultimately ended up losing \$50,000.

3 *LAC Minerals Ltd. V. International Corono Resources Ltd.* (1998) 2 S.C.R. 574

4 *Id.*

5 *Id.*

6 *Cafritz v. Corporation Audit Co.* (1945) 60 F. Supp. 627 (D.D.C.)

7 *Allen Realty Corp. v. Holbert* (1984) 318 S.E. 2d 592

8 *Stainton v. Tarantino* (1986) 637 F.Supp. 1051 (E.D. PA.)

9 *Dominguez v. Brackey Enterprises, Inc.* (1988) 756 S.W. 2d 788 (Tex. App.)

In *Myers v. Finkle*, the CPA gave investment advice to the client¹⁰ and the court found that a fiduciary relationship was created with respect to all services rendered to that client. Other cases have distinguished between the types of services.

Historically, courts have held that accountants have no fiduciary duty to users of audited financial statements. However, in *Stern Stewart & Co. v. KPMG Peat Marwick*¹¹ a New York appellate court assessed damages to a client based on the existence of a fiduciary relationship between KPMG and its audit client, a consulting company. This suit was brought by the consulting company against the accounting firm and three of its former employees and alleged that they stole trade secrets and engaged in unfair competition when the former employees joined KPMG and helped them develop a performance measurement tool for incentive compensation schemes, in direct competition with Stern Stewart. The appellate court dismissed those charges for lack of evidence but ruled that KPMG had breached its fiduciary responsibilities to its client. The court stated that there are special obligations placed on accountants to engage in conflict checks and take actions to avoid injuring existing clients.

In short, determining whether a CPA owes a fiduciary duty to a client is a question of fact and often depends on whether:

- The client relinquished substantial control of the business to the CPA;
 - The CPA is actually a business partner;
 - The CPA acts as an investment advisor;
 - A long-standing business and personal relationship exists between the accountant and the client; or
 - The court finds the client was justified in placing special confidence and trust in the CPA.
- The terms of any agreement between the client and the CPA, including the terms of any engagement letter between the parties.

The Importance of the Engagement Letter

Great importance should be placed on the careful characterization of the engagement that includes the meticulous drafting of an engagement letter that sets out what tasks will (and will not) be performed by the CPA. A separate engagement letter is suggested for every different type of engagement. It must be remembered that litigation is about shifting losses. If the client or third party suffers a loss, they will want to shift it to anyone, including the CPA. The loss can be shifted to the CPA only if the CPA has a “duty” to the client or third party, and the CPA has breached that duty, causing a loss to the client or third party. An accountant’s duty is created either: (a) by the accountant’s agreement to perform services for the client, or (b) by law because the accountant has made representations to a third party upon which the third party was entitled to rely. One of the most important functions of an engagement letter is to define the scope of the accountant’s duty. Defining the scope of the duty is critical because if there is no “duty”, there is no need to inquire whether there has been a breach of duty causing loss. Whether there are genuine misunderstandings between the CPA and the client or the client is simply using hindsight in an attempt to shift the blame, the opportunity for these disputes to arise is sharply reduced if the engagement letter clearly spells out the respective responsibilities of the parties.

¹⁰ *Myers v. Finkle* (1991) 950 F.2d 165 (4th Cir.)

¹¹ *Stern Stewart & Co. v. KPMG Peat Marwick* (1997) 240 A.D.2d 334 (N.Y. App. Div.)

A properly drafted engagement letter can alleviate any “expectation gaps” between the CPA and the client regarding the scope of the representation. The clear delineation of the scope of the engagement can often prevent litigation or at least substantially enhance the CPA’s defenses, perhaps to the point of getting the lawsuit dismissed. It can control the forum and give the CPA control over the choice of decision maker.

Additionally, a well- drafted engagement letter can limit recoverable damages. If the CPA does not intend to undertake fiduciary obligations toward the client, this should be expressly stated in the engagement letter. The engagement letter may contain language that limits liability and contractual limitations on damages are becoming increasingly common. The acceptability of such limiting language varies from state to state. In California, for instance, a limitation of liability clause is generally enforceable as long as the Court finds that the parties knowingly agreed to the limitation and the clause is not unconscionable. Limitation on damages may be structured to limit both compensatory damages and punitive damages. Additionally, the CPA and the client may decide at the time of contracting whether to include a liquidated damages provision. While such clauses limiting liability are generally disfavored, the Court will look to whether the clause was clearly visible in the engagement letter, whether the provision was non-negotiable due to unequal bargaining power and whether its enforcement is contrary to strong public policy.

The ongoing monitoring and assessment of the development of the engagement by the CPA is essential. ET Section 55, Article IV, .03 of the AICPA Code of Professional Conduct states, “For a member in public practice, the maintenance of objectivity and independence requires a continuing assessment of client relationships and public responsibility.” This same vigilance should extend to protect the CPA from inadvertent and unintended fiduciary relationships. The fiduciary standard of care is not only a CPA using ordinary and prudent care but requires actions and decisions of the most scrupulous honor, good faith, and undivided loyalty to the client’s interest; a standard that should be taken on with full knowledge and considered before accepting the engagement.

In addition, because of the professional status of the CPA, when fiduciary duty is imposed upon the CPA, the CPA is often held to the higher professional standard of *best practices*, rather than ordinary care.

The CPA as Advisor to the Fiduciary

It is not unusual that a CPA will be engaged to perform tax accounting services as well as other services for a fiduciary entity that is either a trust or estate. This is often a result of expanded services to individual or business clients. In this situation, the fiduciary relationship is clearly identified, as should be the services provided by the CPA. Each state has its own rules regarding conduct. Within the Accountancy Rules and Regulations are those provisions related to confidentiality. Additionally, Rule 301 of the AICPA *Code of Professional Conduct (AICPA 2006)* prohibits CPAs in public practice from disclosing confidential client information without the consent of the client. The standards on confidentiality create potential problems when the CPA is the advisor to a fiduciary entity, and the standards involve the determination and identification of the “client” for the purposes of applying the confidentiality rules. The confidential relationship between the CPA and the client includes the general prohibition, and accompanying exceptions to the prohibition, against the disclosure by the CPA of confidential information without the client’s permission.

It must be remembered that in a structured fiduciary entity there is a duality of ownership between legal and equitable title, and title to the assets is divided. Among the beneficiaries, there are both current and remainder beneficiaries. Therefore, the proper identification of the client for purposes of the duty of confidentiality becomes important. Who is the client, the fiduciary, or the beneficiary?

Client is defined in the AICPA Code of Professional Conduct as

...Any person or entity, other than the member's employer, that engages a member or a member's firm to perform professional services or a person or entity with respect to which professional services are performed...¹²

The fiduciary is the party that hires the CPA to perform services for the entity, the fiduciary signs the engagement letter, and the work product is conducted between the CPA and the fiduciary; all of which suggest that the duty of confidentiality by the CPA is generally owed to the fiduciary. This can place the CPA in a very difficult situation when problems arise between the fiduciary and the beneficiary. However, the CPA must understand and respect the duty owed the fiduciary.

The CPA Acting as Fiduciary

A CPA is a perfect candidate for the job of fiduciary. There are multiple authorities and disciplines that must be understood and carried out, and a CPA is usually very familiar with these disciplines and authorities as well as the grantor's financial situation. The accounting, tax and financial planning components to fiduciary duty are routine to most CPAs. Fiduciary administration is detail-oriented work with due dates and record keeping that requires the type of organizational skills that are common to an accounting practice. Accountants routinely make sound judgment calls regarding clients' financial situations and often have a natural aversion to risk, making them prudent administrators. Clients often think of their CPA first when asked to name an independent party as successor trustee. Should the CPA accept the role of fiduciary over their clients' estate plans? Other than potential conflicts of interest and self-dealing issues, there is no legal or ethical requirement that prevents a CPA from serving as a fiduciary. However, CPAs should carefully consider accepting the role of fiduciary. It is an important business decision involving risk assessment, the standard of care owed to the beneficiary, and an assessment of the time involved in competently carrying out fiduciary duties while dealing with the needs of the beneficiaries. And as stated previously, the standard of care of a CPA as fiduciary is generally higher than that of a member of the general public.

¹² AICPA Code of Professional Conduct: Rules Section, ET Section 92.03

Fiduciary Indemnification

Because of the breadth and scope of fiduciary duty, the CPA acting as fiduciary must clearly understand the dynamics among the beneficiaries, the issues that could result in conflict, and the complexity of the assets. In the planning stages, the CPA should consider requesting that indemnification provisions be inserted in the governing documents. These provisions can protect the CPA/fiduciary but must be carefully drafted so as not to violate public policy or local law underlying the general standards of fiduciary care. Shortening the objection period to an account summary is also a method that can serve to protect the fiduciary and shorten the CPA/trustee's potential liability horizon.

Fee Considerations

From a practical viewpoint, it is important to determine whether adequate fees can be paid from the fiduciary entity for the work performed by the CPA/fiduciary. A fiduciary engagement can be very time consuming, and the level of detail can far exceed most routine client engagements. Because of the tax, accounting and investment requirements, the CPA acting as fiduciary must determine those tasks that must be outsourced and the overall budget for these costs. A fiduciary is under a duty to incur only those expenses that are reasonable to the entity. Often the review of fees paid to advisors is done retroactively and often by the court in the midst of litigation. Therefore, the fiduciary must continually be aware of costs of the engagement and whether the fiduciary engagement makes economic sense.

Conflicts of Interest

The CPA acting as fiduciary must be vigilant regarding any conflicts of interest. Rule 102 of the AICPA *Code of Professional Conduct* prohibits conflicts of interest. When performing any professional service, Rule 102 requires that a CPA "shall maintain objectivity and integrity, shall be free of conflicts of interests, and shall not knowingly misrepresent facts or subordinate his or her judgment to others." Interpretation 102-2, which was revised and broadened in 1995, specifically describes a conflict of interest as occurring when an accountant performs a professional service for a client or employer and the accountant or his or her firm has a relationship with another person, entity, product, or service that could, in the CPA's professional judgment, be viewed, by the client, employer, or other interested parties, as impairing the CPA's objectivity. If the accountant believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other interested parties, the rule shall not operate to prohibit the performance of the professional service. The examples provided in Revised Interpretation 102-2 include the rendering of tax or personal financial planning services for several members of a family who may have opposing interests.

CPAs working with attorneys, investment advisors, and other professionals in multi-generational tax planning situations, may encounter disputes over the division of property, ownership of businesses, and charges of either favoritism or conflicts of interest from disgruntled beneficiaries. Although it may be preferable for all parties to the planning engagement to be represented by independent professionals, this may not be practical due to cost factors and other realities of the professional environment. As the life styles of clients change as they age, so do the dynamics of the advisor relationship. Where the CPA may begin as the accounting and tax advisor to a married couple, this

relationship can change on the death of the first spouse. If the CPA is named as fiduciary to a sub-trust, the duty expands not only to the surviving spouse but also to the remainder beneficiaries who are often the children and grandchildren. Statutory and common law require that a fiduciary be impartial to all beneficiaries unless the governing document provides otherwise. The CPA/fiduciary and the client must understand and honor this change in relationship. CPAs should have a clear engagement letter that outlines their responsibilities in any planning situation. The engagement letter should explicitly detail whether the CPA firm is assuming the primary responsibility for the planning or is merely acting in an ancillary or secondary team role to other professionals. The CPA firm should fully disclose potential conflicts of interest and secure written approval from all parties if it undertakes to represent multiple parties in the transaction. All engagement letters or contracts should clearly specify for whom the practitioner is working and to whom information may be disclosed.

Some insurance carriers even discourage CPAs who represent more than one party in a succession or estate planning engagement from completing the tax return for any beneficiary. Since the CPA has access to personal financial information that could be used to the beneficiary's disadvantage, a conflict of interest may arise. If so, both the CPA firm and attorneys may be named in a liability claim for not fully disclosing the details of the succession plan. While the realities of practice may preclude such representation, the CPA should secure written permission from the client to engage in such work. The CPA should also keep written records of any discussions with the clients.

Statutory Guidance and Authority for the Fiduciary

A complete understanding of the role of fiduciary duty is crucial to effective estate planning and administration. There are competing pressures on the fiduciary that make the role of fiduciary difficult such that the position should not be accepted casually. The person or entity holding "legal title" to an asset has significant power over the asset. Holding bare "legal title" to an asset entitles the holder to buy or sell, to encumber, or to expend sums for its maintenance or repair. The holder of legal title is empowered to distribute the income from the asset, or the asset itself.

The position of fiduciary carries with it important responsibilities. There must be standards set for the performance of the fiduciary's duty to protect the fiduciary from criticism and lawsuits while also protecting the beneficiaries and their property interests.

To what standard do we hold the fiduciary?

What guidance is provided to the fiduciary in dealing with the trust assets and making distributions to the beneficiaries?

What protection is there for the fiduciary from liability for breach of fiduciary duty?

It is important that the fiduciary and the representatives and advisors of the fiduciary understand the guidelines under which the fiduciary must operate. To be unaware of the rules can expose the fiduciary to unnecessary liability. There are overlapping sources of authority that guide the fiduciary's behavior. Planning in this area can appear almost three-dimensional.

Grantor's Intent

The grantor owns the assets that comprise the estate plan and it is up to the grantor how the assets are to be transferred and to whom. Therefore, the grantor's intent as manifested in the governing document is regarded and respected as the primary authority. This intent is determined through the interpretation of the written documents of the estate plan. It is, therefore, essential that the estate planning documents are clearly and accurately drafted. They should be amended when circumstances change and they must keep up with the changing of the family dynamic.

Because an estate plan is designed to endure many years and weather many transitions, some of which are unexpected, there must be flexibility built into the plan. Flexibility is created in several ways. One way is for the plan to give the trustee *discretion* in making decisions regarding the management of the assets or the distributions made to the beneficiaries. This requires that the grantor choose the trustee carefully. The trustee already has legal title to the assets. The possession of legal title combined with broad discretionary authority gives the trustee significant control over the assets. Another method used to create flexibility is for the documents to remain silent on certain issues. When the document is silent, the fiduciary looks to state or local law for guidance.

The Role of State or Local Law

The default authority to *state or local law* is a fallback that provides the fiduciary both guidance and protection. Thus, it becomes important to determine in what state the estate is located or the situs of the trust. (See discussion in Chapter III.) Because each state is sovereign, each has its own probate code or state law controlling and dictating fiduciary conduct. In addition, different localities within the state may adopt their own local statutory or common law. Thus, state and local law are used interchangeably in this Guide. Once the documents are reviewed for specific direction, any aspects not specifically addressed in such documents will follow the dictates of state law. While the tax advisor is not expected to be an attorney, a thorough understanding of the applicable state law is essential in properly interpreting the client's estate plan.

Investment Planning

A trust is essentially an investment vehicle and part of the job of the fiduciary is to make and keep the assets productive. This is a big responsibility and the type of job the trustee does in the management and investment of the trust assets can have significant economic consequences to the beneficiaries. Therefore, it is important that there be some type of statutory guidance to provide a standard and a "safe harbor" for the fiduciary. The success or failure of the investment portfolio is often affected by circumstances outside the fiduciary's control that include market conditions and the state of the overall economy. The Uniform Prudent Investor Act was approved by the National Conference of Commissioners on Uniform State Laws in 1994. This model code sought to modernize investment practices of fiduciaries, focusing on trustees of private trusts. The new features that were added to the Code recognized the importance of balancing risk and return at levels appropriate to the purposes of the trust. It allowed for the delegation by the trustee of investment and management decisions and created a safe harbor for trustee liability where the trustee satisfied the delegation standards. The UPIA also set a standard for compliance for the trustee in light of the facts

and circumstances existing at the time of a trustee's decision or action rather than by hindsight. The conduct of the fiduciary not related to investments continues to be measured under a "prudent man" standard. (See discussion in Chapter IV.)

Fiduciary Accounting

Between 1962 and 1999, trust principal and income allocation rules for most states were governed by the Revised Uniform Principal and Income Act (RUIA). State law will apply, however, only in the absence of specific contrary instructions in the trust or estate documents. The RUIA was actually a 1962 revision of a model code, called the Uniform Principal and Income Act, which was drafted in 1931. It typically characterized principal and income and the apportionment of receipts and expenses among income and remainder beneficiaries.

A grantor creating a will or trust can empower the trustee with discretionary authority to make these determinations and the paramount rule is the intention of the creator of the interests. If an instrument is silent on the treatment of principal and income, the allocations are to be made in accordance with the uniform principal and income act as adopted in the particular state. Where the instrument provides complete discretion to the fiduciary in allocating receipts and expenditures to income or principal, the fiduciary is nevertheless required to exercise this discretion reasonably and equitably considering the interests of all beneficiaries.

Many estate plans distinguish between *income and principal* in a trust and have done so for many years based on the theory that the income beneficiaries receive the income produced from the assets while the remainder beneficiaries receive the actual assets at some point after the income beneficiaries' interests end. Therefore, this distinction between income and principal is important and is reflected by the well known *fruit and tree* analogy. The assets themselves are *branches* of the tree and any income produced by these assets are *fruit*. The fruit goes to the income beneficiary while the remaindermen get the tree (assets) at some point in time as described in the governing document.

This economic theory that focuses so heavily on the income produced by an asset and the preservation of the asset itself has been outdated for some time and is often out of sync with modern portfolio theory. The modern investment portfolio cannot be evaluated solely by the amount of income it earns. More complex factors, such as inflation and market fluctuations come into play in influencing the required diversification of investment in growth stocks, foreign markets, etc. Many states recognized this need to grant authority to the fiduciary to use a balanced approach to investing and this was later codified in the Uniform Prudent Investor Act as discussed above. However RUIA still used the income/principal concept and trustees operated under a "prudent man" standard for allocating between income and principal when the instrument was silent. Therefore, when states enacted the Uniform Prudent Investor Act, which brought the standard of care for fiduciary investment of trust assets in sync with modern investment theory, RUIA, which was enacted in 1962, created tension for trustees attempting to comply with Uniform Prudent Investor Act. Fiduciaries have long struggled with RUIA as being outdated and inadequate in addressing the types of assets that typically constitute a trust portfolio. Between 1962, when the Uniform Principal and Income Act was revised, and the present, much has changed in the investment world requiring statutory consideration. (See discussion in Chapter IV.)

Duty to Inform and Report under the Uniform Trust Code

The Uniform Trust Code (2000) is the first national codification of the law of trusts. The primary stimulus of the Commissioners' drafting of the Uniform Trust Code is the greater use of trusts in recent years, both in family estate planning and in commercial transactions, in the United States and internationally.

Section 813(c) of the Uniform Trust Code provides:

“A trustee shall send to the distributees or permissible distributees of trust income or principal, and to other qualified or nonqualified beneficiaries who request it, at least annually and at the termination of the trust, a report of the trust property, liabilities, receipts, and disbursements, including the source and amount of the trustee's compensation, a listing of the trust assets and, if feasible, their respective market values. Upon a vacancy in trusteeship, unless a co trustee remains in office, a report must be sent to the qualified beneficiaries by the former trustee. A personal representative, [conservator], or [guardian] may send the qualified beneficiaries a report on behalf of a deceased or incapacitated trustee.”

The comments to the Uniform Trust Code can help an accountant understand what the drafters of the code intended. One of the comments on 813(c) states:

“The duty to keep beneficiaries reasonably informed of the administration of the trust is a fundamental duty of a trustee. For the common law duty to keep the beneficiaries informed, see Restatement (Second) of Trusts Section 173 (1959).”

The Uniform Trust Code is only one of the many documents that may help to define the requirements for a fiduciary accounting, under the applicable statutes. When discussing a fiduciary accounting with a client the accountant needs to clarify what the applicable requirements are. It is quite likely the accountant will need to discuss this issue with the attorney for the fiduciary, since the anticipated users of the accounting will most likely be comparing the information received to that required to be prepared under the applicable statutes.

The states which have adopted a version of the new Uniform Trust Code have had to address Section 813 (c) of the uniform act and their desire to make any required annual report mandatory by adopting provisions under 105 of the act.

States Not Adopting the Uniform Trust Code

At the present time most states have not adopted the Uniform Trust Code. The requirements for an annual accounting in states not adopting the Uniform Trust Code may be harder to determine.

In those instances where an annual accounting is not explicitly required by either the document or the applicable state law the accountant may find themselves in the position of explaining to the client why some effort must be expended to arrive at least a partial annual accounting for the trust, for example if the applicable instrument requires that income be distributed annually, then it would

appear to logically follow that a) income must be determined, and b) the amount distributed must be determined to see if the income was fully distributed, or if distributions actually made exceeded the income required to be distributed.

The New Principal and Income Act

After five years in the making, the Uniform Principal and Income Act (Act) (The 97 Act last revised in 2000) was revised by the drafting committee of the National Conference of Commissioners on Uniform State Laws. The 97 Act offers more detailed provisions concerning the treatment of modern investment vehicles and accepts modern portfolio management concepts as well as revising the standards of fiduciary conduct from those promulgated under the “Prudent Man Rule” of the 1961 revision. Where the prior law focused on a certain level of “income” as traditionally perceived from interest, dividends, royalties and rents, the new law has attempted to provide statutory authority that compliments the Uniform Prudent Investor Act. Additionally, it recognizes the widespread use of the revocable living trust as a will substitute.

The new standards require fair, reasonable, and impartial administration of the interests of both the current income beneficiaries and the remaindermen consistent with the wishes of the settlor. The grantor’s intentions still override the provisions of the model code. If a fiduciary has any doubt in a situation, any uncertainties regarding receipts or disbursement are to be credited or charges to principal.

The prior Acts as well as the new Act deal with four questions affecting the rights of beneficiaries:

1. How is the income earned during the probate of an estate to be distributed to trusts and to persons who receive outright bequests of specific property, pecuniary gifts, and the residue?
2. When does an income interest begin, what property is principal that will eventually go to the remainder beneficiaries and what is income?
3. When does an income interest end and who gets the income that has been received but not distributed, or that is due but not yet collected, or that has accrued but is not yet due?
4. How should receipts and disbursements be allocated to or between principal and income after an income interest begins and before it ends?

Clarification and Changes in the Existing Rules

A number of matters provided for in the prior Acts were changed or clarified in the 97 Act, including the following:

1. An income beneficiary’s estate will be entitled to receive only net income actually received by a trust before the beneficiary’s death and not items of accrued income.
2. Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions.
3. Distributions from corporations and partnerships that exceed 20% of the entity’s gross assets will be principal whether or not intended by the entity to be a partial liquidation.
4. Deferred compensation is dealt with in greater detail in its own section.
5. The 1962 Act rule for “property subject to depletion” (patents, copyrights, royalties, and the like), which provided that a trustee may allocate up to 5% of the asset’s inventory value to

income and the balance to principal, has been replaced by a rule that allocates 90% of the amount received to principal and the balance to income.

6. The percentage used to allocate amounts received from oil and gas has been changed – 90% of those receipts are allocated to principal and the balance to income.
7. The unproductive property rule has been eliminated for trusts other than marital deduction trusts.
8. Charging depreciation against income is left to the discretion of the trustee.
9. A trustee can separately account for a business or other activity if the trustee deems it in the best interest of all the beneficiaries.
10. A trustee who has made a prudent, modern portfolio theory-based investment decision that has the initial effect of skewing the return from all the assets under management, viewed as a portfolio, can adjust between income and principal. The Act gives that trustee a power to reallocate the portfolio return suitably. To leave a trustee constrained by the traditional system would inhibit the trustee's ability to fully implement modern portfolio theory.

The above changes are more fully discussed in Chapter V of this Guide.

Conclusion

Because of the rigors and risks of fiduciary duty, it is essential that such duty be taken on knowingly and willingly. The impact of the inadvertent imposition of fiduciary duty upon an advisor relationship exposes the CPA to significant additional risk. Therefore, as CPA services expand to areas outside of accounting and tax, it is important to review and monitor engagements for fiduciary duty. Where a fiduciary entity is involved, it is important to clearly define in writing the services provided by the CPA, whether as advisor or fiduciary, and tailor those services within manageable areas of risk.

When the CPA is retained solely as an advisor to the fiduciary, the CPA must be familiar with the terms of the governing instrument and applicable local law and how they might impact the services being performed for the fiduciary.

III. Fiduciary Accounting Income Defined

Introduction to Fiduciary Accounting Income

Fiduciary accounting income (also referred to as trust accounting income) is the amount, stated in money or its equivalent, generally available to the income beneficiary or beneficiaries of a trust or estate. It differs from taxable income, gross income and distributable net income, which are tax concepts.

Fiduciary accounting income is determined in accordance with the terms of the governing instrument. In those cases where the governing instrument is either silent or ambiguous, applicable local law generally provides the necessary guidance. It is determined for a specific period (such as a fiscal year) by way of a system that allocates receipts and disbursements between income and principal (corpus) of the estate or trust.

Trusts and estates generally provide benefits for two classes of beneficiaries, income beneficiaries and remainder beneficiaries. In essence, the fiduciary accounting income is allocated to the income beneficiaries according to the governing document and/or local law.

While fiduciary accounting rules vary among the states, each state usually adopts some variation of the Uniform Principal and Income Act (The 97 Act). Some states, such as New York, have expanded or redefined income beyond the definition found in the Uniform Act. They do so for the purpose of transitioning to an investment philosophy under the “total return” concept as opposed to the traditional view of income as primarily interest, dividends, royalties and rents. This concept attempts to accommodate the market shift from decreasing dividend yields to greater capital appreciation, thereby allowing the trustees greater flexibility to comply with the prudent investor standards. (See discussion in Chapter IV.)

Review and Relevance of the Governing Documents/Authority

Reading and understanding the governing documents is the initial step for preparing a fiduciary accounting. The governing documents are the will and/or trust document. These documents may provide some guidance on allocations between principal and income. When creating a will or trust, the testator/settlor may define income in any way he or she chooses. Such direction provided in the governing documents will impact the ultimate determination of how much income is distributable to the current income beneficiaries and how much is retained for the remainder beneficiaries.

If the creator has not defined income and principal (i.e. the governing document is silent), the fiduciary must rely on state law. Each state has adopted guidelines for allocation of receipts and disbursements between income and principal. However, all states have not adopted the same guidelines. The Uniform Principal and Income Act is the guideline used by the states. The original act was approved in 1931 and then revised in 1962, 1997 and most recently 2000. Most states have adopted the 1997 revision but may have modified it or have only adopted parts of it and modified others. Therefore, it is extremely important to review the state law that applies to the particular trust or estate document. (See Appendix for a matrix of states adopting some version of the Uniform Principal and Income Act.)

If neither the document nor state law provides guidance in this area, the fiduciary must decide what is “fair and reasonable” to both the income and remainder beneficiaries. The general rule is to allocate an item to principal if it is not clear whether it is income or principal.

Situs

The situs of the trust or estate is usually determined by the governing instrument. Many trust documents will specify the state laws that are to be followed. If the governing document is a will, and is silent regarding situs, the place of the testator’s domicile at the time of death will usually control.

Situs is often times not easily determined. For example, an individual may have a will and trustdrafted in one state, fund a trust while living in that state, and then move their permanent residence to a different state. If the will and trust documents are not revised or updated upon their change of residence, there may be questions raised regarding the intended situs.

Additionally, if an individual creates a trust in one state, names a fiduciary in another state, and has beneficiaries in several other states, state laws needs to be reviewed to determine whether situs is determined by the residence of the grantor (or creator), the fiduciary or the beneficiary.

The type of property held by the trust may also cause problems in determining situs. In some states, real estate owned within that state determines situs. The situs of a trust may also determine where the fiduciary is obligated to file state income tax returns. Therefore, it may be necessary to obtain the opinion of an attorney or obtain a court order to determine the proper situs.

IV. How the 1994 Uniform Prudent Investor Act Affects the 1997 Act and the Unitrust Option

Investment Standards for a Trustee in a Trust – Overview of the 1994 Uniform Prudent Investor Act

A trust is inherently an investment vehicle and the trustee has a duty to invest all trust funds as soon as possible. In making such investments, the trustee is potentially subject to the broad prudent investor standard pertaining to trustees under Prudent Investor Act as adopted by each particular state. The extent to which the Trustee of a particular trust is subject to the Prudent Investor Act of any particular state will be a function of the terms of the agreement. Grantors may address the applicability of this Act in the governing documents. Some documents will waive some or all requirements of the Act. As stated earlier, the governing document controls.¹³

Prudent investor standards have changed over time. The most recent changes were as a result of the 1994 revision to the Uniform Prudent Investor Act (“1994 Act”). Various states have revised the Prudent Investor Standards as a result of the 1994 Act.

There is perhaps no better explanation of the rationale for the adoption of the 1994 Uniform Prudent Investor Act than that provided by the National Conference of Commissions of Uniform State Laws.

Prefatory Note

Over the quarter century from the late 1960s, the investment practices of fiduciaries experienced significant change. The Uniform Prudent Investor Act (1997 ACT) undertakes to update trust investment law in recognition of the alterations that have occurred in investment practice. These changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as “modern portfolio theory.”

This Act draws upon the revised standards for prudent trust investment promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992) [hereinafter Restatement of Trusts 3d: Prudent Investor Rule; also referred to as 1992 Restatement].

Objectives of the Act. The 1997 Act [1994 Act] makes five fundamental alterations in the former criteria for prudent investing. All are to be found in the Restatement of Trusts 3d: Prudent Investor Rule.

The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term “portfolio” embraces all the trust’s assets. 1997 Act §2(b).

¹³ Uniform Prudent Investor Act Section 1(b)

The tradeoff in all investing between risk and return is identified as the fiduciary's central considerations. 1997 [1994] Act §2(b).

All categorical restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing. 1997 [1994] Act §2(e).

The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. 1997 [1994] Act §3.

The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards. 1997 [1994] Act §9.¹⁴

The emphasis of the 1994 Uniform Prudent Investor Act is to allow the Trustees to follow the investment principles of modern portfolio theory. It allows the trustee to invest for total return.

The total return on an asset is not strictly limited to the yield (interest, dividends, rents, etc.) but also includes the gain or loss that the asset realizes as its value appreciates or depreciates. Total return encourages investors to seek the highest overall return (given a certain risk tolerance and within the bounds of prudent investing) without needlessly being hampered by how that return is specifically created. This concept has been codified in the 1994 Uniform Prudent Investor Act. Prior to this, a *prudent person rule*, the measurement of investment performance centered on the amount of trust income earned by the assets and the conservation of the assets for eventual distribution to the remainderman. There was no mention of, or interest in, growth of the assets.

Under the 1994 Uniform Prudent Investor Act, the fiduciary is required to create an investment strategy for the trust.¹⁵

What is the appropriate investment strategy for the trust? The Uniform Prudent Investor Act codifies a number of principles and standards for prudent investing that reflects the American Law Institutes Restatement (Third) of Trusts (1992). This model code has been adopted in one form or another by individual states throughout the country. This could be by statute or case law or other type of legislation. It embodies the general standard that trustees should use care, skill, prudence and diligence in making investment decisions and that trust assets should be appropriately diversified.

Further, the investment strategy should have proper risk and return allocations that are reasonable in light of the investment objectives. While asset allocation plays a pivotal role, how each beneficiary shares in the risk and return is also largely driven by the distribution policy adopted by the fiduciary.

¹⁴ Uniform Prudent Investor Act, drafted by the National Conference of Commissioners on Uniform State Laws and by it approved and recommended for enactment in all the states at its annual conference meeting in its one hundred and third year in Chicago, Illinois, July 29 to August 5, 1994

¹⁵ Uniform Prudent Investor Act Section 2

Following is a summary of the Standards in the Uniform Prudent Investment Act:

- a. The standard of prudence is applied to the portfolio as a whole rather than each individual asset.
- b. The primary consideration of fiduciaries in finding the appropriate balance between risk and return for the trust. Because there are two equitable owners, this is more complex in the trust situation.
- c. There are no prohibitions in the selection of assets as long as the selected asset plays an appropriate role in achieving the risk and return objectives and meets the other requirements of prudent investing.
- d. The trustee has an obligation to diversify unless the trustee determines that there are special circumstances where the purposes of the trust are better served without diversifying.
- e. The trustee may delegate investment and management functions to a third party.

The 1997 Uniform Principal and Income Act and the 1994 Uniform Prudent Investor Act

When the 1997 Uniform Principal and Income Act was adopted, part of the intent was to allow trustees to comply with the 1994 Uniform Prudent Investor Act. Quoting again from the National Conference on Commissioners of Uniform State Laws explanation of the intent of the Act -

Prefatory Note

This revision of the 1931 Uniform Principal and Income Act and the 1962 Revised Uniform Principal and Income Act has two purposes.

One purpose is to revise the 1931 and the 1962 Acts. Revision is needed to support the now widespread use of the revocable living trust as a will substitute, to change the rules in those Acts that experience has shown need to be changed, and to establish new rules to cover situations not provided for in the old Acts, including rules that apply to financial instruments invested since 1962.

The other purpose is to provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of income as traditionally perceived in terms of interest, dividends, and rents.¹⁶

Coordination with the Uniform Prudent Investor Act

The law of trust investment has been modernized. Now it is time to update the principal and income allocation rules so the two doctrines can work well together. This revision deals conservatively with the tension between modern investment theory and traditional income allocation. The starting point is to use the traditional income allocation. If prudent investing of all of the assets in a trust viewed as a portfolio and traditional allocation effectuate the intent of the settler, then nothing need be done. The Act, however, helps the trustee who has made a prudent, modern portfolio-based investment

¹⁶ Uniform Principal and Income Act (Last amended or revised in 2000), drafted by the National Conference of Commissioners on uniform state laws and by it approved and recommended for enactment in all the states at its annual conference meeting in its one hundred and sixth year in Sacramento, California, July 25 – August 1, 1997

decision that has the initial effect of skewing return from all the assets under management, viewed as a portfolio, as between income and principal beneficiaries. The Act gives that trustee a power to reallocate the portfolio return suitably. To leave a trustee constrained by the traditional system would inhibit the trustee's ability to fully implement modern portfolio theory.

1997 Act Section 104 – Trustee's Power to Adjust

Chapter V discusses the allocation of receipts and disbursements between principal and income under the provisions of the 1997 Act. A trustee may believe that the allocations between principal and income under the 1997 Act do not result in the appropriate level of fiduciary accounting income. Under section 104 of the 1997 Act, trustees investing as a prudent investor are authorized to make "adjustments" between income and principal as necessary to provide the income beneficiary with an appropriate degree of beneficial enjoyment where the income component of the trust portfolio's total return is too small or too large because of investment decisions under the prudent investor rule.

Many trustees are uncertain how to use the new adjustment power, as the statute provides no guidelines addressing the questions of whether or how much to adjust. This absence of statutory guidelines was intentional and is appropriate. Trustees have considerable leeway in determining target levels for payments to income beneficiaries and for the rate of growth of the principal that will ultimately benefit the remainder beneficiaries.

Depending on the circumstances, and in accordance with the prudent investor rule, different trusts and the same trust at different times may properly be administered to provide widely differing rates of benefits to the income beneficiary. Under the prudent investor rule, trustees generally should set target levels of benefits for the income beneficiary and target rates of growth for trust principal. Once such target levels are set, the trustee usually will be prepared to answer the questions of whether and how much to adjust. Disputes may rise among the trustee, the income beneficiary and the remainder beneficiaries concerning the particular plan adopted by the trustee in exercise of the adjustment power. Although Section 105 discusses judicial control of discretionary, some states have enacted notice provisions to protect trustees utilizing the power. Further, the statute provides no guidance for determining an appropriate adjustment following a beneficiary's objections. The statute contains exculpatory provisions that should give comfort to even the most cautious trustee.

Conditions Precedent to the Adjustment Power

The conditions that must be met before the trustee can make an adjustment under the 97 Act Section 104(a) are as follows:

- a. The trustee must invest and manage the trust assets under the prudent investor rule.
- b. The trust must describe the amount that must or may be distributed to a beneficiary by referring to the trust's income.
- c. The trustee must be unable to discharge the trustee's duty of impartiality under Section 103(a) by exercising any power the trustee has to invade principal or accumulate income.

Factors To Be Considered

Section 104(b) of the 97 Act provides a series of factors the trustee may consider in determining whether to make an adjustment between principal and income. These factors include the following:

- a. The nature, purpose and expected duration of the trust.
- b. The settlor's intent.
- c. The identity and circumstances of the beneficiaries.
- d. The needs for liquidity, regularity of income, and preservation and appreciation of capital.
- e. The types of assets held in the trust; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor.
- f. The net amount allocated to income under other statutes and the increase or decrease in the value of the principal assets, which the trustee may estimate for assets for which market values are not readily available.
- g. Whether and to what extent the trust gives the trustee the power to invade principal and accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income.
- h. The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation.
- i. The anticipated tax consequences of the adjustment.

Situations Where the Trustee May *Not* Adjust

There are a number of circumstances under Section 104(c) of the 97 Act where the trustee may not exercise the power to make an adjustment between principal and income that include:

- a. Where an adjustment would diminish the surviving spouse's income interest in a marital deduction trust requiring all income to be paid to the settlor's surviving spouse.
- b. Where it would reduce the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion.
- c. It would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets.
- d. It would be made from an amount permanently set aside for charitable purposes under a will or trust, unless both income and principal are so set aside.
- e. Possessing or exercising the power would cause an individual to be treated as the owner of a trust for income tax purposes, where that would not otherwise be the case.

- f. Possessing or exercising the power would cause all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, where the assets would not otherwise be included.
- g. Where the trustee is also a beneficiary of the trust.

Trustee's Duty of Impartiality under Section 103(b) of the 1997 Act

The Duty of Impartiality is found in the 97 Act Section 103(b).

In exercising the power to adjust under Section 104(a) or a discretionary power of administration regarding a matter within the scope of the [Act], whether granted by the terms of a trust, a will, or this [Act], a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this [Act] is presumed to be fair and reasonable to all of the beneficiaries.

Trustees have long understood that the duty of impartiality requires that the trust investments be reasonably productive of income for the benefit of the income beneficiary. This has also long been the IRS view with respect to marital deduction trusts.

Trustees experienced high inflation in the 1970s and 1980s and understood that the duty of impartiality also required concern for the maintenance of the purchasing power of trust principal.

The Prudent Investor Act supports this broader understanding of the duty of impartiality. This Act specifically mentions “the possible effects of inflation or deflation” and “preservation or appreciation of capital” as among the circumstances that are appropriate to consider in investing and managing trust assets. In the current economy, it has become increasingly difficult for trustees to meet this broadly defined duty of impartiality with respect to trusts that require current payments of trust income to one beneficiary, usually a life beneficiary, while also requiring the trustee to take into account the interests of one or more remainder beneficiaries who will receive the trust corpus on the death of the life beneficiary or on the expiration of a term of years.

Two principal factors contribute to the difficulty:

- a. It has become generally accepted that the real (i.e. inflation adjusted) value of trust corpus cannot be maintained over the long term unless:
 - a. The trust's investment portfolio is heavily weighted toward growth investments, and
 - b. The income beneficiary receives annual distributions totaling no more than 4% of the current value of the trust corpus.

- b. When the S & P 500 average annual dividend yield dropping to approximately 1%, for example, it is clear that an investment portfolio heavily weighted toward equities will not, in most cases, produce a reasonable level of benefits for the income beneficiary.

This leaves the trustee in a dilemma. The purchasing power of the annual income stream will not be protected unless the purchasing power of the trust corpus is likewise protected and to do this, the trustee must invest heavily in growth stocks such as common stocks. However, these growth stocks will not produce an adequate level of traditional fiduciary accounting income for the income beneficiary. If the trustee invests for the purpose of producing an adequate income for the income beneficiary, it will do so at the expense of the long-term growth prospects of the portfolio.

Situations in Which a Trustee Might Consider the New Trustee's Power to Adjust Under 1997 Act Section 104

"Income to A (life), Remainder to B"

The distribution provision described above is common to many trusts. Traditional yields on assets in the way of interest and dividends are the major contributors to accounting income. However, with the decline in interest rates and dividend yields over the past years, many trusts can no longer generate a level of "income" that meets the needs of current beneficiaries and satisfies the intent of the grantor. A basic conflict then develops between the income and remainder beneficiary. This conflict then spreads to the relationship between the fiduciary and the beneficiaries.

Consider the situation in which a trustee manages a trust investment portfolio that is invested 60% in stock and 40% in bonds. Historically such a portfolio would have produced the following yield over the twenty year period from 1982 - 2002:

8.8% in 1982
4.7% in 1992
2.9% in 2002

In 2002 to produce the 1992 yield of 4.7%, the portfolio would have to be invested 10% in stocks and 90% in bonds. This would possibly provide enough traditional fiduciary accounting income but would effectively remove all growth potential from the portfolio, thus diminishing the value to the remainder beneficiary. The trustee could seek higher yields with the bonds by increasing their maturity, perhaps to 30-year bonds. This, however, subjects the portfolio to increased interest rate risk. If interest rates rise, the value of long-term bonds is likely to suffer a far greater decline in price than bonds with shorter-term maturities. The trustee could seek a higher yield by investing in bonds with lower credit qualities, so called "junk bonds," with the ensuing downside of increased credit or default risk. The trustee could seek a higher yield by investing in higher dividend paying stocks like those of utility companies. This strategy must be weighed in light of the duty to diversify and avoid large concentrations of investments in one sector of the market. Trustees are in a bind and often resort to fixed income assets to boost distributions. But fixed income assets often restrain portfolio growth and are eroded by inflation resulting in an unfavorable result for the remainder beneficiary.

A “dramatic tension” has been created by trying to balance current portfolio needs with long term return potential. Over the past decade, various pieces of legislation have been enacted across the country to allow the fiduciary to invest for the highest total return without “starving” the current beneficiary in the process.

Implementing the Trustee’s Power to Adjust

Implementation of the equitable adjustment statute is a function of a three-prong analysis. Each prong has statutory authority that provides standards, guidelines and safe harbors. Each prong must be considered and properly implemented so that the fiduciary is adequately protected in the event that beneficiaries become unsatisfied or litigious. These prongs include:

Investment Prong - Uniform Prudent Investor Act – What is the appropriate investment strategy for the trust?

Distribution Prong - Uniform Principal and Income Act – What is the appropriate distribution policy for the trust?

Tax Prong - Treasury Regs under IRC Sec. 643(b) – What portion of the income taxes should be paid by the trust and by the current beneficiary?

Prong 1 - Uniform Prudent Investor Act

What is the appropriate investment strategy for the trust?

The Uniform Prudent Investor Act codifies a number of principles and standards for prudent investing. It embodies the general standard that trustees should use care, skill, prudence and diligence in making investment decisions and the trust assets should be appropriately diversified.

Further, the investment strategy should have proper risk and return allocations that are reasonable. While asset allocation plays a pivotal role, how each beneficiary shares in the risk and return is also largely driven by the distribution policy adopted by the fiduciary.

The Standards in Uniform Prudent Investment Act

- a. Standard of prudence is applied to the portfolio as a whole rather than each individual asset.
- b. The primary consideration for fiduciaries is finding the appropriate balance between risk and return for the trust. Because there are two equitable owners, this is more complex in the trust situation.
- c. There are no prohibitions to selection of assets as long as the asset plays an appropriate role in achieving the risk and return objectives and meets the other requirements of prudent investing.
- d. The trustee has an obligation to diversify unless the trustee determines that there are special circumstances where the purposes of the trust are better served without diversifying.
- e. The trustee may delegate investment and management functions to a third party.

Prong 2 - Uniform Principal and Income Act

What is the appropriate distribution policy for the trust?

Duty to Provide Beneficiary with Reasonable Level of Beneficial Enjoyment

Discharging this duty, with or without the power to adjust, requires the trustee to exercise judgment in determining an appropriate level of benefits. The power to adjust permits the trustee to exercise this discretion in a manner that will not conflict with the trustee's objectives for optimal total investment return, but it does not otherwise change the trustee's duties including the fundamental duties regarding impartiality and productivity. It is expected that the power to adjust will be exercised to provide a variety of different levels of benefits for income beneficiaries, within a range of productivity, depending on the particular circumstances of each trust and its beneficiaries. Just as reasonable people may disagree, reasonable trustees will also inevitably and appropriately exercise discretion to provide differing level of benefits to income beneficiaries, even under hypothetically "identical" circumstances.

Under traditional fiduciary accounting standards, the trustee has been forced to choose an investment strategy that maintains an appropriate income level for the current beneficiary that often erodes principal or corpus. Investing to produce fiduciary accounting income is at the sacrifice of growth. Discretionary investment powers create some limited ability to equitably adjust between current and remainder beneficiaries. Because the trustee is under a duty to treat the beneficiaries impartially, this creates a dilemma for the fiduciary. The adoption by the Model Code of the Total Return Concept through the equitable adjustment statute attempts to solve this dilemma. The Trustee's Power to Adjust helps to integrate the income and principal rules with Total Return investing by completely ignoring the traditional concepts of fiduciary accounting income.

A Trustee may establish a target level of benefit rather than the traditional target level of trust accounting income. The Trustee can begin the analysis with the assumption that the income beneficiary will receive an annual distribution in the range of 3% to 5% of the FMV of the trust principal. This range reflects a widespread recognition that as a general rule, the 4% level is the highest that can be maintained in the long term without reducing the purchasing power of the principal, even if the trust portfolio is heavily weighted toward growth investments. Also the 4% amount takes into consideration typical administration expenses and taxes. A trustee may choose to weight growth investments somewhat less heavily in order to reduce portfolio volatility, but this will necessarily reduce the portfolio's growth potential and limit the maximum "sustainable" distributions to the income beneficiary to a level somewhat below 4%. The initial assumption must be adjusted to take into account the particular circumstances. One of the most significant circumstances is whether the settlor intended to preserve the purchasing power of the principal for the benefit of the remainder beneficiaries.

If the current beneficiary(ies) is the primary beneficiary and future benefits to the remainder beneficiaries are given secondary importance, the trustee may consider establishing a level of benefits for the income beneficiary higher than 4%. If the income beneficiary has a long life expectancy, however, the trustee probably will not be able to target distributions significantly above

4% out of concern that higher levels of benefits will, in the long run, erode the purchasing power of the income distributions. To summarize, if the investment horizon is long, both present and future interests will benefit from a portfolio heavily oriented toward growth. To the extent that the FAI is inadequate to meet the target level of benefit, the trustee will exercise the power to adjust for the purpose of augmenting the trust income with an allocation of principal.

The prudent investor act requires the trustee to set a target level of benefits for the income beneficiary. This follows from the language in the Prudent Investor Act that the trustee consider the “purposes, terms, distribution requirements, and other circumstances of the trust.” Also, it requires that the trustee consider the needs for “liquidity, regularity of income and preservation or appreciation of capital.”

There are a variety of approaches to setting target levels for current distributions.

- Fixed Percentage
- Fixed Percentage With Averaging
- The Shadow Portfolio

Fixed Percentage

This is the simplest approach. The Trustee determines a fixed percentage starting with baseline of 3% - 5% and increases or decreases this depending on the circumstances. He then picks a valuation date (maybe the first day of the year). This method may conflict with the common objective of providing a reasonably stable flow of annual benefits to the income beneficiary since it is based on a different number each year.

Fixed Percentage with Averaging

This method reduces the volatility of the current beneficiary’s benefits. The fixed percentage is applied to a rolling average of market values for the previous three to five years, instead of a single year. The trustee would apply the fixed percentage target to a rolling three-year or five-year average of the FMV of the trust’s investment portfolio over the selected period. The adjustment could then be made to meet that target.

The Shadow Portfolio

With this method, the trustee determines the income target percentage each year with reference to a hypothetical or “shadow” portfolio. This would be like the actual non-optimal portfolio used before the power to adjust was made available by the Act. Assume that the trustee had previously been meeting its income objective by investing 50% in stocks and 50% in bonds. Using the shadow portfolio approach, the trustee would continue to monitor the performance of the shadow portfolio, or an appropriate version of it adapted from time to time, for the purpose of computing an appropriate target level of benefits for the income beneficiary. Some trustees prefer this approach, because it is based on traditional trustee methods, and beneficiaries might be more comfortable with this more familiar approach.

Prong 3 – Intent of the Trust Prong – 1997 Act Section 103(a)

To meet the third condition, the trustee must first meet the requirements of Section 103(a), i.e., she must apply the terms of the trust, decide whether to exercise the discretionary powers given to the trustee under the terms of the trust, and must apply the provisions of the Act if the terms of the trust do not contain a different provision of give the trustee discretion. Second, the trustee must determine the extent to which the terms of the trust clearly manifest an intention by the settler that the trustee may or must favor one or more of the beneficiaries. To the extent that the terms of the trust do not require partiality, the trustee must conclude that she is unable to comply with the duty to administer the trust impartially. To the extent that the terms of the trust do require or permit the trustee to favor the income beneficiary or the remainder beneficiary, the trustee must conclude that she is unable to achieve the degree of partiality required or permitted. If the trustee comes to either conclusion that she is unable to administer the trust impartially or that she is unable to achieve the degree of partiality required or permitted, she may exercise the power to adjust under section 104(a).¹⁷

Income Tax Aspects of the Power to Adjust

Reg. Sec. 1.643(c) - Tax Issues Regarding the Power to Adjust

The final regulations under IRC Sec. 643(b) (2003) now refer to the state law definition of income for purposes of the DNI calculation.

As discussed more fully in Chapter VI, the traditional calculation of DNI excludes capital gains. But the final regulations now recognize these statutorily permitted reallocations of capital gains to FAI as a part of DNI. Regulations under IRC Sec. 643 now refer to the definition of income using state law or the document provisions. This means that any capital gains that are adjusted into fiduciary accounting income may now be included in DNI for purposes of calculating the distribution deduction.

GST Tax Issues

Fortunately, the IRS has ruled that the exercise of the power to adjust under 1997 Act section 104 will not constitute a “modification” such as would terminate the exemption from the generation-skipping transfer tax that is enjoyed by trusts that became irrevocable on or before 9/25/85 [Prop. Reg. Sec. 26.2601(b)-1(b)(4)(I)(D)(2)].

The Unitrust Conversion Option

Various states have adopted one or both of the following mechanisms to provide for distributions to income beneficiaries from a trust that is invested for total return. The alternatives can be described as providing the Trustee either

- a. The power to adjust as discussed above, or
- b. The power to convert the trust to a Unitrust.

¹⁷ *Id.*, extract from Comments on Section 104

The Unitrust Conversion option is not covered in the 1997 Act.

The intent of the Unitrust legislation has been described as providing a mechanism to bypass traditional definitions of fiduciary accounting income and the artificial distinction between income and principal. This new private trust paradigm follows the concept of certain type of charitable split interest trust, the charitable remainder unitrust.

Under the Unitrust model the amount to be distributed to the current beneficiary is determined by reference to the value of the Trust principal, and without regard to whether the distribution is composed of dividends, interest, rental income or other traditional fiduciary accounting income.

The Unitrust model has been applied to include income-only trusts or other trusts that allow distributions of income and principal.

The following discussion from a bill analysis for the Senate Judiciary Committee of the State of California regarding California's proposed adoption of the Unitrust Conversion may help to illustrate the policy reason for the such state legislation.

Trusts: Unitrust Conversions

Description

This bill would allow a trustee, under specified terms and conditions, to convert a trust into a unitrust, reconvert from a unitrust to a trust and change the distribution payout of the unitrust. Finally, the bill would require a fiduciary administering a unitrust, reconverting a trust, or changing the percentage payout from a unitrust, to administer the trust impartially.

Background

It is not unusual for a trust, a revocable trust for example, to provide for distribution of income to the current trust beneficiary. Income has traditionally included rent, interest, and dividends received by the trust, but not capital gains or increase in the value of invested assets. Because most trustees are subject to the Uniform Prudent Investor Act, they generally invest trust assets with long-term growth in mind (such as bond). This, according to the sponsor of SB 754, very often results in the trust producing very little current income (i.e. dividends and interest), while the total value of the trust assets increases significantly. The beneficiary entitled to receive income therefore will not derive any benefit from the increasing value of the trust. On the other hand, if the trustee modifies the investments to generate more income to distribute to beneficiaries, the trustee may in the end be sacrificing total return and run afoul of the prudent investor rule.

Sponsored by the Trusts and Estates Section of the State Bar, SB 754 seeks to resolve a potential conflict between a trustee's two obligations (to preserve and grow trust assets as a prudent investor and to make current income payments to a beneficiary as may be required by the trust instrument), by allowing the trustee to convert a trust into a "unitrust." This would enable the trustee to take advantage of new U.S. treasury regulations treating unitrust distribution payouts as income payments to beneficiaries.

According to the sponsor, the U.S. Treasury regulations would provide relief only if the distribution payout is between three percent and five percent of the total unitrust assets and provided distributions are made pursuant to state statute. SB 754 would be enabling statute for the use of unitrust distributions in California. Seventeen other state have similar statutes.

Changes to Existing Law

Existing law provides for the administration of trusts, obligates a trustee to administer a trust as a prudent investor, and empowers a trustee as a fiduciary to make allocations of receipts and disbursements to or between principal and income. [1600 to 16465 of the Probate Code, which includes the Uniform Prudent Investor Act and the Uniform Principal and Income Act. All other references are to the Probate Code unless otherwise indicated.]

This bill would authorize a trustee to convert a trust into a unitrust, establish the conditions and procedures for the exercise of this authority, and detail the notice requirements prior to conversion with or without a court order.

This bill would authorize a trustee to change the unitrust payout percentage and to reconvert the unitrust to a trust pursuant to specified procedures.

Existing law defines “net income” for purposes of the Uniform Principal and Income Act. [16328]

This bill would define this “net income” to include the unitrust distribution amount, if the trust is being administered as a unitrust and if the amount is no less than three percent or not more than five percent of the fair market value of the unitrust assets.

Existing law allows a trustee to make adjustments between principal and income to the extent trustee determines necessary provided: (1) the trustee invests and manages the assets under the prudent investor rule; (2) the trust describes the amount that shall or may be distributed to a beneficiary by reference to the trust’s income; and (3) the trustee determines that after application of specified rules relating to the discretionary power of administration and the prohibition against improper exercise of such power, he or she cannot comply with the requirement of impartiality towards all beneficiaries of the decedent’s estate. [16336(a).] Existing law provides that a trustee may not make an adjustment between principal and income in seven specified circumstances, such as where the trustee is also a beneficiary, where the adjustment would change the amount payable to a beneficiary as a fixed annuity or fixed fraction of the value of the trust assets, and where the adjustment would be made from an amount that is permanently set aside for charitable purposes. [16336(b)(1) to (b)(7).]

This bill would add to these seven circumstances under which a trustee may not make adjustments, during any period when the trust is being administered as a unitrust.

The Trust and Estates Section of the State Bar, sponsor of SB 754, provided the following illustration of how existing law on the administration of trusts results in a problem that recently adopted U.S. Treasury Regulations may cure.

Decedent named her surviving spouse as the trustee of a trust. The trust provides for the distribution of income to the surviving spouse, with the remainder passing to the decedent's children from a previous marriage upon the surviving spouse's death. The trustee's investment in bonds would increase trust income, but with little potential for appreciation in value. This investment would favor the income beneficiary (the surviving spouse). The trustee's investment in stocks would enhance the potential for appreciation in stock value, but produce very little income. This investment would favor the remainder beneficiaries (perhaps the children or other family members). The trustee (the surviving spouse) cannot invest for total return and make adjustments to income under 16336(a), since the trustee is also a beneficiary of the trust.

The author and the sponsor of SB 754 contend that recently adopted U.S. Treasury regulations that qualify the distribution of a "unitrust" amount equal to a fixed percentage of the value of the trust assets as a distribution of "income" for both transfer and income tax purposes provide the answer to this problem. The new regulations require the percent distributed to be between three percent and five percent and the distribution to be made pursuant to state statute.

The sponsor of SB 754 states that this bill is necessary to enable California trustees to take advantage of these new regulations, so that a trustee may avoid running afoul of the "prudent investor" rule while meeting the terms of an instrument requiring income to a beneficiary such as a surviving spouse.

As you can see from the above, the Unitrust Conversion feature in a state law is seen as an alternative to the Trustees power to adjust, and may provide a solution to the impartiality dilemma in those situations where a Trustee is not able to invoke the power to adjust.

Conclusion

Investing trust assets under the prudent investor standard may require a Trustee to invest for total return. A large component of total return may be capital appreciation, which under the 97 Act might be considered principal. Allocating receipts to principal under the 97 Act may have the result of reducing fiduciary accounting income, and thus distributions to an income beneficiary where those distributions are determined with respect to fiduciary accounting income. Therefore, two alternative approaches have been developed to provide Trustees the ability to administer the trust impartially with respect to income beneficiaries. As discussed above, those two approaches are generally referred to as the Power to Adjust under section 104 of the 97 Act or the Unitrust Conversion.

V. Statutory Accounting Rules

Introduction to Statutory Accounting Rules

Many states have now adopted some version of the 97 Act. Following are overviews of additional significant sections of the model code as well as simple examples that help illustrate such provisions.

Caution: The various states have made changes to certain provisions of the 97 Act when it was adopted. Be sure to review the Act as adopted in the state whose laws govern the estate or trust before making a decision as to the proper treatment of a payment or expense.

Article 1. Trustee's Power to Adjust

Section 104 – Trustee's Power to Adjust

This section is fully discussed in Section IV of this Guide. Also see Problem #6 in Chapter VIII.

Article 2. Decedent's Estate or Terminating Income Interest

Section 201 – Determination and Distribution of Net Income

Sections 201 and 202 apply to decedent's estates and terminating income interests. A terminating income interest is one that has ended but whose administration is not complete. This section is intended to supersede provisions in the prior Act and to set out rules in logical order in situations where the fiduciary must make determinations and allocations. It applies to trusts with a single income beneficiary where an outright distribution of the remainder assets is made when the income interest ends. It also applies in more complicated situations where there are multiple income beneficiaries that may have multiple income interests that are either concurrent or successive, and the trust may continue when one such income interest ends. In any event, the trustee's powers continue during the winding up period required to complete its administration.

If property is specifically given to a beneficiary, that beneficiary is entitled to all of the net income and principal receipts associated with the specific property. This includes all of the amounts that the fiduciary receives or pays with respect to the property, regardless of whether the amount accrued or became due before, on, or after the decedent's death or the end of an income interest in a trust. While the net income and principal receipts may be reduced by obligations directly related to this specific devised property, these amounts may not be reduced by expenses or charges normally allocated to income or principal.

Interest earned on pecuniary bequests that are not distributed within one year may be distributed from the remaining net income or principal.

Upon making the distributions, the remaining income shall be distributed to all other beneficiaries.

A fiduciary may pay administration expenses and interest on death taxes from either income or principal. This is a change from prior law that charged all estate settlement expenses to principal.

This provides flexibility and eliminates the need for adjustment between income and principal. The provision also permits a fiduciary to pay and deduct administration expenses from income only to the extent that it will not cause the reduction or loss of an estate tax marital or charitable contribution deduction and responds to the Supreme Court case in Commissioner v. Estate of Otis C. Hubert, 117 S.Ct. 1124 (1997) and the Treasury Regulations that followed.

Also see Problems #1 and 2 in Chapter VIII.

Section 202 – Distribution to Residuary and Remainder Beneficiaries

Each beneficiary, other than a beneficiary entitled to a specific or pecuniary bequest, is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in the undistributed principal assets. The issue is how these residuary beneficiaries share the probate income. The values as of the distribution dates, or reasonably near, are used without reduction by any unpaid principal obligations. If a fiduciary does not distribute all of the collected but undistributed net income to each beneficiary as of a distribution date, the fiduciary must maintain appropriate records of the beneficiaries' interest in the net income. This provision retains the concepts in that the residuary legatees of estates are to receive net income earned during the period of administration on the basis of their proportionate interests by using asset values. What is different is it changes the basis for determining the proportionate interests by using asset values as of a date reasonably near the time of distribution instead of inventory values. From a practical viewpoint, using inventory values provides a more equitable result so it is questionable whether this new method of apportionment will be used or ignored. Additionally, current IRS regulations require the use of the lesser of FMV or carrying value in the determination of who is taxed on the distributable net income. Having two different sets of rules for income tax allocations and accounting income allocations can lead to some tax inequities.

Article 3. Apportionment at Beginning and End of Income Interest

Section 301 – When Right to Income Begins and Ends

An income interest begins on the date specified in the terms of the trust or, if no date is specified, on the date an asset becomes subject to the trust or successive income interest.

An asset becomes subject to the trust on the date it is:

Transferred to the trust in the case of an assets that is transferred to a trust during the transferor's life;

On the date of a testator's death in the case of an asset that becomes subject to a trust by reason of a will, even if there is an intervening period of administration of the testator's estate;

On the date of an individual's death in the case of an asset that is transferred to a fiduciary by a third party because of the individual's death.

An asset becomes subject to a successive income interest on the day after the preceding income interest ends, even if there is an intervening period of administration to wind up the preceding income interest.

An income interest ends on the day before an income beneficiary dies or another terminating event occurs, or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income.

Section 302 – Apportionment of Receipts and Disbursements when Decedent Dies or Income Interest Begins

A trustee shall allocate an income receipt or disbursement to principal if its due date occurs before a decedent dies in the case of an estate or before an income interest begins in the case of a trust or successive income interest. A trustee shall allocate an income receipt or disbursement to income if its due date occurs on or after the date on which a decedent dies or an income interest begins and it is a periodic due date. An income receipt or disbursement must be treated as accruing from day to day if its due date is not periodic or it has no due date. The portion of the receipt or disbursement accruing before the date on which a decedent dies or an income interest begins must be allocated to principal and the balance must be allocated to income.

To understand the application of this section several terms need to be defined:

Due Date: An item of income or an obligation is due on the date the payer is required to make a payment. If a payment date is not stated, there is no due date for the purposes of this Act. Distributions to shareholders or other owners from an entity to which Section 401 applies are deemed to be due on the date fixed by the entity for determining who is entitled to receive the distribution or, if no date is fixed, on the declaration date for the distribution.

Periodic: A due date is periodic for receipts or disbursements that must be paid at regular intervals under a lease or an obligation to pay interest or if the entity customarily makes distributions at regular intervals.

Examples

Assume a decedent dies on July 1, 200X and the assets are to be held in further trust with income being distributed to a surviving spouse. The income interest of the decedent ended on the day before death. The income interest of the surviving spouse begins on July 1, 200X, the day after the income interest ends. The following examples will illustrate the fiduciary accounting handling of income from various assets in this scenario.

Example 1

Decedent owned a \$100,000 5% bond issued by XYZ company that paid interest semi-annually on April 1, and October 1st. Assuming a 365 day year, the accrued interest through June 30 would be \$1,247. This amount would be listed on the decedent's form 706 as an asset and be considered IRD when received. However, from a fiduciary accounting point of view, the entire \$2,500 check received on October 1st will be income since the payment was periodic and the due date fell after the date the income interest began.

Example 2

Decedent owned 1,000 shares of ABC company common stock. The stock paid quarterly dividends. The company declared a dividend of \$1 per share payable July 2 to holders of record as of June 28. For purposes of preparing the decedent's form 706 the accrued dividend of \$1,000 is an asset of the decedent's gross estate and will be considered IRD when received. However, from a fiduciary accounting point of view, the entire payment will be principal when received since the record date fell prior to the date that the decedent's income interest ended.

Example 3

Decedent owned a piece of commercial rental property. Rent was payable on the 15th of each month in the amount of \$5,000. On July 16, 200X, the trustee received \$5,000 representing rents for the period June 16 through July 15, 200X. When received, this entire payment will be considered income since it is periodic, and the due date fell after the termination of the decedent's income interest.

Example 4

As of the date of death, the decedent had not yet paid the property taxes in the amount of \$3,000 for the commercial rental referred to in example 3 above. The taxes became a lien on the property January 1, 2000X and were due by March 31, 200X. The trustee made payment of these taxes on August 1, 2000X. The payment of these taxes will be charged to principal since they are periodic and had a due date prior to the date on which the decedent's income interest ended. However, the current income beneficiary will receive the benefit of the income tax deduction arising from the payment of these taxes.

Example 5

Decedent was the payee of a demand note with a principal balance of \$100,000. Both interest and principal were payable on demand. As of the date of death there was accrued interest on this note of \$25,000. On December 1, 200X, the trustee demanded and received payment of the entire principal balance and \$30,000 of accrued interest. Since the payment of the interest is note periodic and did not have a due date, it is treated as accruing from day to day. Therefore, \$25,000 of the interest payment will be treated as principal when received and the balance of interest will be income.

Also see Problem #3 in Chapter VIII.

Section 303 – Apportionment When Income Interest Ends

Under the provisions of the 1962 Act, the decedent or person entitled to income was entitled to undistributed income accrued through the date the income interest ended. This applied to all payments other than dividends which were not treated as accruing from day to day. This section changes this approach by defining "undistributed income" as net income received before the date on which an income interest ends. The term does not include an item of income or expense that is due or accrued or net income that has been added or is required to be added to principal under the terms of the trust. This can be illustrated as follows:

Example 1

Assuming the same commercial rental property as in Examples 3 above, but the rental payment was due June 30, 200X, but not received until July 5, 200X. Applying the accrual rules of Section 302, the entire payment will be principal when received. However, since the payment was not received until after the decedent's income interest terminated, no part of the payment is payable to the decedent's estate. In this case, neither the succeeding income beneficiary nor the decedent is entitled to this income.

Article 4. Allocation of Receipts During Administration of Trust

Following is a discussion of each section of the 97 Act on receipts. It is advisable to review all of the chapters because in some instances there is more than one section that could apply.

Part I. Receipts from Entities

Section 401 – Character of Receipts

This section defines the treatment of receipts from "entities." An entity is defined as "a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or estate to which Section 402 applies, a business or activity to which Section 403 applies, or an asset-backed security to which Section 415 applies."

The 97 Act requires a trustee to allocate to income all monies received from an entity other than:

Property other than money

"Money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity."

"Money received in total or partial liquidation of an entity":

"Money is received in partial liquidation to the extent that the entity, at the time of distribution, indicates that it is a distribution in partial liquidation, or"

"If the total amount of money and property received in a distribution or series of related distributions is greater than 20% of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt."

"Money is not received in partial liquidation, nor may it be taken into account under this section to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money."

"A trustee may rely upon a statement made by an entity about the source or character of a distribution of the statement is made at or near the time of distribution or by the entity's board of directors or other person or group or persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors."

"Money received from an entity that is a regulated investment company (RIC) or a real estate investment trust (REIT) if the money distributed is a capital gain dividend for federal income tax purposes."

This is a departure from the previous uniform principal and income act in several important ways.

For partnerships and unincorporated businesses, income computed in accordance with Generally Accepted Accounting Principles (GAAP) or an Other Comprehensive Body of Accounting (OCBOA), depending on what was customary for the business, was considered income even if not received. Losses similarly computed were charged to principal. Cash distributions were considered principal when received.

Corporate dividends, other than liquidating distributions, were considered income.

LLCs were not addressed by the prior act.

Character of Receipts – in Simple Terms

This section seems to be the most misunderstood part of the Act. Very simply put, cash received from an entity is income. An exception applies if the cash received is in partial or complete liquidation of the trust's investment in an entity or is a capital gain dividend from a RIC or REIT.

There is no distinction of the type of entity, other than a RIC or REIT. In other words, cash from a corporation is treated the same as cash from a partnership.

Income tax principles do not apply to trust accounting income except in the instance of a capital gain dividend from a RIC or REIT. Entities that are disregarded for tax purposes are still entities for trust accounting purposes. The tax rules on partial liquidation are not the same as the fiduciary accounting rules on partial liquidation. These are arguably very difficult concepts for the practitioner but are key points. Be sure not to confuse or apply tax terms when determining trust accounting income.

Issues Arising from Application of this Section

The best way to illustrate UPIA Section 401 is through examples.

Example 1

A limited partnership refinances one of its many rental properties and receives \$1,000,000 in cash. The entire \$1,000,000 is distributed to the limited partners in the year of the refinancing. The total book value of assets of the limited partnership, prior to the distribution, was \$20,000,000. The fiduciary owns a 50% limited partnership interest and, as such, receives a \$500,000 distribution. Is this distribution income or principal?

A strict reading of section 401 would seem to require the distribution be treated as income. The general rule under section 401 is that cash from an entity is trust accounting income unless it is treated as a distribution from a partial or complete liquidation of the entity. This would not be considered a partial liquidation as the money distributed does not exceed 20% of the entity's gross assets ($\$1,000,000/\$20,000,000 = 5\%$).

Would this be a fair treatment? Immediately after the refinancing and distribution, the net value of the partnership capital has been reduced by the amount of the debt financed distribution. If the partnership were liquidated in the following year, the fiduciary, and thus the remainder beneficiary, would receive approximately \$500,000 less in liquidating distributions than would have been received had the debt financed distribution not been made. Would this be fair to the remainder beneficiary? It is important to remember the fiduciary's duty of impartiality to all beneficiaries.

Another issue that arises in this example is when the fiduciary invests in a non publicly traded entity where the financial statements are not readily available. The fiduciary then has little means to determine whether the cash distribution is not in partial or full redemption of the entity.

Example 2

Assume that a fiduciary invests \$1,000,000 into a limited partnership which then invested in marketable securities. As such, the entity generates dividends and capital gains. Had the fiduciary not used the entity as an investment vehicle, the dividends would be considered income for fiduciary accounting purposes, while the capital gains would generally be considered principal. By holding the assets in an entity versus outright, the calculation of fiduciary accounting income is based on distributions of cash from the entity and not the character of the income earned by the underlying assets.

There may be other provisions to consider if the fiduciary determined the treatment under section 401 results in an inequitable allocation among the beneficiaries such as the "power to adjust". This would allow the fiduciary to classify a portion or all of the distribution to principal if that adjustment results in a more equitable allocation.

If the entity is a flow through entity such as a partnership and distributes cash to the partners to pay their income tax, also see sections 505 – Income Taxes and 506 – Adjustments Between Principal and Income Because of Taxes.

If the fiduciary simply cannot be comfortable that he has the appropriate information to determine whether the cash received was not in partial or complete liquidation of the entity, then section 103(4) of the Act provides that a fiduciary shall classify the receipt to principal.

Also see Problems #1 and 2 in Chapter VIII.

Section 402 – Distribution From Trust or Estate

The 97 Act provides that receipts from another estate or trust in which the trust has other than a purchased interest, the fiduciary shall allocate amounts received from the income of the trust or estate to income and amounts received as principal from the other trust or estate to principal. This may necessitate the fiduciary making an inquiry of the fiduciary of the other trust or estate to determine the source of the distribution which will often be from both income and principal.

If the interest in the other estate or trust is a purchased interest, the fiduciary shall account for the receipts under either sections 401 or 415, whichever is applicable.

Section 403 – Business and Other Activities Conducted by Trustee

Section 403 provides direction to the fiduciary in accounting for businesses conducted by the trust that are operated as a sole proprietorship as opposed to an “entity” as defined in section 401. If the trust operates as a sole proprietorship, it owns the business assets outright and not in a legal entity, including a single member LLC, which is governed by section 401. This section is designed to apply to rental, retail, manufacturing, service and other traditional businesses as well as farming and livestock operations.

Under traditional concepts of principal and income, the fiduciary could be faced with distributing 100% of the net income earned by the business enterprise to the income beneficiary. This would not allow the fiduciary to retain the amount of cash required to service debt, replace equipment or meet other working capital requirements of the business. This section will allow the fiduciary to continue to operate the business as a proprietorship and obtain similar accounting treatment as provided in section 401 for entities. If the fiduciary chose not to separately account for such businesses under this section, then the fiduciary would account for the businesses under the provisions specific to each type of asset [section 405 – Rental Properties, section 411 – Minerals, Water, and Other Natural Resources, section 412 – Timber, section 414 – Derivatives and Options and section 415 – Asset Back Securities].

This section provides:

If a trustee who conducts a business or other activity determines that it is in the best interest of all beneficiaries to account separately for the business or activity instead of accounting for it as part of the trust’s general accounting records, the trustee may maintain separate accounting records for its transactions, whether or not its assets are segregated from other trust assets.

A trustee who accounts separately for a business or other activity may determine the extent to which its net cash receipts must be retained for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business activity, and the extent to which the remaining net cash receipts are accounted for as principal or income in the trust’s general accounting records. If a trustee sells assets of the business or other activity, other than in the ordinary course of business or activity, the trustee shall account for the net amount received as principal in the trust’s general accounting records to the extent the trustee determines that the amount received is no longer required in the conduct of the business.

Part II. Receipts Not Normally Apportioned

Section 404 – Principal Receipts

A trustee shall allocate to principal in the following situations:

Assets received from (1) a transferor during the transferor’s lifetime (gift), (2) a decedent’s estate, (3) a trust with a terminating income interest, or (4) a payor under the contract naming the trust or its trustee as the beneficiary;

Money or other property received from the sale, exchange, liquidation, or change in form of a principal asset, including realized profit;
Amounts recovered from third parties to reimburse the trust because of disbursements described in Section 502(a)(7) or for other reasons to the extent not based on the loss of income;
Proceeds of property taken by eminent domain, but a separate award made for the loss of income with respect to an accounting period during which a current income beneficiary had a mandatory income interest in income;

Net income received in an accounting period during which there is no beneficiary to whom a trustee may or must distribute income; and
Other receipts normally apportioned.

Section 405 – Rental Property

To the extent that a trustee accounts for receipts from rental property pursuant to this section, the trustee shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease. An amount received as a refundable deposit, including a security deposit or a deposit that is to be applied as rent for future periods, must be added to principal and held subject to the terms of the lease and is not available for distribution to a beneficiary until the trustee's contractual obligations have been satisfied with respect to that amount.

As an alternative, the fiduciary can elect to use the provisions of section 403 and account for the rental activity separately. Please refer to section 403 – Business and Other Activities Conducted by Trustee.

Also see Problem #4 in Chapter VIII.

Section 406 – Obligation to Pay Money

An amount received as interest on an obligation to pay money to the trustee, including an amount received as consideration for prepaying principal, must be allocated to income without a provision for amortization of premium.

A trustee shall allocate to principal an amount received from the sale, redemption, or other disposition of an obligation to pay money to the trustee more than one year after it is purchased or acquired by the trustee, including an obligation whose purchase price or value when it is acquired is less than its value at maturity. If the obligation matures within one year after it is purchased or acquired by the trustee, an amount received in excess of its purchase price or its value when acquired by the trust must be allocated to income.

This section does not apply to an obligation to which Sections 409, 410, 411, 412, 414, or 415 apply.

This section presents several challenges to the fiduciary. The Act provides that premiums paid on the purchase of debt obligations are not subject to amortization. Even though many obligations purchased at a premium represent higher quality bonds with better yields to maturity than many

bonds sold at par, the fiduciary will have a hard time justifying the purchase of premium bonds since, without amortization, the entire premium paid will be born by the remainderman, while the benefit of the higher yield is reaped by the income beneficiary.

The Act deals with discounts differently. For obligations purchased at a discount and maturing more than one year after they are purchased, the entire amount received is allocated to principal. If the obligation matures in less than one year, the entire amount received over the purchase price is allocated to income.

This presents another dilemma for the fiduciary. If the trustee purchases “zero” coupon obligations with a maturity of greater than one year, the entire amount of the proceeds received is allocated to principal with no adjustment made for accretion of the obligations discount.

Also see Problem #3 in Chapter VIII.

Section 407 – Insurance Policies and Similar Contracts

The Act provides that “a trustee shall allocate to principal the proceeds of a life insurance policy or other contract in which the trust or its trustee is named as a beneficiary, including a contract that insures the trust or its trustee against loss for damage to, destruction of, or loss of title to a trust asset. The trustee shall allocate dividend on an insurance policy to income if the premiums are paid from income and to principal if the premiums are paid from principal. A trustee shall allocate to income proceeds of a contract that insures the trustee against loss of occupancy or other use by an income beneficiary, loss of income, or, subject to section 403, loss of profits from a business. This section does not apply to a contract to which section 409 applies.”

Part III. Receipts Normally Apportioned

Section 408 – Insubstantial Allocations Not Required

This section allows a certain degree of latitude for allocation of receipts under sections 409 - Deferred Compensation, Annuities, and Similar Payments, 410 - Liquidating Assets, 411 – Minerals, Water, and Other Natural Resources, 412 – Timber and 415 – Asset Backed Securities. The Act provides that if a receipt described in the above sections is “insubstantial” the fiduciary shall allocate the entire receipt to principal.

An amount is deemed “insubstantial” if:

- The amount of the allocation would increase or decrease net income in an accounting period, as determined before the allocation, by less than 10 percent; or
- The value of the asset producing the receipt for which the allocation would be made is less than 10% of the total value of the trust’s assets at the beginning of the accounting period.

This section is designed to relieve the trustee from making relatively small allocations. However, its application is narrowly applied only to receipts governed by certain sections of the Act.

Section 409 – Deferred Compensation, Annuities, and Similar Payments

Unlike the 1962 Act which treated payments under deferred compensation as liquidating assets and provided different treatment for payments made under annuities and qualified retirement plans, the 97 Act now treats them all the same.

“Payments” are defined in the 97 Act as payments “that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer’s general assets or from a separate fund created by the payer, including a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock- ownership plan.”

To the extent the payment received is characterized by the payer as interest, dividends or a payment made in lieu of interest or dividends, the trustee is to allocate the payment to income with the balance allocated to principal.

If no part of the payment is characterized as interest, dividend, or an equivalent payment and the payment is required to be made, the trustee shall allocate 10% of the payment to interest and the balance to principal. If all or part of the payment is not required to be made or the payment represents a total distribution, the trustee shall allocate the entire amount to principal.

Discussions in the comments to the 97 Act indicate that it was the intention of the drafters that IRAs and “arrangements with payment provisions similar to an IRA,” are to be treated as if no part of the payment is characterized as interest, dividends or their equivalent, even if the trustee is able to determine that the source of the payment. As a consequence, trusts required to distribute income currently and from which no distributions of principal are made, will allocate 90% of the IRA distributions received to principal and 10% to income. The effects of this can be minimized in trusts over which the trustee possesses a power to adjust under section 104 of the Act.

The Act allows for greater amounts to be allocated to income in the case of a QTIP trust in order for the trust to qualify for the marital deduction.

Caution: The Internal Revenue Service has issued Rev. Rul. 2006-26, effective June 1, 2006 rejecting the 10% allocation of IRA required minimum distributions to satisfy the requirements of IRC section 2056 that the spousal beneficiary be entitled to all income from a trust qualifying for the marital deduction. The IRS rejected the saving language allowing the trustee to distribute more income if it is necessary to qualify for the marital deduction under IRC §2056. At the time of the release of this guide, efforts are under way by the AICPA, American Bar Association and ACTEC to encourage NCCUSL to make the required changes to UPIA section 409 to comply with Rev. Rul. 2006-26.

Also see Problem #5 in Chapter VIII.

Section 410 – Liquidating Asset

Liquidating assets are assets whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration. This would include leaseholds, patents, copyrights, royalty rights and rights to receive payments during a period of more than one year under an arrangement that does not provide for the payment of interest on the unpaid balance. Assets described in sections 409 – Deferred Compensation, Annuities, and Similar Payments, 411 – Minerals, Water, and Other Natural Resources, 412 – Timber, 414 – Derivatives and Options, 415 – Asset Backed Securities, or to any assets for which the trustee establishes a reserve for depreciation under section 503.

For all such assets, the fiduciary shall allocate to income 10 percent of the receipts from the liquidating asset to income and the balance to principal.

Also see Problem #4 in Chapter VIII.

Section 411 – Minerals, Water, and Other Natural Resources

This section provides direction for fiduciaries that chose to account for receipts from an interest in minerals or other natural resources pursuant to this section. Alternatively, the fiduciary may choose to account for receipts and disbursements from the entity under the provisions of section 403.

Receipts from natural resources shall be allocated:

If received as nominal delay rental or nominal annual rent on a lease, a receipt must be allocated to income.

If received from a production payment, a receipt must be allocated to income if and to the extent that the agreement creating the production payment provides a factor for interest or its equivalent. The balance must be allocated to principal.

If an amount received as a royalty, shut-in-well payment, take-or-pay payment, bonus, or delay rental is more than nominal, 90 percent must be allocated to principal and the balance to income.

If an amount is received from a working interest or any other interest not provided for in paragraph (1), (2), or (3), 90 percent of the net amount received must be allocated to principal and the balance to income.

An amount received on account of an interest in water that is renewable must be allocated to income. If the water is not renewable, 90 percent of the amount must be allocated to principal and the balance to income.

The 97 Act provides that this section will apply whether or not a decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust.

Further, if a trust owns an interest in minerals, water, or other natural resources on the effective date of the Act in the governing jurisdiction, the trustee has the choice of allocating receipts from the interest as provided in this Act or in the manner used by the trustee before the effective date of the Act. Interests acquired after the effective date of the Act will be accounted for in accordance with this Act unless the fiduciary elects to account for the activity as provided in section 403.

While it may not seem equitable to allocate only 10% of the receipts to income and the balance to principal, the 97 Act drafters in their comments, expressed concern that in the case of a depleting natural resource, the income beneficiary will experience a declining amount of income as the asset is depleted. By allocating only 10% of the receipts to income, the fiduciary is able to invest the remaining 90% into income producing assets to provide for future income for the income beneficiary.

Section 412 – Timber

This section is designed to provide different methods for accounting for the receipts from Timber activities depending on the nature of the harvest. If the fiduciary is clear-cutting the land and not making any attempt to reforest, it seems only fair that proceeds from such clear-cutting would be properly allocated to principal. If, on the other hand, the Timber operation is being operated as an ongoing business activity, the allocation becomes more complex. As an alternative to section 412, the fiduciary may choose to account for the activity under the provisions of section 403.

To the extent that a trustee accounts for receipts from the sale of timber and related products pursuant to this section, the trustee shall allocate the net receipts:

To income to the extent that the amount of timber removed from the land does not exceed the rate of growth of the timber during the accounting periods in which a beneficiary has a mandatory income interest;

To principal to the extent that the amount of timber removed from the land exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber;

To or between income and principal if the net receipts are from the lease of timberland or from a contract to cut timber from land owned by a trust, by determining the amount of timber removed from the land under the lease or contract and applying the rules in paragraphs (1) and (2); or

To principal to the extent that advance payments, bonuses, and other payments are not allocated pursuant to paragraph (1), (2), or (3).

The Act further directs the trustee to transfer from income and transfer to principal a reasonable amount for depletion. It seems that if the amount of timber being removed does not exceed the rate of growth, or is in fact less than the rate of growth, an allowance for depletion may not be appropriate.

This section applies whether or not the decedent or transferor was harvesting timber from the property before it became subject to the trust.

Further, if a trust owns an interest in timberland on the effective date of the Act in the governing jurisdiction, the trustee has the choice of allocating receipts from the interest as provided in this Act or in the manner used by the trustee before the effective date of the Act. Interests acquired after the effective date of the Act will be accounted for in accordance with this Act unless the fiduciary elects to account for the activity as provided in section 403.

Section 413 – Property Not Productive of Income

The prior version of the Act required a fiduciary to allocate proceeds from the sale of underproductive property to income based on a formula provided in the Act.

The Act abandons this concept and now provides:

“If a marital deduction is allowed for all or part of a trust whose assets consist substantial of property that does not provide the spouse with sufficient income from or use of the trust assets, and if the amounts that the trustee transfers from principal to income under Section 104 and distributes to the spouse from principal pursuant to the terms of the trust are insufficient to provide the spouse with the beneficial enjoyment required to obtain the marital deduction, the spouse may require the trustee to make property productive of income, convert property within a reasonable time, or exercise the power conferred by Section 104(a). The trustee may decide which action or combination of actions to take.”

The Act further provides that proceeds from the sale of an asset are principal without regard to the amount of income they produced while held by the fiduciary.

CAVEAT: Be careful of amounts of income that may have accrued under the Old Act which were not paid out upon enactment of the 97 Act in the governing state. Consult with the trusts legal counsel to determine if this accrued income is considered a property right under state law and subject to later payment when principal cash becomes available.

Section 414 – Derivatives and Options

This Section of the Act is new. When the old Act was written, derivatives and options were not well known or widely held.

The 97 Act defines a derivative as; “a contract or financial instrument or a combination of contracts and financial instruments which gives a trust the right or obligation to participate in some or all changes in the price of a tangible or intangible asset or group of assets, or changes in a rate, an index of prices or rates, or other market indicator from an asset or group of assets.”

The 97 Act provides that, unless a fiduciary elects to account for the activity under section 403, the fiduciary shall allocate all receipts and disbursements to principal.

Options are treated similarly with all receipts and disbursements related to the granting and exercise of an option shall be allocated to principal.

Section 415 – Asset- Backed Securities

Asset-Backed Securities are defined in the 97 Act as “an asset whose value is based upon the right it gives the owner to receive distributions from the proceeds of financial assets that provide collateral for security. The term includes an asset that gives the owner the right to receive from the collateral financial asset only the interest or other current return or only the proceeds other than interest or current return. The term does not include an asset to which sections 401 or 409 applies.”

Typical asset backed securities would be pools of mortgages or other obligations that are acquired in an investment trust and sold to investors. It would also include “Primes” and “Scores” where the investor is acquiring the right to participate in the capital appreciation of, or the income from, underlying equity investments.

To the extent the fiduciary receives payments categorized by the payor as representing interest or other current return from the underlying assets, the payments will be allocated to income and the balance to principal. Amounts received by the fiduciary in exchange for the trust’s entire interest in an asset-backed security shall be allocated to principal. If the amounts received represent a payment in a series of payments that will result in the liquidation of the trust’s entire interest in the underlying security, and the payments will extend beyond one accounting period, the fiduciary shall allocate 10% of the payments to income and the balance to principal.

Article 5. Allocation of Disbursements During Administration of Trust

Section 501 – Disbursements from Income

The following expenses are to be charged to income:

One-half of regular compensation of the trustee, and of any person providing investment advisory or custodial services to the trustee;

One-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;

All other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income, including

- a. Interest
- b. Ordinary repairs
- c. Regularly recurring taxes assessed against principal
- d. Expenses of a proceeding or other matter that concerns primarily the income interest
- e. Recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of an asset.

Also see Problems #1 and 2 in Chapter VIII.

Section 502 – Disbursements from Principal

The following expenses are to be charged to principal:

- The remaining one-half of regular compensation of the trustee, and of any person providing investment advisory or custodial services to the trustee
- All of the trustee's compensation calculated on principal as a fee for acceptance, distribution, or termination
- Disbursements made to prepare property for sale
- Payments on principal of a trust debt
- Expenses of a proceeding that concerns primarily principal, including a proceeding to construe the trust or to protect the trust or its property
- Premiums paid on a policy of insurance not covering the loss of a principal asset or the loss of income or use of an asset. (i.e. life insurance premiums)
- Estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust
- Disbursements related to environmental matters, including;
 - Reclamation
 - Assessing environmental conditions
 - Remedying and removing environmental contamination
 - Monitoring remedial activities and the release of substances
 - Preventing future release of substances
 - Collecting amounts from persons liable or potentially liable for the costs of those activities
 - Penalties imposed under environmental laws or regulations or other payments made to comply with those laws or regulations
 - Statutory or common law claims by third parties
 - Defending claims based on environmental matters

If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to income paid to the creditor.

Also see Problem #4 in Chapter VIII.

Section 503 – Transfers from Income to Principal for Depreciation

The 1931 version of the Act made no provisions for depreciation. The 1962 Act provided that a charge shall be made against income for “a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles.” Many states failed to adopt this portion of the 1962 Act and actually barred the trustee from making a charge for depreciation unless the governing instrument directed such a charge be made.

The 97 Act gives discretion to the trustee regarding the decision to transfer a “reasonable amount” of income cash to principal cash as charge for depreciation. However, the 97 Act does not allow any amount of depreciation to be charged during the administration of a decedent's estate or on property

used or available for use by a beneficiary. Additionally, if the trustee is accounting for a business activity under Section 403, no additional amount of depreciation will be taken by that trustee, other than that amount taken under Section 403.

The decision of when to, or when not to, transfer from income to principal for depreciation will be driven by the facts and circumstances unique to each trust. The trustee will need to take into consideration whether or not the property in question is actually depreciating in value, or in the case of appreciating real property, whether the cash generated by transferring income to principal for depreciation is required for service of outstanding debt on the property.

Example 1

A simple trust with a single income beneficiary owns a rental property. It earns net rental income before depreciation of \$100,000. Depreciation expense is \$20,000. The trust document is silent with respect to the depreciation reserve.

If the trustee does not create a reserve for depreciation, fiduciary accounting income is \$100,000 and the distribution to the income beneficiary is \$100,000. For tax purposes, Schedule K-1 will indicate rental income of \$100,000 and a depreciation deduction of \$20,000.

If the trustee creates a \$20,000 reserve for depreciation, fiduciary accounting income is \$80,000 and the distribution to the income beneficiary is \$80,000. For tax purposes, Schedule K-1 will indicate rental income of \$80,000 and no depreciation deduction. Such depreciation deduction is taken on the fiduciary income tax return.

Also see Problem #4 in Chapter VIII.

Section 504 – Transfers from Income to Reimburse Principal

This section of the 97 Act provides that “if a trustee makes or expects to make a principal disbursement described in this section, the trustee may transfer an appropriate amount from income to principal in one or more accounting periods to reimburse principal or to provide for future principal distributions.”

This section applies to the following types of payments to the extent reimbursement from a third party is not expected:

An amount chargeable to income but paid from principal because it is unusually large, including ordinary repairs. (Example: The fiduciary pays property taxes on real estate owned by the trust each November of \$12,000. Rather than charge the entire amount in the month of November, which would result in a dramatic reduction of the income payable to the income beneficiary, the fiduciary could transfer \$1,000 per month from income to reimburse principal.)

Capital improvements to a principal asset, whether in the form of changes to an existing asset or the construction of a new asset, including special assessments. (*This provision of the Act appears to allow the charging of the cost of capital improvements to income in addition to any adjustment that may be made for depreciation.*)

Disbursements made to prepare property for rental, including tenant allowances, leasehold improvements, and brokers commissions. *(As with the above provision regarding capital assets, this provision providing for a possible transfer of income cash to principal for leasehold improvements seems to allow an additional transfer for depreciation of the underlying leasehold improvement.)*

Periodic payments on an obligation secured by a principal asset to the extent that the amount transferred from income to principal for depreciation is less than the periodic payments. *(This provision appears to allow the payment of principal on an indebtedness from income notwithstanding the provisions of section 502(a) (3) which requires that payment on the principal of a trust debt is to be paid from principal.)*

Disbursements related to environmental matters, including reclamation, assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing the future release of substances, collecting amounts from persons liable or potentially liable for the costs of those activities, penalties imposed under environmental laws or regulations and other payments made to comply with those laws or regulations, statutory or common law claims by third parties, and defending claims based on environmental matters. *(These are the same expenses which under section 502(a)(7) are required to be paid from principal.)*

Also see Problem #4 in Chapter VIII.

Section 505 – Income Taxes

This section addresses how the trustee should allocate income taxes between income and principal. The general rule is that taxes must be paid from income to the extent that receipts are allocated to income and from principal to the extent that receipts are allocated to principal. The general rule is modified in section 505(d), which requires the trustee to reduce taxes allocable to income or principal to the extent that the trust receives a deduction for payments made to the beneficiary. Thus, where the trustee of a simple trust pays all its dividend and interest income to the current beneficiary and receives a full deduction for the payment (income distribution deduction), the trustee allocates no taxes to income.

The general rule is further complicated when the trust owns interests in pass-through entities that do not distribute all of their taxable income. Section 505(c) requires a trustee to pay taxes on the trust's share of an entity's taxable income proportionately as follows:

- From income to the extent receipts from the entity are allocated to income; and
- From principal to the extent receipts from the entity are allocated to principal and the trust's share of the entity's taxable income exceeds the total receipts allocated to income or principal.

Consider the following example.

Example 1

A simple trust is a partner in a partnership. The trust's share of the partnership's taxable income is \$100,000. The partnership makes distributions to the trust in the amount of \$40,000 (assuming this

is not a redemption under section 401). From a fiduciary accounting perspective, the trust has \$40,000 of fiduciary accounting income (see section 401) which is distributable to the income beneficiary. Assume both the trust and the beneficiary are in the 35% tax bracket; they owe a combined \$35,000 tax on the income. How should that amount be allocated?

Under the most widely adopted interpretation of this section (including that of E. James Gamble, co-Reporter of The 97 Act), all taxes payable by the trust should be allocated to income because all receipts from the entity are allocated to income. However, in determining its taxes, section 505(d) requires the trustee to take into account that the trust receives a deduction for amounts paid to the beneficiary. This requires the trustee to use simultaneous equations because each time the trustee figures its tax, the amount it owes the income beneficiary decreases, further reducing its tax. The trustee uses the following formula to determine the amount payable to the income beneficiary.

[Cash from the entity minus total tax on entity income] divided by [1 minus the income tax rate]

Using numbers from the above example.

$$[\$40,000 - \$35,000] / [1 - 0.35] = \$7,692.31$$

Proof

| | |
|--|--------------------|
| Gross Income | \$100,000.00 |
| Distribution Deduction | <u>(7,692.31)</u> |
| Taxable Income | 92,307.69 |
| Income Tax @ 35% | <u>\$32,307.69</u> |
| | |
| Fiduciary accounting income Before transfer | \$40,000.00 |
| Less income tax transfer | <u>(32,307.69)</u> |
| Equals newly computed Fiduciary accounting income | <u>\$7,692.31</u> |

Some experts however interpret section 505 differently. They read it to require a proportionate allocation of taxes between (a) income receipts from the entity reduced by amounts for which the trustee receives a distribution deduction and (b) principal receipts plus the trust's share of the entity's undistributed taxable income. Using the above example, the trustee would allocate taxes as follows:

Tax allocated to income = [FAI less Distribution Deduction] divided by Trust Taxable Income

Tax allocated to principal = Undistributed Entity Taxable Income divided by Trust Taxable Income

Using numbers from the above example.

Tax allocated to income = $[\$40,000 - \$40,000] / \$60,000 = 0\%$

Tax allocated to principal = $\$60,000 / \$60,000 = 100\%$

Under this interpretation, the trustee allocates no taxes to the income beneficiary because payments to him are fully deductible to the trust. The trust allocates \$21,000 of income taxes to the principal beneficiary (35% X \$60,000). However, the income and principal beneficiary each bear the \$35,000 tax burden proportionately, \$14,000 born individually by the income beneficiary by virtue of having included the \$40,000 on his income tax return and \$21,000 by the principal beneficiary on the trust's share of \$60,000 of taxable income. This interpretation might be resolved by clarification in the near future. As this guide was being released the AICPA, American Bar Association and ACTEC are encouraging NCCUSL to clarify this section.

Regardless of what interpretation the reader chooses, the trustee's cash position is irrelevant. The 97 Act does not address the trust's ability to pay the tax. Therefore, if taxes on undistributed income of a pass-through entity create liquidity problems, or result in an undesirable allocation, the trustee needs to consider other provisions that might be helpful, such as the power to adjust under section 104 or section 506 – adjustments between principal and income because of taxes. Applying the first interpretation above, the liquidity problem can be alleviated.

Section 506 – Adjustments Between Principal and Income Because of Taxes

A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income and remainder beneficiaries. Such shifts could arise because of elections and/or decisions that the fiduciary makes at the time the tax return is filed or as a result of a transaction or distribution from the trust or estate.

Consider the example in section 505 above. In that instance, the fiduciary could classify the \$40,000 received as a reimbursement for taxes instead of income. The trust is taxed at the trust level on the \$100,000 income earned from the partnership. Its tax liability (federal and state) is approximately \$40,000 based on rates in existence at time of publication. The trust has the cash available to satisfy its tax liability. The income beneficiary in this instance would not receive any distribution.

Modern estate planning techniques often involve tax elections that can impact both the income and remainder beneficiary.

For example a trustee may choose to pay expenses of estate administration from principal of a trust qualifying for either the charitable or marital deduction and not claim the deduction on the estate tax return; rather the deduction is used as an income tax deduction. The resultant decrease in the charitable or marital deduction will result in increase estate taxes which are payable from principal

while giving the income beneficiary the benefit of the income tax deduction. The 97 Act provides that these additional estate taxes incurred shall be reimbursed from income to principal the entire amount of the increase in tax to the extent the amounts of principal expended for such expenses would have qualified for the charitable or marital deduction, but for the payment of the expenses. The purpose of this mandatory provision is to preserve the charitable and marital deduction for amounts that would have otherwise been disallowed.

VI. Relationship of Fiduciary Accounting Income, Distributable Net Income, and Taxable Income

Introduction to Relationship of Fiduciary Accounting Income, Distributable Net Income, and Taxable Income

Due to many conflicts between fiduciary accounting and federal income tax rules, CPAs practicing in the estate and trust area need a firm grasp of the interrelationship between fiduciary accounting income, distributable net income (DNI) and taxable income. This is not intended to be a discussion of all of the complexity of Sub Chapter J, rather to give a broad overview of some of the interrelationships that exist.

Fiduciary Accounting Income

Internal Revenue Code Section 643(b) defines income for fiduciary income tax purposes as follows:

...the term “income”, when not preceded by the words “taxable”, “distributable net”, “undistributed net”, or “gross” means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.

Please review Chapter III for a more expansive discussion on the definition of fiduciary accounting income.

Distributable Net Income (DNI)

DNI serves as the upper limit of the amount of income to be taxed to trust beneficiaries who receive distributions from the trust or estate and what amount will be deductible by the trust. It is an integral part of determining the distribution deduction for the estate or trust.

In its simplest terms, DNI is defined as:

Taxable income determined without the distribution deduction or the personal exemption
Plus tax exempt income reduced by expenses (and any charitable deduction) allocated to such income and
Without regard to capital gains and losses allocated to principal.

Taxable Income

Taxable income is computed by subtracting from gross income all allowable deductions (whether they were charged to income or principal), the distribution deduction and the allowable exemption.

The following table will help illustrate the interrelationship among fiduciary accounting income, DNI and taxable income.

| Description | Actual | Adj. | FAI | Adj. | Taxable | Adj. | DNI |
|-----------------------------|----------------|-----------------|----------------|----------------|----------------|-----------------|----------------|
| <u>Receipts</u> | | | | | | | |
| Interest | 25,000 | 0 | 25,000 | 0 | 25,000 | 0 | 25,000 |
| Dividends | 50,000 | 0 | 50,000 | 0 | 50,000 | 0 | 50,000 |
| Capital Gain | <u>20,000</u> | <u>(20,000)</u> | <u>0</u> | <u>20,000</u> | <u>20,000</u> | <u>(20,000)</u> | <u>0</u> |
| Subtotal | 95,000 | (20,000) | 75,000 | 20,000 | 95,000 | (20,000) | 75,000 |
| <u>Disbursements</u> | | | | | | | |
| Trustee Fees | | | | | | | |
| Income | (2,000) | 0 | (2,000) | 0 | (2,000) | 0 | (2,000) |
| Principal | (2,000) | 2,000 | 0 | (2,000) | (2,000) | 0 | (2,000) |
| Subtotal | <u>(4,000)</u> | <u>2,000</u> | <u>(2,000)</u> | <u>(2,000)</u> | <u>(4,000)</u> | <u>0</u> | <u>(4,000)</u> |
| Total | <u>91,000</u> | <u>(18,000)</u> | <u>73,000</u> | <u>18,000</u> | <u>91,000</u> | <u>(20,000)</u> | <u>71,000</u> |

The Updated Trust Income Tax Rules

When a trustee employs the unitrust method or exercises the power to adjust, there has been some debate as to whether amounts not traditionally included in DNI which are recharacterized as fiduciary accounting income will be included in the computation of DNI. The final regulations under IRC Section 643(b) resolved many of these issues. They further coordinate federal taxation with state accounting rules.

Regulation 1.643(b)-1 adopts the following positions for trust income tax purposes:

Approval of Powers to Adjust and Certain Unitrust Distributions

The IRS will treat a distribution right as an “income interest” if there is a state statute to authorize it and that authorization either:

- Permits the type of adjustment power authorized by the state’s adopted accounting provision, or
- Permits the fiduciary to satisfy a right to income with a unitrust distribution of no less than 3 percent and no more than 5 percent.

If the trust instrument includes an adjustment power or a provision allowing a unitrust distribution (to the income beneficiary), but there is no state statute authorizing the fiduciary to make such distributions, the distribution will most likely not be accepted as an income distribution, under the regulations.

If the new method, that is of satisfying income distribution rights, is authorized by state statute (and satisfies the limitations in the regulation), the switch will not result in any gift or income or capital gain tax recognition or reporting. Thus, existing trusts will be able to convert to the unitrust method,

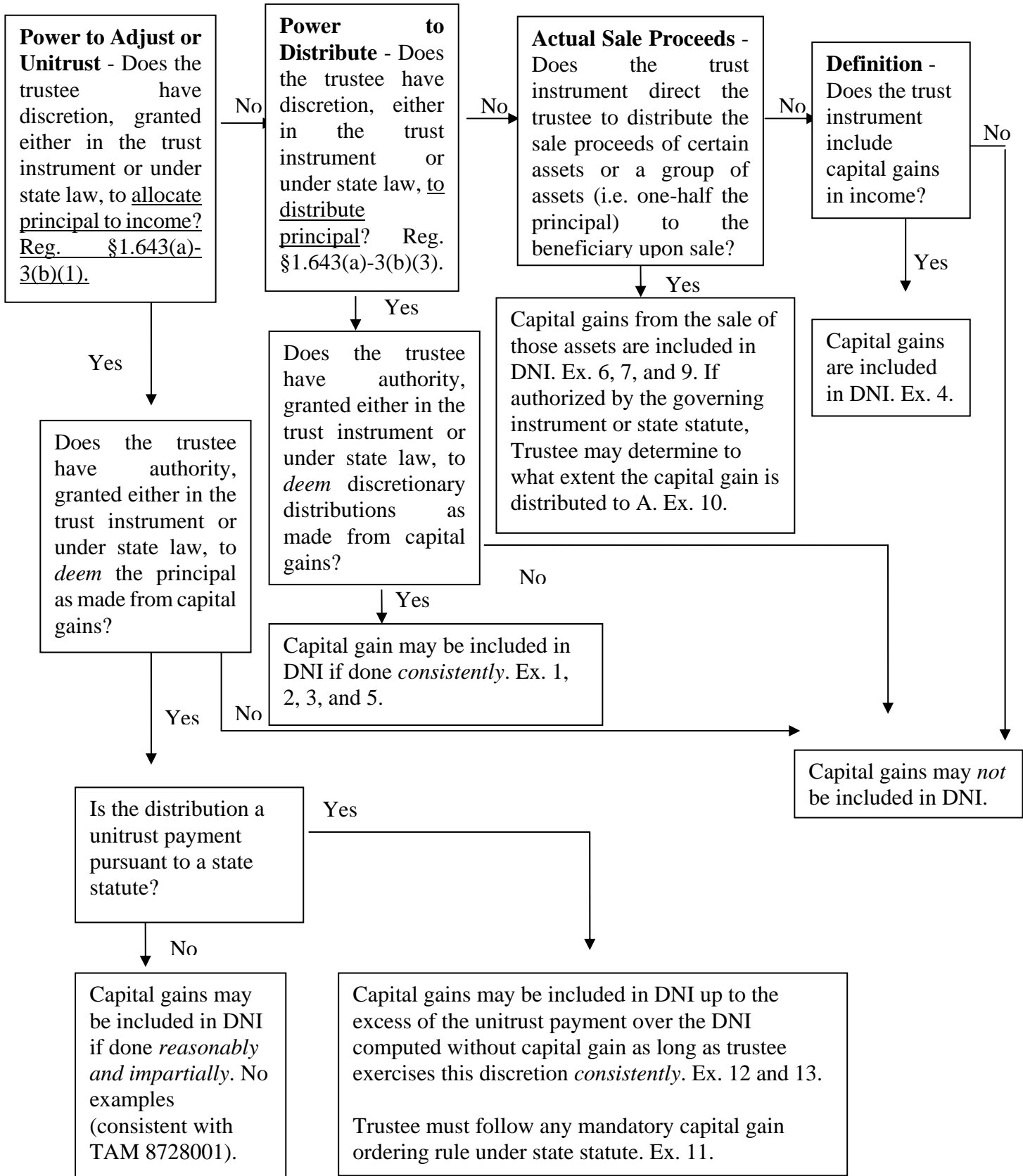
assuming that the state statute authorizes the distribution method and the fiduciary is authorized to change the distribution method.

Allocation of Gain(s) to Income

Regulation Section 1.643(a)-3 has been revised to allow trust instruments to be drafted, as well as allow fiduciaries more flexibility in determining whether and when current year capital gains can be included in DNI and therefore taxed to the beneficiary.

Following is a chart that assists in navigating through the examples of when capital gains are appropriately included in DNI. Note that all Example references in the following chart refer to the examples in Regulations Section 1.643(a)-3.

Flow Chart – When can Capital Gains be Included in DNI?



VII. Reporting Requirements

Introduction to Reporting Requirements

“Fiduciary Accounting” does not have one commonly understood meaning. In a broad sense, it can mean the entire process whereby a fiduciary - - normally a personal representative, trustee, or guardian - - communicates information on an on-going basis regarding his administration of a fund and periodically justifies his administration to the parties in interest and, perhaps, to a court. In another sense, it may be the process whereby a fiduciary - - here more often a trustee - - periodically keeps parties in interest currently informed of transactions and investment policies being followed.

In a narrower sense, to which this report is directed, a fiduciary accounting may refer to the statement prepared by a fiduciary at the close of his administration of a fund (or at some appropriate intermediate stage) to reflect transactions that have occurred and to be presented to the parties in interest as part of a process whereby the fiduciary seeks discharge from liability for the events disclosed.”¹⁸

Given the range of possible meanings of the term “fiduciary accounting” the best practice for the accountant undertaking to prepare such a fiduciary accounting is to obtain mutual understanding of scope of the engagement with the client, and perhaps the anticipated users of the accounting. Ideally, in order to mitigate the prospect of future confusion the accountants understanding of the nature of the project will be explicitly outlined in an engagement letter. [See Section II]

When is an Accounting Required?

This question may be best addressed by breaking it down in to the following components;

Is there a requirement that an accounting for the entity be prepared?

Is there a specified form or format for such an accounting?

Who are the users of the accounting?

The first place to look to determine the requirement for an accounting is the applicable governing instrument. The document may speak to the need to annually prepare an accounting, who may be entitled to receive copies, and the form the accounting should take. The terms of the instrument will govern unless they are determined to be against public policy. If the document is silent, state law will apply.

In those instances where some type of annual accounting is mandated by the state statutes, the accountant may wish to have the fiduciary obtain from counsel an understanding of the appropriate recipients of the accounting.

¹⁸ National Fiduciary Accounting Standards, May 1984 Version, Developed by the Committee on National Fiduciary Accounting Standards, A Joint Project of: American Bankers Association, Trust Division, American Bar Association, Section of Real Property, Probate and Trust Law, The American College of Trust and Estate Counsel, American Institute of Certified Public Accountants, National Center for State Courts, and National College of Probate Judges.

Format of Accounting

Once it has been determined an accounting is required, the next step is to determine the format to be used in the preparation of the accounting. The rules regarding the format in which fiduciary accounting information is required to be presented vary state to state, since they are a function of the Probate/Trust law enacted by each state. They can also vary by local jurisdiction within a state.

In Appendix E to the ALI/ABA publication *Fiduciary Accounting Guide, Second Edition*¹⁹ Robert Whitman makes the statement that as of January 1, 1998, forty-seven Jurisdictions accept the Uniform Fiduciary Accounting Principles as one method of accounting within the jurisdiction. An example of such an accounting for a trust is contained in Chapter VIII.

One issue for the accountant to consider when discussing the format for a fiduciary accounting is while the *Fiduciary Accounting Guide* represents an acceptable approach it may not be the preferred approach by the anticipated user, i.e. a particular court. Another issue to be considered is the need to supplement any accounting with explanatory notes.²⁰

The preparation of a fiduciary accounting is a time consuming process. The preparation of an accounting requires presenting the transactions that have occurred during the relevant period, in detail or summary, and the allocation between principal and income. Additionally, the accountant may feel such an accounting requires explanatory notes to be understandable.

Accounting Standards

Unfortunately, there is currently no pronouncement from an authoritative body such as the FASB, such as a statement or interpretation, or any APB Opinions dealing with fiduciary accounting. Nor are there any authoritative documents from the AICPA such as Accounting Research Bulletins, Industry Audit Guides, or Statements of Position on fiduciary accounting.

There is also currently a debate among accountants regarding whether GAAP exists for fiduciary accounting for private, i.e. non ERISA and non charitable trusts²¹. As previously mentioned, the settlor of a trust has tremendous discretion in establishing the terms of the trust. This discretion makes it very hard to formulate general principles applicable to all private trusts. Additionally, each state may adopt different default rules applicable to the definition of income for estates and trusts, precluding a national standard.

In light of the unsettled status of the accounting standards in this area, the accountant undertaking to help a fiduciary with an accounting would be well advised to determine their/their firms position on

¹⁹ *Fiduciary Accounting Guide, Second Edition*, Robert Whitman, © 1998 The American Law Institute

²⁰ See for example, AS 13.36.100(g)92 enacted June 2004 which specifies that a report for the purpose of putting a beneficiary on notice includes an accounting, but does not elaborate on what else might be necessary.

²¹ A very complete discussion of this issue is found at Chapter 16, PPC's *Guide to Compilation and Review engagements*, _____ Edition (____ 2003) Practitioners Publishing Company. See also Chapters 3 and 4 of PPC's *Guide to Accounting for Estates and Trusts*, Fifth Edition (October 2003) Practitioners Publishing Company.

the existence of an applicable method of accounting in order to determine if they are engaged to prepare a financial statement, which could require a compilation report.

What If All You Prepare is a Tax Return?

Currently there is no requirement to issue a compilation report if the accountant only prepares a tax return. See SSARS No. 1 (section 100) Interpretation which provides that there is no requirement to report on financial information contained in a tax return.

VIII – Examples

- A. Example of Columnar Approach to Preparation of a Fiduciary Accounting
- B. Sample Formal Accounting

Appendix – Practice Aids

- A. Checklist for Trust Instrument Provisions (Content)
- B. Matrix/Chart of States, UPIA, Power to Adjust, and Unitrust Option or Total Return Trust/Statutory Ordering Rule for Unitrust Payments
- C. Publications Available as Reference Resources on Fiduciary (Trust) Accounting
- D. Websites for Fiduciary (Trust) Accounting References
- E. Articles on FAI Written by Members of the AICPA Fiduciary Accounting Income Task Force and AICPA Trust, Estate, and Gift Tax Technical Resource Panel
- F. Columnar Approach Excel Template
- G. Sample Adjusting Journal Entry Excel Template
- H. Summary of Trust Agreement Template